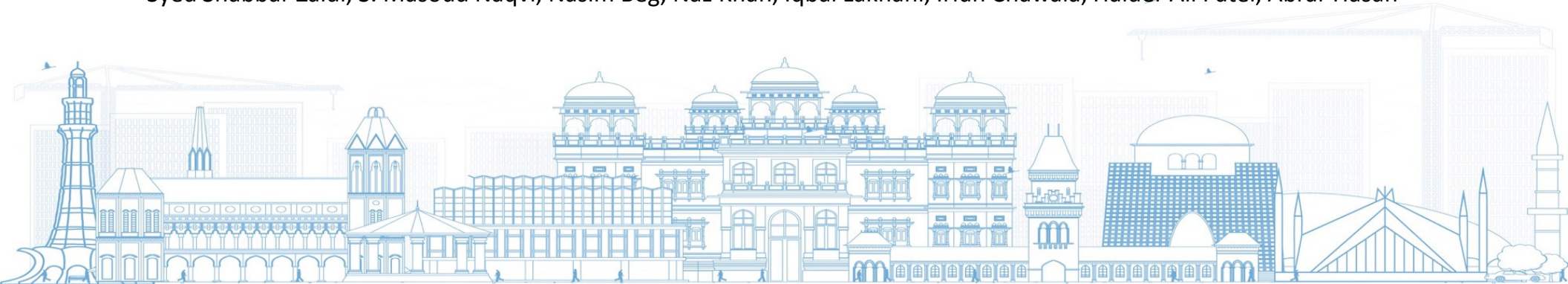




Equitable Fiscal Policy



Syed Shabbar Zaidi, S. Masoud Naqvi, Nasim Beg, Naz Khan, Iqbal Lakhani, Irfan Chawala, Haider Ali Patel, Abrar Hasan



Present Tax Policy

- Tax policy has contributed to premature de-industrialization leading to recurrent pressure on foreign reserves and rampant unemployment.
- **Tax to GDP ratio** has not crossed the **minimum** desired benchmark of 12.5% of GDP. Even in that collection the nature, form and manner is not in line with overall economic objectives. There is high tax incidence on very limited number of taxpayers.
- Tax policy requires serious review focus on immediate, medium and long term corrections.

Tax to GDP

If the contribution of informal economy in overall GDP is also taken into account then this percentage will further reduce at least by 2 to 3 percent.

Fiscal Year	Tax Collection (PKR Billion)	Tax to GDP %
2006	713.5	8.7
2007	847.2	9.2
2008	1,008.1	9.5
2009	1,161.1	8.8
2010	1,327.4	8.9
2011	1,558.2	8.5
2012	1,882.7	9.4
2013	1,946.4	8.7
2014	2,254.6	9.0
2015	2,589.9	9.4
2016	3,112.7	10.7
2017*	3,621.0	10.8

