FEDERAL BUDGET PROPOSALS 2024-2025

The Federation of Pakistan Chambers of Commerce and Industry

Vision

I am honored to present FPCCI budget proposals for the fiscal year 2024-25. This year, more than ever, our recommendations are drafted with a profound understanding of the critical juncture at which the Pakistani economy stands today. Our proposals are not merely numerical adjustments but are aimed at fostering a resilient and inclusive economic environment that supports the aspirations and needs of our people

With a firm commitment to creating an enabling environment for investment and sustainable growth, the FPCCI recognizes the significance of a more equitable, balanced, and sustainable tax system. We advocate for structural reforms that simplify the tax structure, encourage compliance, and promote economic growth. By broadening the tax base and rationalizing tax policies, we aim to create a fairer environment for businesses while ensuring that the burden of taxation is distributed equitably across society.

In FY2023, Pakistan faced significant economic challenges including macroeconomic imbalances, supply shocks, and a global economic slowdown, leading to reduced growth. Widespread floods in the first quarter of FY2023, caused extensive damage, with flood-related expenses totalling Rs3.2 trillion, contributing to GDP loss and rehabilitation costs. Despite these multiple hurdles, Pakistan anticipates a growth rate of 3 percent for FY2024, surpassing the World Bank's conservative estimate of 1.8 percent. However, economic pressure persists, including high inflation, stagnant export growth, and precarious foreign reserves. Concerns about fiscal health remain, with a widening fiscal deficit and ever-growing debt levels, highlighting the need for urgent fiscal management reforms.

The government's efforts to safeguard foreign exchange reserves last year inadvertently disrupted industries and trade, with delays in imports stemming from non-issuance of Letters of Credit (LCs) and import bans causing trade flow disruptions. These measures resulted in detention charges, supply shortages, and even factory closures and layoffs. So, we propose prioritizing export-oriented industries and essential imports to mitigate shortages and enhance trade.

Privatization holds the key to continuous economic growth and revival of the economy, thus it is vital to privatize State-Owned Enterprises (SOEs) to unlock economic activities in the country. The possible investment of USD 8 billion by Saudi Arabia in Pakistan is a testament to SIFC's role in facilitating investment in Pakistan. We express gratitude for the establishment of the Special Investment Facilitation Council (SIFC), which plays a pivotal role in attracting and facilitating investments in various sectors. Furthermore, we emphasize the urgent need to address the issue of energy costs in Pakistan, which continues to pose a significant challenge to businesses and economic growth.

Our budget proposals for FY2024-25 prioritize fairness, sustainability, and growth, addressing immediate fiscal challenges while fostering a more inclusive economy. We commit to close collaboration with the government and stakeholders for effective implementation, recognizing the direct link between economic prosperity and citizen well-being. Looking ahead, we emphasize investing in human capital, infrastructure, and innovation to unlock Pakistan's full potential. By embracing these strategies, we can pave the way for a brighter future characterized by economic resilience, ample opportunities, and improved living standards for all.

Atif Ikram Sheikh
President, FPCCI

Preamble

For the fiscal year 2024-25, the FPCCI Advisory Council on Budget is proud to present its policy recommendations aimed at fostering a robust and inclusive economy. Our primary focus is on broadening the tax base, formalizing the economy, and promoting industrialization to ensure real economic growth and enhance the socio-economic well-being of Pakistan.

We strongly believe that the forthcoming budget should prioritize providing relief to the common man, enhancing industrial productivity, boosting the competitiveness of export products, and improving the overall socio-economic landscape of the country. To achieve these noble goals, we advocate for expanding the tax base through fair and transparent measures, alongside reasonable reductions in tax rates to incentivize investment and stimulate economic activity.

Furthermore, we emphasize the importance of promoting industrialization, particularly within the SME sector, as a key driver of economic growth and job creation. By removing barriers and impediments to business operations and fostering a conducive environment for entrepreneurship, we can unleash the full potential of our industries and propel Pakistan towards sustainable development.

Our Advisory Council is committed to supporting the government's efforts to create a business-friendly environment and drive economic growth. We believe that by working together to broaden the tax base, formalize the economy, and promote industrialization, we can pave the way for a brighter future for all Pakistanis.

I extend my sincere appreciation to Mr. Atif Ikram Sheikh, President of the Federation of Pakistan Chambers of Commerce and Industry, for entrusting me with this important task. I also extend my gratitude to all members of the FPCCI Advisory Council on Budget for their dedication and hard work in preparing our budget proposals.

Together, let us strive towards a budget that reflects the aspirations of the people and lays the foundation for a prosperous and inclusive future for Pakistan.

Zubair Taufail
Convenor Budget Advisory Council, FPCC

Message

In 2021, the Federation of Pakistan Chambers of Commerce & Industry (FPCCI) the apex body of the business community, took a pivotal step by establishing the Policy Advisory Board (PAB). This board is dedicated to providing research-based expert input for policy advocacy, streamlining business operations, and formalizing the feedback from the business community for various governmental bodies. Its primary objective is to amalgamate the private sector's insights to formulate policies conducive to economic expansion and prosperity.

The federal budget is a crucial policy tool that significantly impacts the nation's economic dynamics. Currently, the government is facing a range of economic challenges, such as the high cost of doing business, inflation, high policy rate, corruption, and terrorism, which are further exacerbated by policies imposed by the International Monetary Fund (IMF). Additionally, the heavy burden of debt servicing has severely limited the government's fiscal flexibility.

