‘Homegrown’ Revenue Mobilization Strategy

By

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The Federal government has apparently accepted the target for FBR revenues of Rs. 5,550 billion in 2019-20 as a prior condition to the approval by the Executive Board of the IMF of a 39 month Extended Fund Facility of $6 billion to Pakistan. The likely outcome of FBR revenues in 2018-19 is close to Rs. 4,000 billion, based on the performance in the first eleven months. Therefore, the target of Rs. 5,550 billion implies that FBR will have to achieve a growth rate in revenue of almost 39% next year.

It is noteworthy that the highest actual growth rate achieved by the FBR in the last seventeen years was near 21% in 2015-16. This was largely attributable to the windfall gain arising from the exceptional fall in the international oil price. Consequently, the sales tax rate on petroleum products was raised in some cases to over three times the standard rate.

Therefore, the 39% growth in FBR revenues will be completely unprecedented. It will also have to be achieved at a time when the economy is struggling and the GDP growth rate has fallen to 3.3% only. The real growth in the two major tax bases, namely, imports and large-scale manufacturing output, has actually been negative. Consequently, there is only marginal growth in FBR revenues in 2018-19.

Clearly, the new negotiating team has now accepted a virtually impossible target of 39% growth in FBR revenue with reasons to fear that a whole host of measures are likely to be introduced which will further clutter and make more cumbrous the already ungainly tax structure, raising concerns about their economic, administrative and political viability in addressing the prevailing uncertainty.

There is, therefore, the risk that this will lead to hasty and ad hoc escalations in tax rates, especially in indirect taxes. This will not only jeopardize further the process of growth in the economy but will place an intolerable burden on the lower income groups leading to widespread public protect.

Ideally, the target of 39% growth should have been spread over two years. In addition, the process of fiscal stabilization should not have been focused solely on raising FBR revenues. A comprehensive reform strategy would have also included development of other revenue sources, especially those of Provincial Governments, and substantial efforts at economy in expenditure at the Federal level. Surely, the ultimate objective should be to bring down the fiscal deficit and not only increase in FBR revenues.

In fact, along with the FBR revenue target, there is also agreement on bringing down the primary deficit to 0.6% of the GDP in 2019-20 from over 2% of the GDP this year. This ought to be the overriding concern of the IMF and the Government must have the flexibility to achieve this target in the best possible manner.

A feasible target for additional taxation in 2019-20 appears to be an enhancement in the FBR tax to GDP ratio of 1% of the GDP. This will raise FBR revenues to almost Rs. 5000 billion and imply a still ambitious growth rate of 25%, not achieved before. The reform of the tax system can then be sustained over the full three years of the IMF program.

The revised target of Rs. 5,000 billion will still require additional taxation of almost Rs. 450 billion by FBR. This will still be challenging but potentially achievable. As such, this article focuses instead on tax reforms in 2019-20 to achieve the target of Rs. 5000 billion for FBR revenues.

The design of our proposed reform agenda is based on achieving the following objectives:-

a) Achieve a simpler, transparent and a more friendly tax system, presently unwieldy and unnecessarily complicated.
b) Support a shift to a higher revenue-yielding and more buoyant tax regime.
c) Make the tax burden more equitable across income groups.
d) Promote investment, savings, exports and employment.
e) Minimize multiplicity of taxes and escalation in tax rates and focus on a gradual rationalization of rates with broad-basing of revenue sources.
f) Promote integration and cooperation between the Federal and Provincial tax systems.
g) Build in mechanisms, regulations and institutional processes to check tax evasion and corruption.
h) Create a more modern, autonomous and functional tax administration.

INCOME TAX

The proposals related to income tax focus more on the development of a documentation -based income tax system, steadily reducing reliance on withholding taxes, many of which are indirect and regressive in nature and tend to have more nuisance value instead of only targeting income related transactions. The underlying intention is to distribute the liability of the long overdue structural adjustments on the basis of the capacity of different income groups to bear this burden.

Personal Income Tax

In the budget of 2018/19 the exemption limit for personal income tax was trebled from Rs 400,000 to Rs 1,200,000 along with the slashing of tax rates for all income groups – highly unjustified concessions for a country struggling with inequities and large fiscal deficits. While a welcome correction was made in the mini-budget by the levy of a small lump sum tax and the raising of the marginal tax rate applicable to the highest income slab (the original budget was disproportionately benefiting individuals earning higher incomes), in our view there is a need to partially reverse this generous enhancement.