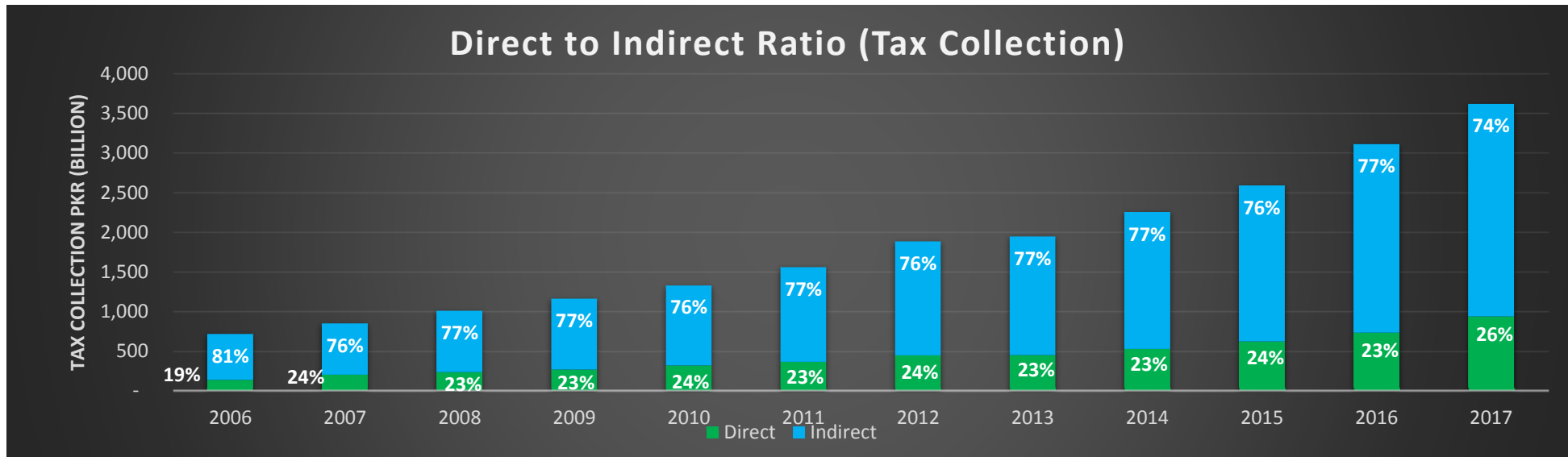
*Provisional

Country	Year	Tax to GDP %
Turkey	2016	25.5
Malaysia	2015	14.3

Source: The World Bank Data

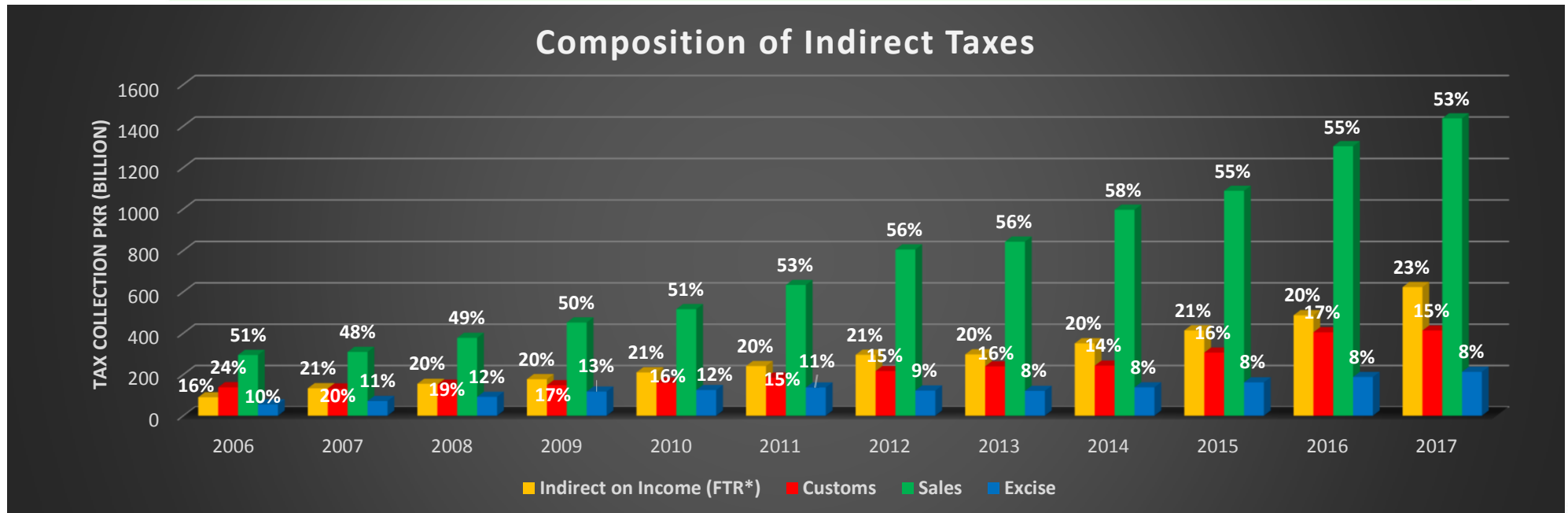
Source: Pakistan Economic Survey
2016-17

Exorbitant reliance on Indirect Taxes



Indirect Taxes also include non-income based direct taxes commonly known as “**Presumptive/Fixed Tax Regime(FTR)**” which constitutes of approximately 40% of direct taxes. This FTR regime for all economic purposes is an indirect tax. It is not based on ‘**Net Income Basis**’. The remaining 26 % income based direct tax on income basis is paid by very few taxpayers mostly corporations. In summary, the incidence of indirect taxation is to be reduced whereas the base for direct taxes collected on income based taxation is to be increased.