Amidst a temperate economic forecast and a waning business milieu, it is imperative to implement measures that streamline tax administration, expand the tax base, and foster revenue augmentation. Such initiatives are critical to cultivating an advantageous business environment and bolstering the government's fiscal stabilization endeavors.

The FPCCI's policy research team has diligently engaged in a sequence of consultative dialogues with pertinent stakeholders and has meticulously compiled budgetary suggestions from a spectrum of chambers and associations. These efforts aim to integrate a diverse array of industry viewpoints. There is a firm conviction that the FPCCI's Budgetary Proposals, which encapsulate the business community's collective stance, will receive due consideration from the Government during the formulation of the Federal Budget for the fiscal year 2024-25.

Mian Zahid Hussain
(Sitara-e-Imtiaz), Hon. Ph.D.
(Former Minister Information Technology Govt. of Sindh.)
Chairman Policy Advisory Board – FPCCI

Office Bearers

Atif Ikram Sheikh
President

Saquib Fayyaz Magoon
Senior Vice President

Abdul Mohamin Khan
Vice President

Ashfaq Ahmed
Vice President

Asif Inam
Vice President

Asif Sakhi
Vice President

Aun Ali Syed
Vice President

Muhammad Aman Paracha
Vice President

Nasir Khan
Vice President

Qurrat-ul-Ain
Vice President

Zain Iftikhar Ch.
Vice President

Zaki Aijaz
Vice President

FPCCI Budget Advisory Council

Chairman of the Council

MR. ZUBAIR F. TUFAIL
FORMER PRESIDENT FPCCI
CEO, TUFAIL CHEMICALS INDUSTRIES LIMITED

Members/Advisors of the Council

MIAN ZAHID HUSSAIN
SITARA-E-IMTIAZ, HONORARY PHD
CHAIRMAN FBR ADVISORY COUNCIL
ON INLAND REVENUE

MR. KHURRAM IJAZ
CHAIRMAN, FBR ADVISORY
COUNCIL ON CUSTOMS
FORMER VICE PRESIDENT FPCCI

ENGR. HAJI DAROO KHAN ACHAKZAI
FORMER PRESIDENT FPCCI

SHAIKH KHALID TAWAB, SI
FORMER SENIOR VICE PRESIDENT
FPCCI

MR. MUHAMMAD HANIF GOHAR
FORMER SENIOR VICE PRESIDENT
FPCCI

MR. AHSAN ZAFAR BAKHTAWARI
MEMBER GENERAL BODY FPCCI

MR. AHMED CHINOY, HI, SI
MEMBER GENERAL BODY FPCCI

MR. ABDUL QADIR MEMON
FOUNDER & CHIEF ADVISOR, A.
QADIR & COMPANY

MR. MAHFUZ-UR-REHMAN PASHA
MEMBER EXECUTIVE COMMITTEE
FPCCI

DR. ASHFAQ AHMED TUNIO
CONSULTANT & TAX ADVISOR

SYED TANVIR AHMAD
FORMER MEMBER FBR

MR. ZEESHAN MERCHANT
TAX CONSULTANT

Members of the Council

SYED MAZHAR ALI NASIR
FORMER SENIOR VICE PRESIDENT FPCCI

MR. IZHAR-UL-HAQ QAMAR
MEMBER GENERAL BODY FPCCI

Mr. SHAUKAT AHMED
FORMER SENIOR VICE PRESIDENT FPCCI

MR. GHAZANFAR ALI KHAN
CONVENER, FPCCI SC ON AUTOMOTIVE VENDORS & MANUFACTURERS

MR. MUHAMMAD AHMED
CONVENER, FPCCI ICT COMMITTEE ON DIPLOMATIC AFFAIRS

MR. ZAHID ULLAH SHINWARI
CONVENER, FPCCI SC ON SALES TAX

MR. MUSLIM S. MOHAMEDI, B.E. (Mech)
FORMER VICE PRESIDENT FPCCI

MR. RAZI AHSAN
ADVOCATE HIGH COURT & TAX CONSULTANT

MR. ZAHID UMAR NUMBERDAR
PROMINENT MEMBER FPCCI

MR. JAVED KHALILI
PROMINENT MEMBER FPCCI

MR. SHERAZ ALI KEERIO
PROMINENT MEMBER FPCCI

MR. ABDUL REHMAN KHALILI
PROMINENT MEMBER FPCCI

MR. SUHAIL ASHRAF VOHRA
PROMINENT MEMBER FPCCI

MR. LIAQAT ALI SHAIKH
PROMINENT MEMBER FPCCI

FPCCI Secretariat & Research Team

Brig Iftikhar Opel, SI(M), Retd.
Secretary General

Amjad Qureshi
Additional Secretary General

Ahmed Zaman Khan
Additional Secretary General

Syed Muzaffar Ali Rizvi
Manager
FBR and Member Affairs

Bilawal Suhag
Acting Head
Policy Research Unit

Sehrish Naz
Lead Income & Sales Tax
Policy Research Unit

Muhammad Sohail
Deputy Manager
FBR and Member Affairs

Dr. Asadullah
Junior Researcher
Policy Research Unit

Syed Immad Uddin
Research Associate
Policy Research Unit

Ijlal Mansoor
Research Associate
Policy Research Unit

Table of Contents

Preamble i

Office Bearers v

FPCCI Budget Advisory Council vi

FPCCI Secretariat & Research Team viii

1. Key Highlights 1

2. How Taxes Shape our Financial World 21

2.1. Balancing Tax Revenues: Re-Thinking Tax Composition 21

2.2. Falling Behind: Pakistan's Tax-to-GDP Ratio Versus peer Countries 22

3. Broadening the Tax Base 24

4. Micro, Small, and Medium Enterprises 27

5. Formalizing the Retail and Wholesale Sector in Pakistan 30

Key Highlights
of the Budget

1

Key Highlights

PROPOSALS FOR ENHANCING EXPORTS

I. Export Facilitation Scheme (EFS)

Stagnation in export revenues has been a consistent source of concern for Pakistan's economy. FBR introduced the Export Facilitation Scheme (EFS) in 2021. Besides other factors, there are issues with FBR/EDB (Engineering Development Board) that need to be resolved for real facilitation. Some of the problems regarding FBR/EDB (Engineering Development Board) are given as under:

1. In the case of a Contract application where the applicant so demands, 50% of the value of input goods demanded shall be allowed provisionally by the system at the time of submission of the application which shall be subject to the final determination of input-output ratio. The Customs does not entertain any such request as they say that there is no provision in the WeBOC module. No remedy is available to exporters if their orders are delayed/cancelled.

2. The case is marked to IOCO (Input output coefficient Organization) or Engineering Development Board (EDB) for determining Input/output ratios (IOR). As per Rule 877(6) of EFS, if IOCO does not finalize the Analysis Certificate within thirty days, the WeBOC or PSW system shall automatically allow acquisition against 100% of the value of input goods involved as declared by the applicant provisionally, based on the declared input-output ratios. This provision does not exist in the PSW/ WEBOC system and departments refuse to grant provisional quota. This is a great facility and can boost exports.

3. Most important aspect is that as per Rules if IOR already exists no fresh determination of input/output ratio is required by the IOCO/EDB, which shall use the sectorial database of input/output ratio and wastages. As per Rule 877 (11) the IOCO shall establish a central database of all determination of input or output ratios and, wastages by it, as well as by EDB on a sectoral basis. IOCO will update the sector database by uploading the ratios quantities. IOCO / EDB does not entertain requests to use the database of each sector. If on-visit wastage comes on the lower side than average, then EDB uses sectoral-based data to finalize IOR. As per the above Rule, the Regulatory Collector shall also upload all authorizations granted by him in the database without referring the case to IOCO. Such requests are never entertained

4. EDB then visits the unit to determine input-output ratios. They are required to first import the raw material then they will determine the input-put ratio and determine quota. The issue is that small quantities cannot be imported without a provisional quota. In some cases, the EDB has refused to determine input-output ratios as the import of raw materials was older than 5-6 months and required to import raw material for a test run. How can a manufacturer import small quantities for a trial run to determine IOR? The import process takes at least 2-3 months.

Why locally purchased imported raw materials cannot be used for IOR determination? Even sectoral-based IOR is simply refused. If one has to pay duty and taxes on imports then how will he export the goods competitively for the first consignment?

5. The role of EDB May be curtailed to vehicles and their parts only. The IOCO may determine all input-output ratios and where need be they can call experts of EDB and others in a few items.

6. Units have to wait for months due to long procedures. The first visit is conducted by customs staff and then the second visit is by IOCO if it is an engineering-related item. A joint visit should be carried out by Customs and EDB. Customs are sent to the EDB Islamabad office, which takes 10 to 15 days, and then forwarded it to its field offices in Karachi Lahore, etc. In local field offices (like Karachi) again hard and soft copies of all 15 to 20 documents are demanded which have already been given to Customs. This takes another 15-20 days. IOCO / EDB then sends the application back to the Export Collectorate, which again takes time for issuance of license and quota. One week for forwarding the case and 30 days for IOCO/EDB from the filing of the application has no sanctity and export gets delayed. Please get data from PRAL the date of filing of an application and final uploading of quota will reveal how exports are delayed for months and months.

7. The documentation is another issue. The Customs job is to see income tax registration of unit, land ownership (if the exporter claims ownership), details of raw materials, final product, and remission of duty and taxes sought. The lower staff blackmails by demanding numerous papers. The customs demands irrelevant papers like EPA (Environmental Protection Agency), land papers, SITE NOC, etc. The plea is that it has been written in the Rules that no law is being contravened. If customs has to check every law then how export applications can be processed. Details of exact documents should be specified in consultation with the FPCCI.

8. It takes time to get a bank/Insurance guarantee. The Customs lower staff does not tell the exporter about the exact amount of guarantee till the end. If a guarantee is submitted as per the WeBOC system's calculations of duty and taxes, staff may or may not accept and determine his value and calculate duty and taxes on his own and might return the guarantee. Some solution is needed to make the system automatic. If the staff gets annoyed he will send an Insurance Guarantee for verification. It will delay the case by another 20-25 days at the earliest.

9. Some locally manufactured items are being imported indiscriminately and local industry is being affected. Items imported under EFS, which are also locally produced, may be monitored strictly to save the industry and some reconciliation mechanism in the computer may be developed so that desk audit of such items could be conducted yearly, with a proper risk management system. The time for utilizing the locally produced input materials may also be reduced to one year extendable by 6 months.

II. Issue of DLTL

The Drawback of Local Taxes and Levies (DLTL) scheme has been instrumental in promoting export-led growth and value-added exports in Pakistan. The government's previously announced "Incentive Package" garnered widespread acclaim from the export sector, resulting in tangible progress in export activities. However, the discontinuation of this package has created a setback, impeding the growth trajectory attained. This is crucial to improving the competitiveness of Pakistani exports in the global market. Additionally, numerous genuine cases of exporters have been unjustly rejected due to being labeled as time-barred, despite adherence to the stipulated filing deadlines with the State Bank of Pakistan. These rejections often arise from minor discrepancies, undermining the painstaking efforts of exporters and thwarting the expansion of the export sector. Furthermore, the rebate rates for key sectors, particularly those making substantial contributions to exports, should be set at the higher end. For instance, products from the Pakistan Cutlery Sector, exported globally, including to China, rely on approximately 60% imported raw materials with a value addition of around 40%.