The present exemption limit is equivalent to $9,677, which is almost six times our per capita income. The corresponding exemption limit in India is equivalent to $3,576 and just over two times the country's per capita income. We, therefore, recommend that the exemption limit be brought down from Rs. 1,200,000 to Rs. 600,000, to bring it in line with the tax structure in our region. By introducing an additional slab without raising the marginal tax rate for those falling in the highest income slab we estimate additional revenues of Rs. 60 billion from this policy measure.

Holding Period Extension for Capital Gains

We also strongly propose enhancement of the holding period for any exemption of a capital gains tax in the case of equities and real estate. However, the tax should be levied on real and not nominal capital gains. The Income Tax Ordinance should present the capital values inflation index with respect to the holding period. This index should be applied to the original cost and the difference with respect to the disposal value be treated as the capital gain for tax purposes.

In the case of immoveable properties there is a need to realign values of properties to reflect market rates. To this end the FBR valuation tables for different cities should be revised to ensure real values get captured while denying the assessing authorities the use of discretion. The withholding tax rate can then also be adjusted slightly downward.

The scope of the provincial property tax can then be extended to the taxation of vacant land (identification of ownership made easier by the enactment of the Benami law) to enable the Provincial government to also secure a share of the increased value of land on account of the improved provision of physical infrastructure.

For the Federal Capital Gains tax the upper limit for the holding period in terms of application of the tax on capital gains should be 10 years. For a holding period of up to five years the tax rate should be 15 percent and thereafter 10 percent. This measure will enable additional revenues of Rs. 25 billion, while also being more progressive as it is likely to target the relatively more affluent segments of society.

Substitution of Super Tax by an Excess Profits Tax

A Super tax is levied on corporates. The current rate is 3 percent in the case of banking companies and to 2 percent for non-banking companies having income greater than Rs 500 million. The weakness of this tax is its arbitrary nature. There is a need to opt for a more objective basis for raising the tax burden of companies. In our opinion, the existing Super Tax regime should be discontinued and replaced by a new instrument-the Extra Profits Tax, which will make the tax system more equitable while linking it to the ability of the entity to pay more.

We propose a 10 percent rate for the Excess Profits Tax proposed to be levied in addition to the normal corporate income tax only on profits exceeding the return on equity plus reserves of 30 percent. Of course, if the return is lower than 30 percent then there will be no Excess Profits Tax on the company.

This proposal has the merit that the tax gets linked to higher profits and not just to turnover. A company with high turnover may not necessarily be making larger profits. Companies which enjoy special advantages or quasi-monopoly power will be the more likely candidates for payment of the Excess Profits Tax. The rate of 30 percent of profit on equity and reserves is linked to observed rates of profitability of companies quoted in the Pakistan Stock Exchange. We estimate that the implementation of this proposal should be able to generate an additional Rs. 15 billion.

Tax Treatment of provisioning by Banks of their NPLs

In our opinion, the tax treatment of bad debts of banks-provisioning and write-offs of poorly performing loans-continues to be generous. This policy fails to discourage reckless behavior; in economic terms it is incentivizing moral hazard outcomes. This is important because following the enhancement in the SBP’s Policy Rate and the consequential sharp increases in the lending rates of banks in a slowing down economy there is every reason to expect an increase in the portfolio of poor/non-performing loans of banks. This facility should be restricted to loans to SMEs, small farmers and housing. We estimate that this proposal should be able to save revenues of Rs. 15 billion

Comprehensive Taxation of Personal Incomes

In the case of personal incomes it is time to adopt a more comprehensive taxation structure. To this end there is a need to move away from the notion of fixed taxes on incomes derived as dividends and interest from financial instruments, presently treated as separate streams for tax purposes. Incomes derived in this form should be clubbed as part of total income and the taxes deducted at source on these incomes should not be regarded as final settlements and instead converted into regular withholding/advance taxes. We estimate that an additional Rs.20 billion can be raised from this proposal.