Present Status – Indirect Taxes



*Presumptive tax (FTR) is an acceptance by the government's inability to pursue the undocumented sector. Frequent changes, inconsistency, lack of long term perspective and weaknesses in compliances with the tax policy incentivizes unorganized sectors, de-industrialization and anti-corporatization.

Anti-Corporatization Approach

- Tax policy discourages **corporatization** which is essential for **documentation** and good governance.
- Corporatization has essentially being discriminated by way of higher tax, including multiple taxation on dividends, bonus shares and undistributed profit and huge burden of reporting and compliance in comparison to non-corporate sector.
- Effective Tax Rate on profit on Companies for the year ranges around 40 percent; Following slides present the case by way of practical illustration.

Illustration – Tax incidence on Non-Corporate Sector vs Corporate Sector

Description	Individual / AOP		Company	
		Rs.		Rs.
Taxable Profit (Example)		6,000,000		6,000,000
Tax payable				
(a) For individual / AOP				
- First Rs. 6 million		1,319,500		
- Sum above Rs. 6 million		-		
Total Tax Liability		1,319,500		
(b) Company				
Corporate Rate		-	30%	1,800,000
Net of Tax profit		4,680,500		4,200,000
Tax on dividend	0 %	-	15%	630,000
Net Income in hand of shareholder		4,680,500		3,570,000
Effective tax rate for shareholder		22%		41%
Conclusion		-		Corporatization not feasible

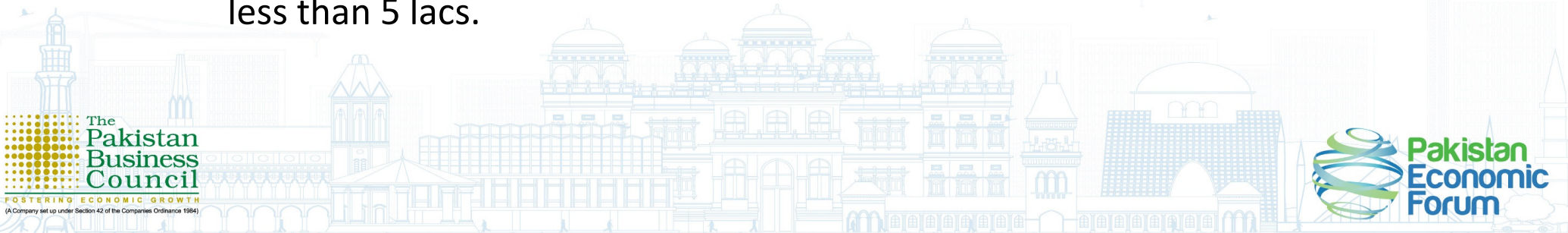
Illustration - Direct Tax overall Incidence on a Corporate Shareholder

8

Description	PKR in Millions	Tax rate (Co.)	Notes
Taxable Profit -Before Labour Levies	538		
<u>Labour Levies</u>			Assuming business falls under the definition of Industrial Establishment
WWF	11	2%	-
WPPF	<u>27</u>	5%	-
Taxable Profit -After Labour Levies	500		-
Corporate Tax	150	30%	For tax year 2018 and onwards
Super Tax	<u>15</u>	3%	Other than banking company, having income equal or exceeding Rs 500 million
Net of Tax	335		
Effective Corporate Tax Rate	-	37.7	Additional, 7.5 % of Profit before tax on public company that does not distribute minimum 40% of it profit after tax
Tax on Dividend	<u>50</u>	15%	Assuming filer and not from power sector or mutual fund or Schemes
Net Income	285		
Tax on inter-corporate dividend	<u>43</u>	15%	Assuming filer
Net Disposable Income	242	45%	-
Effective Rate of Tax (Shareholder)	-	55%	-

Number of Tax-Return Filers

- Tax base (number of filers) has remained constant and not in line with increase in tax revenues; Exhibits stagnation of tax base;
- Tax filers for Tax Year 2016 – 1,342,566 as compared to Tax Year 2015 – 1,074,418; India has got more than 40 million taxpayers.
- Around 40 % plus of the companies registered with SECP are non-filers. Out of filers around 1 million are salaried taxpayers. Effective number is less than 5 lacs.