Recommendation:

(i) To sustain this momentum and further boost the export sector, it is imperative to revive and extend the DLTL scheme until 2027. Furthermore, considering the evolving market dynamics and increasing competition, the DLTL rate should be enhanced from 3% to 5%.

(ii) It is also proposed that all time-barred genuine cases of Drawback of Local Taxes and Levies (DLTL) should be considered once again and cleared, as there had been no fault on the part of the exporters.

(iii) Similarly, the rebate for the Cutlery Sector should be raised to 9% facilitating the enhancement of production capacity for exporting units.

(iv) It is proposed that the system and mechanism to claim DLTL claims should be brought at par with the system and mechanism to claim Custom Duty Drawback Claims so that SMEs could be facilitated in filing, processing, and issuance of DLTL claims.

III. Minimize the difference in import levy rates (WHT and Sales Tax etc.) for the import of Industrial Raw Material by Commercial & Industrial importers

At present import levies on industrial raw materials are higher for Commercial importers as the rate of withholding tax, additional sales tax, etc. are higher and in addition to normal sales tax rates, whereas the industrial importers have an edge as far as import levies are concerned. The industrial importer can import materials, but medium and small industries rely on commercial importers for the supply of their input /raw materials. Raw materials/input materials have no other use, except in the industry.

Recommendation: It is proposed the import levies on raw materials and input materials for the industry may be made uniform for commercial as well as industrial importers. Some of the industrial importers are also misusing this facility and the materials are being sold in the market. The flying invoice business shall also be curtailed. To facilitate the SME sector, a uniform rate of import levies is necessary as commercial importers also provide input/materials to the industry on a credit basis, which eases their cash flow.

IV. Ban on Old & Used Construction Machinery

The Ministry of Commerce (MOC) has banned the import of used heavy construction machinery older than 5 years by applying duties and taxes totaling 45%. It is recommended that the import of old and used construction machinery may be permitted.

V. Export Processing Zone (EPZ

In presence of Export Facilitation Scheme the prospects of EPZ look less promising. Thus, it is recommended the relevant department of government may establish a joint committee with Federation of Pakistan Chambers of Commerce and Industry (FPCC) to review EPZ in line with EFS

SALES TAX PROPOSALS

I. Rationalization of tax rates

The standard rate of sales tax in Pakistan at present is 18%, which is quite high for a developing country. A chart showing the sales tax rates in various countries is given below:

Country	Rate %
Afghanistan	10
Australia	10
Bahrain	10
Bangladesh	15
Canada	5
China	13
Egypt	14
India	18
Indonesia	11
Iran	9
Japan	10
Kazakhstan	12
Kyrgyzstan	12
Luxembourg	16
Malaysia	10
Mexico	16
Nepal	13

Country	Rate %
New Zealand	15
Oman	5
Philippines	12
Saudi Arabia	15
Singapore	7
South Africa	15
South Korea	10
Sudan	17
Switzerland	8
Taiwan	5
Tajikistan	15
Thailand	7
Turkmenistan	15
United Arab Emirates	5
Uzbekistan	15
Vietnam	10

Thus, while sales tax rates are undoubtedly higher in some developed countries (mostly in Europe), the rates are lower than Pakistan in many developing countries.
This high rate of tax is coupled with various additions like "further tax", "extra tax", and "value addition tax", which push the rate to over 22%. In many cases, the withholding/deduction of income tax also puts a burden on the transaction.

Such high rates of taxation discourage many potential taxpayers from registering and declaring taxable transactions and put a drag on the economy, preventing investment and optimum economic growth.

Recommendation: It is therefore recommended to reduce the standard sales tax rate considerably. However, keeping in view the revenue conditions and constraints, the sales tax rate may be reduced gradually every year until it reaches 10%. Such a reduction in the rate of sales tax will boost the economy, encourage documentation, and will improve the overall sales tax collection.

II. Withdrawal of Further tax

Further tax was re-imposed in 2013 by insertion of subsection (1A) in section 3 of the Sales Tax Act, 1990. Its rate has been periodically enhanced, reaching 4% in 2023. The stated purpose of further tax is to discourage sales to unregistered persons. However, simple analysis reveals that this purpose has not been achieved and the number of real (tax-paying) registered persons has not been increased. Instead, the high rate of further tax has distorted the supply chain in the following ways:

- Further tax @ 4% on top of the high sales tax rate of 18%, is an unbearable burden for businesses. This discourages many persons from getting registered, declaring their taxable transactions, and paying tax, which is an overall loss for the revenue.

- Unregistered buyers are unwilling to pay the further tax, which therefore has to be paid by the suppliers. This puts an extra financial burden on suppliers.

- Some suppliers avoid further tax by showing fictitious sales to registered persons, while the goods are sold to unregistered persons. In this way, further tax is encouraging 'flying invoices'. The registered persons who purchase 'flying invoices' claim undue input tax or refund, thus causing revenue loss to the government.