End of Special Category of Taxpayers

To ensure that all segments of society bear their fair share of the burden of structural adjustment we propose the withdrawal of exemption or concession in the manner given below:

a) Business income of trusts/foundations which are not providing or supporting education or health services should be levied a fixed tax of 10 percent.

b) Following the reduction in personal income tax rates, all concessionary tax rates applicable or tax deductions in special cases covered under the Second or Third Schedule of the ITO 2001 on perquisites granted to individuals holding some kind of office should be withdrawn. The value of these perquisites should be merged in their 'salaries' for tax purposes; these concessions are essentially available to the President, and judicial, military and civil officers, teachers and researchers etc. This will convey the right message of the equality of all citizens in the payment of taxes.

c) Any donation paid to institutions recognized by the FBR, other than those operating in education and health, should attract a tax credit at a fixed rate of 15 percent, as against the present system which permits tax deductibility at the highest marginal applicable tax rate for the donor. However, so as not to discourage philanthropy the tax credit should have carry-forward eligibility for 3 years.

These steps are expected to generate an additional Rs. 15 billion.

Enhancement in Rate of Advance Tax on Electricity bills

The withholding tax rate for commercial and domestic consumers of electricity should be enhanced. The exemption limit of Rs. 75,000 monthly bill for domestic consumers should be reduced to Rs. 25,000.In the case of commercial consumers the exemption limit at Rs. 400 per month is too low and may be raised to Rs 1,500. Beyond this the rate should be raised progressively from 5% to 15%.This measure is expected to raise an additional Rs. 15 billion. It should be converted from a fixed tax to an advance tax.

However, a narrative acquiring wider traction that the majority of industrial and commercial electricity connections are not income tax filers is helping create the perception that a huge revenue potential exists by focusing attention on these enterprises. Contrary to this general observation, these seemingly "untaxed/poorly taxed resource" are already paying a large amount as taxes under different heads-withholding, GST, etc. And these are not being adjusted against any tax return filed by them, suggesting that the expectation of income tax additionality through better enforcement, by requiring them to file their tax returns regularly, is somewhat, if not highly, exaggerated.

Improved Administrative Measures

The feasibility of detection of tax evasion has greatly increased with the enactment of the Benami law (which will make Benami transactions illegal). In addition, there is now the information being provided by a host of other tax jurisdictions on assets held and incomes earned from different investments by Pakistani residents.

Further, the biometric identification of holders of bank accounts and information sought by banks on sources of income, the general requirement for disclosure of CNICs of the buyers of motor vehicles and real estate, those acquiring financial instruments, etc/ (which can be made mandatory if all transactions are not fully covered), the easy availability of the state-of-the-art technology and good quality IT services, supported by the sharing of data bases by provincial governments on service providers in their GST net, on owners of property, motor vehicles, etc. the FBR is now well placed to, going forward, triangulate the information contained in these huge data sets by harnessing adequate IT systems. In fact, these

developments are facilitating the gradual elimination of the legal category of 'non-filers', leaving the FBR to focus on tracking down tax evaders instead of finding an easy way of collecting taxes, a route adopted to date.
In our opinion, through some capacity building of the FBR and the intelligent and effective and efficient mining of available data sets should readily enable generation of an additional Rs. 50 billion in 2019/20 through administrative measures.
The total additional revenue generated from the above proposals in income tax is Rs 260 billion on the projected tax bases in 2019-20. This includes the revenue from the restoration of the presumptive income tax on mobile phone cards and telephones of an additional Rs 60 billion.

Incentives

In our opinion some incentives should also be built into the system to ease the cost of doing business, promote and nurture female enrollment in the labor force, and encourage entry into the tax net to support the objective of base broadening, as described below:

a) Lowering of the tax rate for female professionals, up to an annual income of Rs. 2,400,000.
b) Exempting all new filers from the Tax Audit for three years.
c) Exemption from Tax audit of those showing a 20% growth in their taxable income from the previous year, while making sure that the tax filer is not 'closing down its existing business for tax purposes' while making an entry as a new taxpayer and has filed a return every year over the last three years.

SALES TAX

Sales tax is the largest tax in Pakistan today. The revenue from this tax on goods and services combined was Rs. 1715 billion in 2017-18, equivalent to 5 percent of the GDP. The tax has shown an annual growth rate of 14 percent between 2012-13 and 2017-18. It has the features generally of a value added tax. However, the tax base is distributed between the Federal and the Provincial governments. The latter collect the tax on services and the former on goods.
The splitting of the tax base has created a number of problems. First, tax payers have to file separate returns for goods and for services respectively. Second, the rates vary. The tax on services is levied at the rate of 13 percent in Sindh, in Punjab at 16 percent and at the Federal level at 17 percent. Consequently, the features of value-added taxation are distorted. Third, there is a serious problem of refunds between levels of Government and among Provincial Governments.