Tax Rates High and Regime Complex

Country	Corp Tax %	VAT/GST%
Pakistan*	30%	17%
India	30%	12.5%
Sri Lanka	15%	12%
Bangladesh	25%	15%
Vietnam	22%	10%

* In addition to direct and indirect taxes, labour levies i.e. WWF is applicable at 2% of the taxable income and WPPF at 5% of the accounting profit.

PAKISTAN RANKED 172 OUT of 190 COUNTRIES IN PAYING TAXES RANKING

Fiscal Discrimination Against Manufacturing Versus Trade

‘Manufacturing’ has become a fiscally non-viable option. Such tax measures promotes ‘imports’ over ‘local industry’ for same products leaving aside tariff considerations.

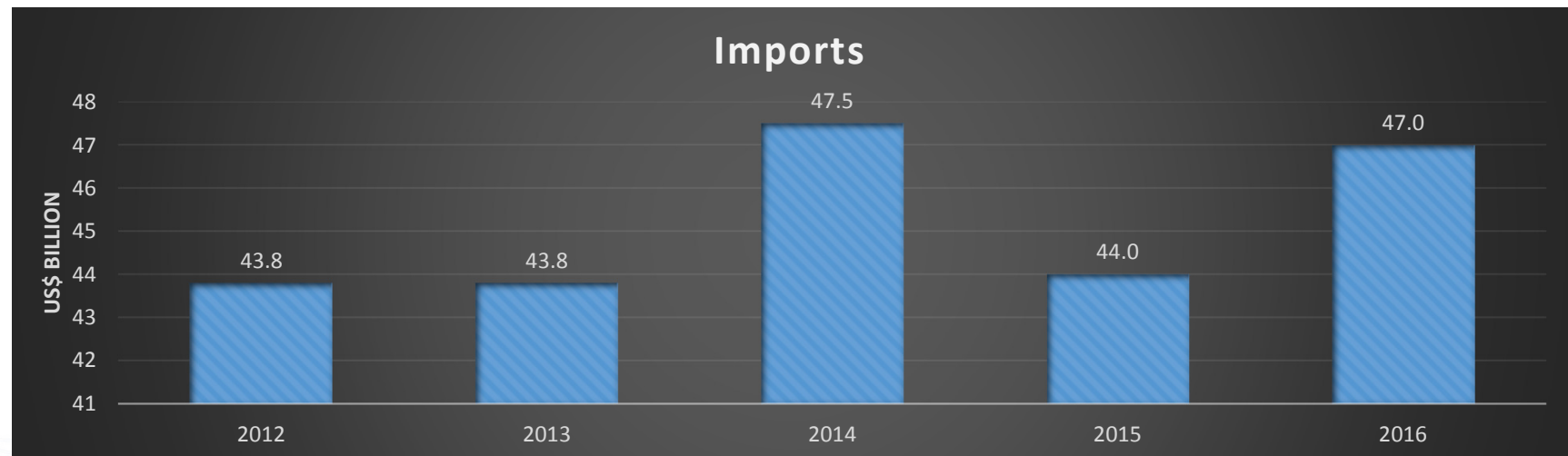
Manufacturing Company	Trader
Taxed at 30% of Profit (Taxable Income)	1% - 9% of import value* 1%-5% of the export proceeds**

*Under section 148 of Income Tax Ordinance, 2001

**Under section 154 of Income Tax Ordinance, 2001

Trade Deficit and Fiscal Policy

Tax policy is heavily reliant on collection on 'imports' and other presumptive taxation. Around 55 percent of total sales tax was contributed by sales tax on import during July-April FY2017. This invariably favors trade versus industrialization. It is in the interest of FBR that our import bill is higher as that directly contributes to tax collection. A clear conflict of interest.



In effect, current account deficit increases tax collection for the reason that bulk of such collections are based on imports.

Unorganized Sector and Indirect Taxes

- On account of presumptive basis of taxation, tax policy promotes informal economy and under invoicing.
- Furthermore organized sector is seriously effected by this incidence of Sales Tax (Federal excise duty, if leviable on products) on account of non-documented economy/unorganized sector.
- There are serious market distortions on account of high sales tax incidence on organized documented sector versus unorganized sector. High tax incidence is directly contributing closure of organized manufacturing sector.

Under-Invoicing is a Major Drain on Tax Revenue...