- Some suppliers, to avoid the extra burden of further tax, declare the lower value of the goods sold to unregistered persons. Thus, the government believes it has collected an extra amount as 'further tax', but in fact, it lo

The damping effect of further tax (and other distorting measures) can be seen from the fact that the growth of sales tax collection was only 2.3% (from Rs. 2,532 m in 2021-22 to Rs. 2,591 m in 2022-23) despite the high rate of inflation, natural growth of the economy and revenue measures.

Recommendation: It is recommended to withdraw "further tax", to remove undue burden on the compliant taxpayers, encourage growth of the economy, and prevent unnecessary distortions. Instead, FBR should utilize the data already available with it to register the persons engaged in taxable activity who remain unregistered.

III . Withdrawal of Section 8B:

Section 8B of the Sales Tax Act, of 1990 restricts input tax adjustment to 90% of the output tax for the tax period. Its stated purpose is to discourage registered persons from declaring low value-addition and claiming excessive adjustment. This limitation significantly disrupts the cash flow of importers-cum-manufacturers, causing an increase in financial cost, and leading to a rise in the prices of end products consumed by the masses.

Besides, the provisions of law and the computations in the online sales tax return software in IRIS are not in harmony. The contradictions are as follows:

- The law states that restriction of adjustment of input tax shall not apply in the case of fixed assets or capital goods, but the online return software has no such mechanism and applies the 90% restriction even in the case of import/purchase of fixed assets and capital goods.
- The application of section 8B is limited to a tax period, but the software adds the previous tax period's tax credit, and again automatically applies the provisions of section 8B as the combined input tax becomes greater than the output tax.
- Section 8B provides for adjustment of the restricted input tax when a registered person, whose accounts are subject to audit under the Companies Act, furnishes a statement along with annual audited accounts duly certified by auditors showing value addition less than the prescribed limit. However, the software does not cater to this.
- Section 8B does not completely disallow the input tax over 90% of the output tax, but merely carries it forward to the subsequent tax period. This amount is liable to be adjusted/refunded on yearly basis, but the software does not enable this.

The law provides for a refund of the amount when the input tax exceeds the output tax as provided in section 10 of the Act, but this is invariable not refunded. Tax officials invariably demand a default surcharge on the short-paid amount found in the audit but take no notice of the amount of refund pending with the department, and the taxpayer has to pay a mark-up on money borrowed for financing.

Recommendation: It is recommended that section 8B be revoked, or amended to allow for 100% input tax adjustment/refund where the taxpayer can justify the excess input tax. It is further proposed that a default surcharge should not be imposed when the taxpayer's refund claims are pending with the department.

IV. Withdrawal of SRO 350(I)/2024

SRO 350(I)/2024 dated 07.03.2024 was recently issued on the plea of stopping flying invoices. Flying invoices are issued by a few culprits, but the onerous requirements of this SRO are causing difficulties and increasing the cost of compliance for all registered persons, even after series of amendments made by SRO 582(I)/2024 dated 18th April 2024 and SRO 644(I)/2024 dated 7th May 2024.

(i) The **new sub-rule (f) in Rule 5(2)** of the Sales Tax Rules, 2006 requires individuals, AOPs and companies having a single shareholder/member (excluding manufacturers) to submit a balance sheet indicating the business capital, assets and liabilities. Otherwise, filing of the return will have to be authorized by the Commissioner. SRO 350(I)/2024 is not clear whether balance sheet is to be submitted every month, but the FBR has now issued a clarification to the effect that it has to be submitted only once. However, the balance sheet is already available to the department with the taxpayer's income tax return. Asking taxpayers to re-submit with sales tax returns only adds to their cost of compliance.

(ii) The **new proviso to sub-rule (3) of Rule 5** replaces automatic sales tax registration with approval of the LRO, the **new proviso to sub-rule (4) of Rule 5** requires yearly biometric re-verification of the registered person, and amendment in **sub-rule (5) of Rule 5** re-introduces pre-verification before registration. These changes will increase the cost of compliance, re-open the door to harassment and corruption, and thus discourage new registrations.

(iii) The new proviso in Rule 18(1) of the Sales Tax Rules, 2006 requires registered persons showing sales more than five times their declared capital plus liabilities to seek prior permission from the Commissioner for filing sales tax returns.

(iv) The **new proviso in sub-rule (3) of Rule 18** and **new sub-rule (4A)** render the sales tax return as provisional until the suppliers file their respective returns. In other words, it makes the buyer responsible for the returns of the suppliers, which is unjust and impractical. Such measures increase the difficulties for registered persons and discourage others from getting registered. Disallowing input from the buyer, if the seller fails to submit his return, is like punishing someone for a sin committed by another, which is an absolute injustice.

(v) The **new proviso to sub-rule (3) to Rule 20** requires prior approval from the Commissioner for issuing credit notes. Again, this is unrealistic, and cumbersome and will open the door for harassment and corruption.

(vi) The **new proviso to sub-rule (1) of Rule 18** replaces the words "declared business capital" with the words "sum of the capital and liabilities declared in the balance sheet".

Thus despite the amendments made by SRO 582(I)/2024, SRO 644(I)/2024 and clarifications issued by FBR, the changes made in the Sales Tax Rules, 2006 will add to the difficulties of registered persons, increase the cost of compliance, enable harassment and corruption, and discourage new sales tax registrations

Recommendation: The changes made through SRO 350(I)/2024 should be withdrawn, and any measures for curbing flying invoices be introduced only after consulting the stakeholders.

