TAXATION – WHERE DOES PAKISTAN STAND?

PART I

OF DIRECT AND INDIRECT TAXES

INFONALYSIS

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Tax reforms: An often used catchphrase

Tax reforms is one of those elements that is more or less emphasized on every forum by businessmen and traders in Pakistan, with respect to the complications they are facing in their business cycle. It is also a 'catchphrase' which the government officials use from time to time in relation to the impediments they face while generating revenue to run the country's operations.

Undue and inexplicable emphasis on indirect taxation

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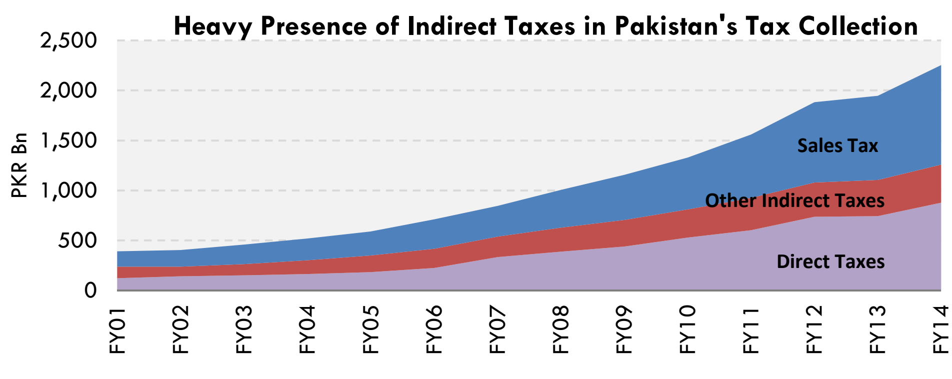
Perhaps the most intriguing aspect of Pakistan's tax system is its undue and often inexplicable emphasis on indirect taxation. Times and again, govts. (elected and otherwise) have shied away from holistically revamping the national taxation system. According to estimates, Pakistan faces tax evasion of PKR 700 to 1,000Bn annually in different forms. But instead of broadening the tax base by bringing the untaxed into the tax net, removing anomalies, rationalizing taxability and tax rates, and putting checks on corruption within the system, govts. have mostly sought the easy way of increasing tax revenues by applying blanket indirect taxation, with the end result that every citizen of the country is liable to pay taxes on the items that he purchases, irrespective of his level of income, which often becomes unfair for the common citizen.



Source: *KCCI Research; FBR*

The GST in Pakistan: How are other countries implementing their indirect taxes?

The General Sales Tax (GST) is the main vehicle of indirect taxation being utilized in the country. The share of sales tax in overall tax collection was recorded at 44% in FY14, overriding the share of direct taxation, which stood at 39% in FY14. Currently charged at 17%, the rate is too high as can be compared with other nations in Pakistan's vicinity; only Turkey has a higher rate of 18%.

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However, in Turkey there exists a reduced rate of VAT of 8% and 1% on essential items including foodstuff, textile products etc. Such measures have been instrumental in Turkey's attainment of a tax-to-GDP ratio of 20.38%, which is almost double that of Pakistan's Tax to GDP of 10.93%.

Targeted implementation of VAT in Turkey has also resulted in elimination of multiple taxation at every stage of sale; this phenomenon is rampantly prevalent in Pakistan and has been a main reason for increasing the effective sales tax rate manifolds in Pakistan.