...and undermines manufacturing

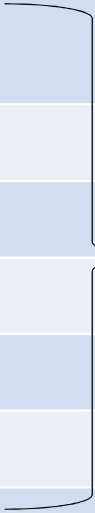
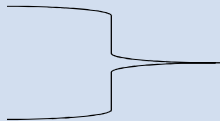
The remaining value of under-invoiced price is paid inter alia through Private Foreign Currency account and undeclared profit is brought back untaxed using Section 111(4). [Slide 18]

Heading	Rate	100% Compliant	60% Under-invoiced
		Rs.	Rs.
Declared or Assessed Value	-	100	40
Customs Duty [CD]	20%	20	8
Regulatory Duty [RD]	25%	25	10
Value after CD & RD	-	145	58
Sales Tax including Value Addition	20%	29	12
Value after Sales Tax	-	174	70
Withholding Income Tax at Import Stage	6%	10	4
Total Tax Levy at Import Stage	-	84	34
Tax evaded at Import Stage	-	-	-50
Tax evaded at Import Stage as % of Tax Due	-	-	60%

Presumptive Tax Creates an Uneven Playing Field for Manufacturing and Results in Total Tax Loss of 67%

	Manufacturer	60% Under-invoiced commercial importer
	Rs.	Rs.
Landed Cost without Input Sales Tax	145	-
Assumed Mark-up of 50%	73	-
Sales Value before Output Sales Tax	218	-
Output Sales Tax at 17 %	37	-
Price to Customer	255	-
Net Profit for Compliant Manufacturer	73	-
Tax at 30%	22	-
Difference of Output and Input Sales Tax	8	-
Total Taxes and Import Levies	104	34
Extent of evasion /avoidance	-	-70
Evasion / avoidance as % of tax liability	-	67%

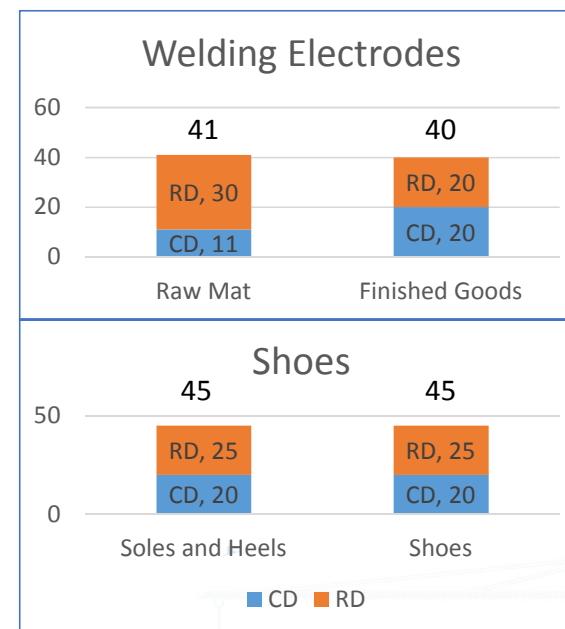
Manufacturers Pay Sales Tax On Entire Value Addition vs. Importers on Import Value Only

Activity	Manufacturer's ST Impact		Com Importer's ST Impact	
RM Import		ST at 17% on final price covering all elements of value addition		ST at 20% on import value only
Conversion			N/A	
Warehousing				
Distribution				
Marketing				
Profit				
Sales Price				

Cascading Tariffs

Parity duty on inputs and finished goods	Import Duty Before RD
<u>RAW & INTERMEDIATE MATERIALS</u>	
Soles	20%
Heels	20%
Laminate Fabrics	20%
PU Chemicals	25%
Insole Board	20%
Zipper	20%
<u>FINISHED GOODS</u>	
Shoes	20%

Duty and RD renders Mfg unfeasible



An extensive exercise should be carried out to provide effective and proper cascading tariff structure to the locally manufactured goods, which have been badly affected due to the (1) reduction in tariff slabs, (2) phasing out / deletion of concessions from SROs and (3) imposition of RD. This has led to the entire tariff structure becoming complex / distorted and non-cascaded which not only will further damage the efficiency and competitiveness of the local industry but will also affect investment and development in the industrial sector