INCOME TAX PROPOSALS

I. Rationalization of Provisions of Withholding of Taxes

The withholding tax regime significantly impacts taxpayers and Inland Revenue Officers alike. On the one hand, the regime has increased the cost of doing business and on the other, it has forced Inland Revenue Officers to devote numerous resources in monitoring these taxes. Even with the best efforts of the Inland Revenue Officers, it is practically impossible to plug all the leakages from the tax collection done by the withholding agents.

Tax administrators all over the world particularly in developing countries like Pakistan face major problems of non-reporting and underreporting of income. The government has introduced various liberal Self-Assessment Schemes to encourage voluntary compliance encompassing virtually all taxpayers including limited companies irrespective of income level. Unfortunately, these measures have fallen short of achieving the objective of broadening the tax base. Furthermore, the Transparency International Corruption Perceptions Index (CPI) has stressed the need for all institutions (including FBR) in Pakistan to strive hard to promote transparency, accountability, and the rule of law.

The withholding and presumptive tax regimes are not new. The presumptive tax approach has been advocated by the Musgrave and well-known French Forfeit System and such laws also exist in countries like Britain, New Zealand, Philippines, Hong Kong, China, Indonesia, Mexico, Russia, Czechoslovakia, and the Channel Islands and Isle of Man. Generally, these apply to only those persons whose income is difficult to determine, easier to evade, or more likely to cross national boundaries. These were initially introduced vide Section 18(3BB) of the Income Tax Act, 1922 in India, through which tax was imposed on trading in liquor, timber, and other forest produce.

In Pakistan, the scope of withholding and presumptive tax provisions was further extended through the Finance Act, of 1991. The withholding tax law has weaved the indirect taxes into direct tax texture and this regime is not only based on the ground of equity but also on the principles of taxability on real income, and to pay tax in a progressive manner.

While initially, the Pakistani tax system required withholding of tax on only two main sources of income (salary and interest on securities), under the current law, the withholding tax regime is applicable for a wide variety of transactions.

Currently, in Pakistan, withholding tax law has been made applicable to almost all categories of taxpayers and the nature of payments under twenty-nine (29) provisions of the law. Furthermore, the withholding agents, who are collecting taxes on the Government's behalf without any remuneration; are being punished heavily even for an inadvertent mistake. Now, the Inland Revenue Officers may recover the tax not deducted or collected as required under the various provisions of the Income Tax Ordinance, 2001 even from the payee; whereas, before this amendment such tax was recoverable from the payer only.

One cannot override the rights of other parties only because a recovery has to be made. Whereas, the superior courts on numerous occasions held that machinery provisions can be extended only to the extent it is permissible under the law.

It is also pertinent that withholding/collection of tax on payment for the sale of goods, services, etc. has ultimately cultivated a culture of "grossing up". With increasing withholding of tax on such activities (and even higher ones for non-filers), most of which are either final or minimum taxes, a significant portion of service/goods providers now require that the tax be borne by the payer. The ultimate effect of this is devastating, with larger businesses passing on the cost to the end consumers and the smaller businesses (who are unable to do so) buckling under this additional cost of doing business. Add on top of this the need to hire specialist tax functions or external consultants, just to keep up with the growing administrative burden on the withholding / collecting agents of computing the withholding tax, filing quarterly statements, and depositing the amounts every week, and smaller businesses are under a serious threat of survival. At a time, when the entire world is looking at the rise of SMEs and technology start-ups, the cost of doing business in Pakistan, due to arduous withholding provisions, hampers the ability of our local innovators.

The default surcharge for non-payment or late payment of tax deducted or collected and stringent, irrational & exorbitant penalties for non-filing or late filing of prescribed statements are being imposed in almost all the cases where such default is observed by the Inland Revenue Officers, even without establishing willful default or mens rea in this regard.

It is also an undeniable fact that given the influx of various notifications, instructions, and circulars in respect of such deductions or collections of tax it has become impossible for taxpayers to monitor and assess their current obligations in this regard.

It is also stated that the legal provisions are scattered in various sections, schedules, circulars, and statutory notifications related to deduction/collection of tax, categories of withholding agents, and status of tax deducted/collected (i.e. adjustable or final).

We at FPCCI therefore propose that in the forthcoming Budget, the Government should consider the following proposals to reduce the cost of doing business, complexity in the tax laws, and leakages from tax collection:

Recommendation:

1. To reduce the withholding tax regime, it is suggested that as a first step, those provisions of law may be withdrawn, in which no substantial revenue has been collected during the recent past.

2. Since the taxpayers are filing quarterly statements of deduction or collection of tax online as such the requirement for filing of annual statements under sections 149 and 165 of the Income Tax Ordinance, 2001 be done away with. There will be no loss of revenue or delay in revenue collection to FBR as tax is already deposited in time and quarterly statements are also being filed accordingly.

3. The rates of withholding and collection of tax are very exorbitant which result in inflation and unfair levy of tax as such should be reduced reasonably, especially on the supply and import of goods.

4. In Pakistan the penalties imposed under the withholding regime have been used as a source of revenue in a too large in scale, size, scope, and intensity. Therefore, it is proposed that the penalties for non-filing or late filing be rationalized and used for deterrence only.

5. The provisions and rate of tax related to withholding/collection of tax should be framed on a long-term basis and not changed frequently.

6. The threshold/limits of withholding of tax on the supply of goods and services provided/rendered should be enhanced from Rs.30,000/- and Rs.75,000/-to Rs.100,000/- and Rs.250,000/- respectively.