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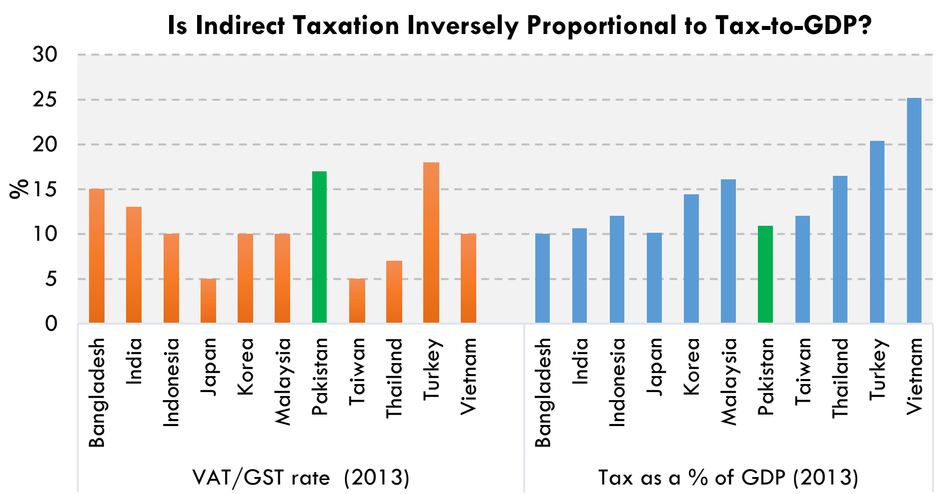
Even Malaysia that charges sales tax of 10% has tax to GDP ratio of 16.11% though a reduced sales tax rate of 5% is applicable to certain items such as foodstuff. Exports are exempt from sales tax. Service tax is chargeable at the rate of 6% on taxable services provided by a taxable person. Such services include hoteling, insurance, telecom and consultancy. Further, a Goods and Services Tax is to be implemented from Apr'15 at a standard rate of 6% which will replace the current service tax and sales tax regime.

Vietnam is correlated to Pakistan in terms of its exports mix, yet it has a high tax-to-GDP ratio of 25.2%. The standard rate of VAT is 10% while a concessionary rate of 5% applies to specific essential goods. However, a Special Sales Tax ranging from 10% to 70% applies to the production or import of certain goods including cigarettes, luxury items, certain automobiles, and the provision of certain leisure services.

It is also interesting to note that Taiwan and Thailand charge only 5% and 7% sales tax but have tax-to-GDP of 12% and 16.5%, respectively. The chart below indicates that in most countries, the lower the indirect tax, the higher is its tax-to-GDP ratio, and vice versa.



Source: *KCCI Research; KPMG; CIA Fact book; World Bank*

In most countries, the lower the indirect tax, the higher is its tax-to-GDP ratio, and vice versa. Can we say that Indirect Taxation Inversely Proportional to Tax-to-GDP?

Clearly Pakistan can also dwell on the indirect taxation models that these nations have successfully followed, in order to get rid of its perennial problem of low tax-to-GDP ratio. Also of note are India and Bangladesh which have 15% and 13% sales tax respectively, but have tax-to-GDP ratio close to 10% only.

The govt. of India is developing a comprehensive Goods and Services Tax (GST) in order to replace the existent complex web of VAT, Excise Duty and Service Taxes. These taxes are applied by the federal and state govts. in different capacities on manufacturing and intrastate movement of good and provision of services, and are a cause of multilevel taxation. Nonetheless, the standard rate of VAT is 12.5%, which is significantly below that of Pakistan.

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Is VAT implementable in Pakistan?

Authorities in Pakistan also have many a times, considered implementing the VAT in order to enhance tax collection, increase documentation and transparency and marginalize corruption. However, such efforts have always faced resistance from various stakeholders, ostensibly due to general unawareness on VAT, general apprehensions about its cumbersomeness, unwillingness on the part of the very strong bureaucracy, and most importantly, lack of systems required for its proper implementation.

A cursory glance at the direct tax structures of regional and similar countries

While deliberating on the topic of broad based tax reforms in Pakistan, one can cast a cursory glance at the prevalent corporate tax structures of regional and similar countries and compare them in brief with the one in Pakistan.

Lower corporate tax rates serve as an incentive for corporatization and lend towards attaining economies of scale in production, while catering to the requirements of increased documentation.

Malaysia

Corporate tax in Malaysia is 25%. Special tax rates of 20% are applicable on the first MYR 0.5Mn income of companies having a paid-up capital of less than MYR 2.5Mn, while 25% is applicable on every ringgit earned higher than 0.5Mn. In Pakistan, the applicable tax rate is 33% while smaller companies are charged at 25%.

Lower corporate tax rates serve as an incentive for corporatization and lend towards attaining economies of scale in production, while catering to the requirements of increased documentation. On the contrary, high taxes impede the process of documentation and fan rent-seeking attitudes.