Integrated National GST/VAT

Therefore, a major reform of the tax system of Pakistan will involve a transition to a nationally integrated value-added tax system. This will include the same return for goods or for services and thereby enhance the ease of doing business. A common standard rate for goods and services of 17 percent initially will be applied. The various tax agencies will set up a clearing house for refunds
The distortionary effects of the tax currently will be greatly reduced. Evasion will be more easily detected. Overall, following implementation in 2019-20, the revenue yield from the sales tax on goods could rise by over Rs. 30 billion, due particularly to more detection of evasion, and in the case of the sales tax on services by Rs. 30 billion, due also to the enhancement in rate.

Changes in Schedules

The agreement with the IMF involves examination of the case for retention of exemptions and special treatment in the taxation system, including the sales tax.

The Federal sales tax has a number of Schedules which contain this type of treatment, as follows:
Third Schedule: a list of consumer goods on which the sales tax is to be levied on the retail price and not on the ex-factory price.
Fifth Schedule: lists the exemptions on imports or domestic supplies of different types of goods. Included in the list are petroleum, crude oil, supply of ships or aircraft, supply to Export Processing Zones, supply to foreign missions, etc.
Sixth Schedule: applies also to imports and domestic supplies. 150 groups of items are included in this Schedule of exemptions. These groups consist of various food items, the Holy Quran, newsprint, medical equipment, stationery, energy equipment, computers, pesticides, etc. In addition, it includes a list which applies only to local supplies.
Eighth Schedule: includes items on which the sales tax is to be charged at a rate lower than the standard rate. It includes major items like cotton on import (5 percent); various food items (10 percent); second hand clothing (5 percent); tractors (5 percent); agricultural equipment (5 percent); sugar (8 percent); natural gas (5 percent); LNG (12 percent); Fertilizer (2 percent), etc.
The basic guiding principle should be to retain the exemption or lower rate on items which have a higher weight in the consumption basket of the lower income groups. In addition, investment and exports, as highlighted earlier, are vital for the sustainability of the growth process and changes which impact negatively on these two macroeconomic magnitudes need to be avoided generally.
Higher taxation of goods which are inputs into the production of items which are already subject fully to the sales tax will not necessarily lead to higher overall sales tax revenues, given its value-added nature. Also, any changes recommended should be such as to yield significant revenues. Further, taxes on agricultural inputs must be avoided. These inputs like fertilizer, pesticides, etc. are subsidized in many countries, including India.
The tax structure summarized above suffers from multiple rates resulting in the case of some significant sub-sectors of higher rates on inputs than the rate applicable on the output, suggesting the need for both the consolidation and rationalization of rates.
Based on the above considerations, the following changes are recommended in the Schedules:

a) The full rate of 17 percent may be applied on LNG.Net revenues will, however, accrue on final consumption only.
b) The Sixth Schedule may be extended to include consumer durables like automobiles, air conditioners, freezers, TVs, etc. acquired mostly by the upper income groups by applying the standard rate.
c) Sales tax on locally produced sugar may be raised to 12 percent so as to discourage the cultivation of sugarcane and its replacement by cotton.

The estimated additional revenue from the above proposals is Rs. 35 billion.

Retention of the Zero-Rating System

There is also a need for examining the case for retention of Sales Tax SRO 1125 of 2011 relating to the zero rating of domestic sales of a number of exportable items, namely, textiles, leather, carpets, sports goods and surgical instruments. The case for retention of this facility is strong for a number of reasons. First, a large part of the production is by SMEs who operate anyway with a competitive disadvantage in terms of access to inputs and credit. Second, in the case of textiles and leather products, the share of income devoted to clothing and footwear is substantially higher for the lower income groups. Third, large refunds are due to exporters against the zero rating provision. These have been pending for a long time. Any modification of SRO 1125 should only be considered after the outstanding refunds are fully paid. Fourth, exports are the lifeline for Pakistan and as highlighted earlier no measures should be taken at this time which could jeopardize export earnings.

To prevent exporters from abusing the zero-rating regime by extending the ensuing benefits of the scheme to their local sales it should be readily possible to update input-output tables of the different sub-sectors of industry to facilitate the restriction of tax related refunds to export earnings routed through the banking system.