Foreign Currency Accounts & Tax Immunity

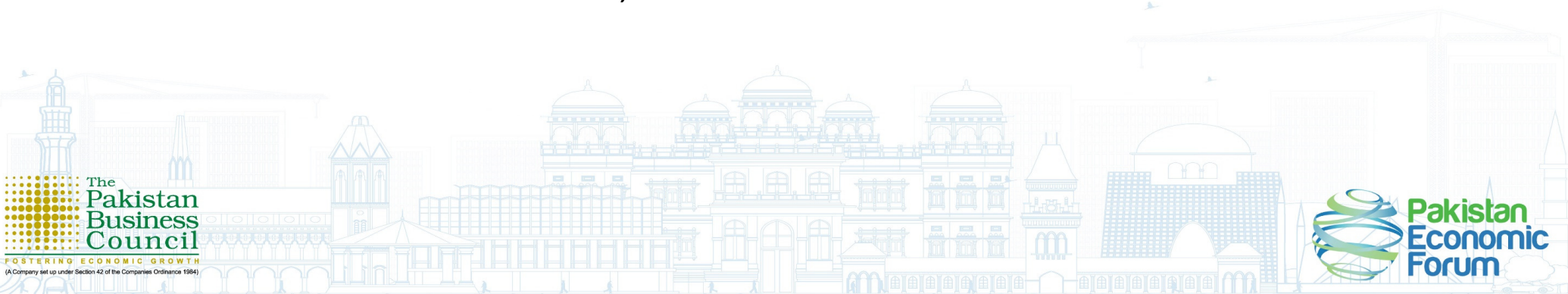
- There is a perpetual tax immunity for foreign exchange remitted from abroad. Section 111(4) of the Income Tax Ordinance, 2001. That provision needs to be removed.
- In addition to the same, there is '**no enquiry regime**' for inward and outward flow in the Private Foreign Currency Accounts.
- The 'no enquiry' provision as contained in Section 5 of the Foreign Currency Accounts (Protection) Ordinance, 2001 needs a review to delink and abuse in the guise of 111(4) of the Income Tax Ordinance, 2001.

Results

- Disequilibrium in the system appeared on account of:
 - **Not promoting documentation**, the concept of 'income based' taxation and complete reliance on 'guaranteed' presumptive taxation; and
 - **Ineffective compliance**, supported by lack of effective '**data base of assets**' with the regulators leading to avenues for corruption;
- **General societal displeasure** on account of lack of equity, discrimination and deterioration in public sector (education, health & security) using the amount of taxes; and
- Results in flow of foreign exchange out of system and accumulation of assets outside Pakistan by Pakistani citizens, **no real investment in manufacturing sector**, constant, stagnation of Tax to GDP and number of taxpayers.

Action Points – General

- I. **Tax policy** to be separated from tax collection system;
- II. Bring the faith back in the system; **Consensus of stakeholders** for future tax policies; medium to long term approach;
- III. **Societal acceptability** to the system; public debate; transparency; documentation of assets;



Action Points – Immediate

- I. Automation / Integration of tax filing system with other databases, such as NADRA
- II. Separation of policy from collection;
- III. Abolition of multiple taxes including tax on inter-corporate dividends, bonus shares and undistributed profits;
- IV. Income-Based Taxation instead of turnover, presumptive income, or indirect taxes on graduated basis;
- V. Law for declaration of foreign assets;
- VI. Delinking Private Foreign Currency Account and Section 111(4) of the Income Tax Ordinance, 2001.

Action Points – Long Term

Tax policy framework to be governed by cardinal objectives of achieving:

- I. Industrialization versus trading;
- II. Corporatization;
- III. Registration of unorganized sector;
- IV. Documentation of existing assets;
- V. Revamping of indirect taxation system, in consultation with provincial governments and equalizing applicable tax rate (15 percent) to effective tax rate (between 5 to 7.5 %).
- VI. Simplification of regulations and processes;
- VII. Similarity of tax incidence for all sort of business organization (leaving no space for arbitrage). Total tax incidence on businesses, irrespective of form of organization, shall not exceed 25 percent;

Summary

These measures will:

- Improve documentation of economy, reduce unorganized sector and informal economy;
- Promote industrialization resulting in import substitution and export promotion;
- Remove discrimination in tax system;
- Provide road map for sustained increase in Tax-to-GDP ratio essentially based on income based taxation;
- Integrated platform for economic management.