Vietnam

The standard corporate tax rate is 22%, expected to be further reduced to 20% from Jan'16, while certain industries like oil and gas have higher applied tax rates. On the personal tax side, there is a unified progressive tax rates applicable to all resident employment and business income. Incomes from 0 to 60Mn Vietnam Dong (VND) are taxed at 5% while the maximum rate of 35% is applicable above VND 960Mn.

Pakistan can surely take a cue for improving its tax system from Vietnam whose tax-to-GDP ratio is more than thrice that of Pakistan even with such lower tax rates.

The tax system in Vietnam also paints a scenario where the focus is high on direct taxation and lesser on indirect means. Rates of VAT have been kept low with high sales tax applicable only on luxury items. Pakistan can surely take a cue for improving its tax system from Vietnam whose tax-to-GDP ratio is more than thrice that of Pakistan even with such lower tax rates.

India

The basic corporate tax rate of 30% in India is nearly at par with Pakistan. However, foreign companies pay a higher rate of 40%. There is also a Minimum

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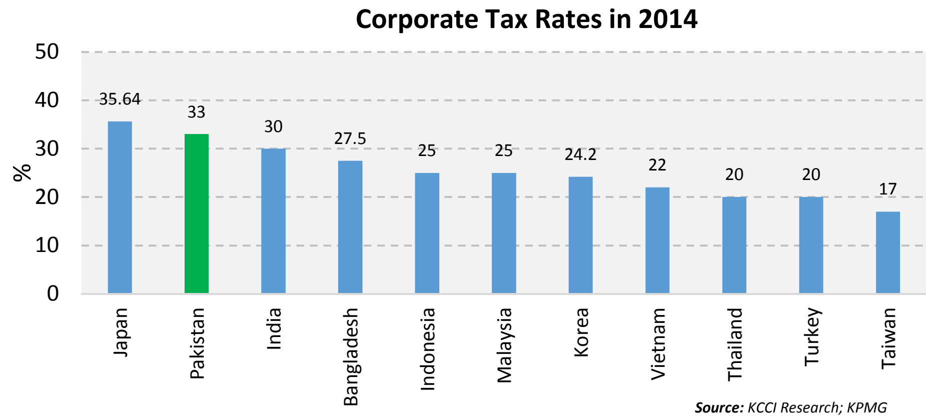
Alternate Tax structure, with basic rate of 18.5%, which is similar to the one introduced in Pakistan as part of budget FY15.

On the personal income tax front, taxation slabs are minimal with only an income below INR 250,000 being exempted from tax. This makes it evident that even India, with whom we consider ourselves to be very similar is working on rationalizing its tax structure to do away with cumbersome procedures and multiple layers of taxes, while putting high focus on direct income taxation.



***Source:** KCCI Research; KPMG*

Focus more on direct taxation to reduce side-effects of high indirect taxation

The exorbitant rate of GST needs to be reduced by at least 5% from current levels.

High indirect taxation has high inflationary impact which reduces the disposable income of the masses and does not serve the purpose of tax rationalization. It is not a solution to the country's chronic problem of tax avoidance and tax evasion. A better approach would be to increase tax revenues by focusing on broad based and far reaching tax reforms. While simultaneously eradicating corruption and enhancing operational efficiency in the tax machinery by minimizing person to person contact through development of a robust and well thought out system involving state-of-the-art technologies, such reforms should put unequivocal focus on targeted progressive direct taxation with a definite principle: collect higher tax from the higher income segments.

As an initial step, the exorbitant rate of GST needs to be reduced by at least 5% from current levels. This would lead to reduction in tax burden on ordinary people and reduce the average tax per person. While reducing pressure on inflation on one hand, this step would increase disposable income on the other which in turn would generate more economic activity thus contributing to higher tax collection.

The resultant decline in tax collection could be offset by reforming income taxation from a regressive model to a progressive one

The resultant decline in tax collection could be offset by reforming income taxation from a regressive model to a progressive one, taxing the wealthiest segments more while providing for the down-trodden and taking measures to curtail evasions and plug leakages in tax collection.

As part of the reforms, the tax base needs to be increased by bringing millions of the untaxed into the tax net, which will invariably increase the tax revenue manifold despite lower applied rates.

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