Sales tax on Petroleum Products

The final area within the sales tax for raising additional revenues is the levy of the tax at the standard rate of 17 percent on the two major petroleum products – motor spirit and HSD oil. The current rate is 13 percent in both cases. Fortunately, there has been a decline of almost 15 percent in the international price of oil. Enhancement to the standard 17 percent from next month onwards could yield an additional Rs. 80 billion in 2019-20.

Overall, the potential additional revenue that can be generated in the domain of the sales tax from the above-mentioned taxation proposals is Rs. 175 billion.

IMPORT DUTY

The Tariff Structure

There is a strong case for retention of the existing tariff structure on imports. There are currently four slabs of 3 percent, 11 percent, 16 percent and 20 percent. The cascading principle applies with basic food items and machinery being subjected to the lowest tariff. Raw materials and intermediate goods are subject to low to intermediate level of tariffs, depending upon the extent of value added. Finally, finished goods should be subject to the highest tariff to promote higher value added by domestic industry. The FBR has adopted the unacceptable practice via SROs of adding duties to the slabs. This must be avoided as it has led to a regime of multiple tariffs and a loss of transparency in the structure of customs tariffs.

Import Duty on Energy Imports

Here again, there is a distortion in the tariff structure on energy inputs. A lower rate of 3 percent has been applied on motor spirit and a higher rate of 11 percent on HSD oil. Similarly, the import duty on LNG is also only 3 percent. There is, therefore, a case for raising the tariff to 11 percent in the case of motor spirit and LNG, especially at a time of somewhat falling prices. This could yield additional revenues of Rs. 50 billion.

Introduction of ITPs

Another important reform that needs to be fully adopted is the introduction of a regime of International Trade Prices (ITPs). It has become essential to protect domestic industry from the under invoicing of imports, especially from China. Adopting this measure will also help create a more level playing field for domestic producers. Estimates are that the extent of under invoicing in imports of telecom, fertilizer, synthetic yarn, electricity generating sets, iron and steel products, rubber tyres and machinery is almost 20 percent on average. Introduction of ITPs on such products will have the consequential impact of yielding higher revenues, especially from sales tax and the presumptive income tax on imports of up to Rs. 50 billion.

Curbing Smuggling

Further, efforts have to be made to curb smuggling by strengthening the Customs border force and withdrawing any regulatory duties on smuggling-prone items.

Review of SROs

An in-depth study also needs to be undertaken for rationalizing the large number of SROs related to imports

The overall revenues that can be generated from the above proposals in import duty are Rs. 100 billion.

EXCISE DUTY

Higher Tax on Cigarettes

The obvious candidate for higher rate of excise duty is cigarettes .In the case of cigarettes, the number of rate slabs needs to be reduced from three to two, with the elimination of the existing slab.

As a way of promoting construction activity, especially of low-cost housing, the excise duty on cement may initially be reduced by 25 percent with a phasing out over the next three years. The overall net revenue impact of the two moves is Rs. 10 billion

Based on the above proposals, the estimate of the potential revenue yield is Rs.260 billion from the income tax, Rs. 175 billion from the sales tax, Rs. 100 billion from import duty and Rs10 billion from excise duty. As such, the total revenue yield from taxation proposals in Federal taxes is Rs.455 billion. This will enable achievement of the more feasible revenue target of FBR of Rs 5000 billion. Therefore, substantial revenue can still be generated while adhering to the canons of taxation and avoiding large-scale ad-hoc impositions to try and achieve unrealistic revenue targets.

Need to retain the Investment Incentives

Second Generation Reforms

Income Tax

1) Capital Value Tax
2) No Minimum Tax on Turnover
3) Law of Pre-eminent Domain on Property
4) Rental Income to be merged in total income
5) Which withholding taxes need to be withdrawn on the basis of some criteria
6) Water Resources Cass
7) Shares Transaction Tax
8) Advance Tax by SECP on Paid Up Capital
9) Maximum Debt-Equity Ratio
10) Three Year Averaging for Advance Tax
11) Transfer Pricing Law
12) Policy on Tax Holidays

Sales Tax

1) Treatment of Machinery Input
2) Better Mechanism for Refunds based on Input-Output Analysis
3) Extension to W&R Trade
4) Enhancement of Withholding Tax on Services

Import Duty / Excise Duty

1) Import Duty on Services
2) No Excise Duty on Services
3) Excise Duty as a 'Green' Tax

Others

1) Water Resources Cess
2) Wealth / Inheritance Tax