7. Mode and manner for monitoring of withholding and collection of tax for large taxpayers be rationalized.

II . Audit and Amendment of Assessment:

a. Audit under Section 177 and 214C of ITO

Every country that taxes income has laws to impose the tax and a system to assess and collect it. Tax assessment is fundamental to tax collection. Globally two systems of taxation can be adopted by the tax authorities to collect taxes namely, Official Assessment System **(OAS)** and Self-Assessment System **(SAS)**

Under the OAS, the responsibility to assess and determine the tax liability of the taxpayer rests with the tax official. On the other hand, under the SAS the taxpayer is required to self-assess its income and tax liability.

Initially, Pakistan recognized the OAS system, under which the tax authorities were empowered to review and assess the income and tax liability of the taxpayer based on the return of income filed.

The concept of Self-Assessment was first introduced in Pakistan for certain categories of taxpayers under specified conditions under the provision of the Repealed Income Ordinance, 1979. Through the Income Tax Ordinance 2001**(ITO)**: effective 01st July 2002, the **"Universal Self-Assessment System" (USAS)** was introduced for all taxpayers in general including companies which also made Pakistan the first country in the region to adopt the system for all taxpayers across the board.

The main aim of the revenue administration is to collect that revenue with minimum administrative and compliance costs. As such more than half of the OECD countries administer Income Tax and Sales Tax (VAT) laws under a system of self-assessment as opposed to administrative assessment and Pakistan is not an exception. The USAS in Pakistan effective from tax year 2003 is based on voluntary compliance and honest reporting of income by the taxable persons of Pakistan. The return of income filed by the taxpayer is deemed to be an assessment order. As such burden of proof to substantiate the entries, deductions, allowances, tax credits, and statements lies on the taxpayers. Therefore, for the success of USAS, this system must be backed by a fair, transparent, efficient, and strong tax audit mechanism.

However, the provisions regarding the selection and conduct of audit from the inception experienced conflicting views, and the taxpayers contested audit selection in the High Courts invoking Article 199 of the Constitution of the Islamic Republic of Pakistan. In these writ petitions, the vires of law as well as administrative arbitrariness were challenged.

A Pakistan's perspective, whilst such powers given to the CIR may be in the interest of revenue, in all honesty, it is practically witnessed that these provisions are exploited more often as a tool to harass the taxpayers rather than as a means for increasing the revenue. There is a possibility of a mistake or a genuine omission/commission. However, having a skeptical attitude that every taxpayer is committing tax fraud and has not declared truthful income or wealth is not appropriate. Tax Authorities should be more courteous and respectful towards existing taxpayers which would eventually help gain the lost confidence of the taxpayers back in the tax machinery.

Unlike audit activities/OAS, which are labour intensive a comprehensive program of information reporting and matching can be an extremely effective tool to verify the reported income and return filing obligations of taxpayers of a vast population of taxpayers, as evidenced by US experience.

Selection for and conduct of audit is not ex facie detrimental to the interest of the taxpayer, however, to exercise such powers; the discretion needs to be structured by framing rules and issuance of policies for ensuring consistency and certainty of procedures; transparency, and fairness. It seems that the FBR continues to focus on the taxpayers who are already within the tax net while those beyond continue to enjoy the ease of non-compliance.

An effective tax audit system is essential to maximize voluntary tax compliance. All the developed tax administrations possess sophisticated tax intelligence systems in place enabling them to enforce voluntary tax compliance. The well-designed information reporting and voluntary tax compliance programs shall create an effective deterrence at minimum cost in the form of reliable tax intelligence information for taxpayers.

The entire world is taking advantage of efficient automation and tax intelligence systems. In New Zealand, the revenue authority generates income tax statements for many taxpayers using information supplied by employers, financial institutions, and other government agencies rather than taxpayers themselves. In the UK, the majority of individuals do not fill in tax returns as their due tax is withheld at source. Tax returns are sent to individuals who need to complete one. In practice this is about 25% of the taxpayer population, being those who are self-employed, have complicated tax affairs, or are in the top tax bracket.

Singapore adopts a risk-based approach in reviewing and selecting income tax returns for audit purposes. Companies are profiled based on the complexity of their businesses and tax matters and risk to revenue. On the other hand, Indian Revenue Authorities have devised and implemented an automated centralized system i.e. CASS for the selection of audit cases, whereby the selection is made based on detailed analysis of risk parameters and 360-degree data profiling of taxpayers.

b. Amendment of Assessment under Section 122(5A) of ITO

Regarding, the amendment of assessment under Section 122(5A) of the Ordinance, it is held by the superior courts that "both the ingredients i.e. erroneousness and prejudice to the revenue should simultaneously co-exist for invocation of the said provisions". However, presently in Pakistan the amendment of assessments is mostly made indiscriminately on surmises, and conjectures, by indulging in fishy inquiries, thus violating all norms of due process of law and good administration; as such in a large number of cases in courts, the taxpayers successfully challenge the abuse of powers and get favourable results.

The power to amend and further amend any order passed as many times as may be necessary by the Commissioner destroys the sanctity of past and closed transactions and increases a tax burden on the existing honest and bonafide taxpayers. Moreover, uncertainty may have implications for taxpayer perceptions about the fairness of the tax system and hence affect the level of voluntary compliance by taxpayers. Uncertainty about the tax implications of a proposed transaction may have adverse economic implications. Taxpayers may be unwilling to enter into economically beneficial transactions if they are not able to obtain assurances about their consequence taxation.

Therefore, we at FPCCI feel that in the forthcoming budget, laws should be formulated in such a manner that there is clarity, fairness, certainty, and finality of an assessment, which has been universally recognized as a hallmark of audit and an amendment of assessment.

Following are few proposals for effective audit selection mechanisms and amendment of assessment based on cogent, honest, and justifiable reasoning and intelligible nexus with the tax affairs of the taxpayers and ability to pay tax:

Recommendation:

1. To place a sophisticated tax intelligence system to gather data from withholding/collection of taxes and third-party information collected based on transactions conducted through computerized National Identity Cards or any other reliable identity.

2. Cases are selected by the Federal Board of Revenue only based on defined Risk Areas or Red Flags that trigger tax audits. The field forces should be restricted to conducting audits of only such cases selected through this defined method.

3. In line with global practice to provide a more supportive legislative and administrative environment for existing self-assessment arrangements and to make the taxation system fairer and more certain.

4. It is suggested that a time frame of 6 months should be prescribed for the tax authorities to initiate and culminate the cases selected for tax audit so that the tax machinery can function efficiently.

5. The amendment of assessment is framed by the field forces under the following circumstances guided by the rules of justice, equity, and judicial consciousness: -

   i) Any income chargeable to tax or sales has escaped assessment, under-assessed, assessed at a low rate, or has been misclassified based on "Definite information" as defined under section 122(5) of ITO.

   ii) The deemed assessment is erroneous (legal error) in so far as it is prejudicial to the interest of revenue (loss of revenue is computable).

6. The Commissioner should not be empowered to amend the assessment as many times as may be necessary on the same issue or point, which has already been a subject matter of reassessment or further assessment proceedings.

7. The time limit for amendment of assessment be reduced to two years from the end of the financial years in which the Commissioner has issued the original order to the taxpayer and one year in case of amended assessment; whichever is later.

8. Relevant laws under the provisions of Direct and Indirect taxes be amended in a manner that:

   i) Once the audit of income tax affairs of any taxpayer for any tax year is conducted/completed under Section 177 or Section 214C of the ITO; there should not be any audit of monitoring of withholding/collection of taxes.

   ii) Once the sales tax audit for any year is conducted in respect of registered taxpayer under Section 72-B of the Sales Tax Act, 1990 (STA) there should not be an audit under Section 25 of the STA.

9. It is imperative that a system of Advance Rulings i.e. "Binding Public and Private Ruling for Residents and Non-Residents" be introduced which will minimize disputes and litigations.

10. The accountability framework and service standards should be introduced for the FBR's employees, more particularly for the Revenue Officer with respect to the quality of assessment order and standing of their orders in the test of appeal including but not limited to final revenue generated by the exchequer.

III. Capital Value Tax on Foreign Assets

Capital Value Tax was introduced through the Finance Act, of 1989 for the first time in the history of Pakistan. The purpose and rationale for bringing this tax in Pakistan were to tax assets that were created from untaxed money, especially with the acquisition of properties and vehicles.

The above understanding is based on the budget speech of Mr. Ihsan ul Haq Piracha the then Finance Minister, while presenting the Federal Budget for the year 1989-90. He categorically stated that this tax would only be levied on persons who are not registered with the tax authority. If any person filed a Wealth Tax return then he was allowed to adjust the payment of CVT against his wealth tax liability.

Later on, the tax was levied on the sale, transfer, or gift of immovable property, such as land or buildings irrespective of the fact that such person is either making such investment from taxed money or not. It was also levied on motor vehicles, stocks, etc.

Now the Finance Act, 2021 reintroduced CVT on the total (gross) cost of the foreign assets declared by the existing taxpayers on the last day of the tax year, in relevant foreign currency converted into rupees as per the exchange rate notified by the State Bank of Pakistan for the said day. Even the liability created by the taxpayer for the purchase of such foreign assets or investment made in the foreign assets viz bank balances, stocks, etc is allowed to be deducted against such foreign assets.

This levy has been imposed to increase the direct tax revenue (a few billion) from the existing taxpayers rather than to broaden the tax net and tax such persons who are not existing taxpayers.

On the one hand, the government is taxing a resident person's global income viz rental income from immovable property or profit on debt (interest), and on the other hand, the CVT is imposed on such foreign assets generating taxable income, which is tantamount to be double taxation and violation of the generally accepted principles of tax law, as such inequitable and unjust. It is pertinent to point out that in most of the cases of foreign assets generating income; the total tax i.e. income tax and CVT on such foreign assets increased to above 50% of the income earned.

CVT is also payable by the resident expatriates as well, (who become residents temporarily by employment exercised in Pakistan) which seems ridiculous why should a foreign national who is here in Pakistan to work on important or national projects, etc. be required to pay CVT on his assets in his home country or elsewhere, while he is in Pakistan temporarily.

The enactment of CVT law is unconstitutional, unlawful, illegal, and void because:

i) It has been imposed retrospectively; which has negatively affected the vested right of the taxpayer.

ii) It is discriminatory, as it does not apply to Non-resident Pakistanis as well as those who are Residents but not existing taxpayers.

iii) Falls outside the scope of the Federal Legislature's scope of competencies, specifically under Entry No.50, Part I of the Fourth Schedule to the Constitution of the Islamic Republic of Pakistan, 1973 concerning those taxpayers holding foreign immovable property as there is no provision in the Federal Legislative List which empowers the Federal Legislature to impose taxes upon immovable property, regardless of whether the properties are situated within or outside of Pakistan.

iv) That in the year 2018 the Foreign Assets (Declaration and Repatriation) Act, 2018, (Act 2018) was promulgated with the express representation made therein, that a one-time tax would be charged on the movable and immovable assets held outside of Pakistan, declared under the **Act 2018** at the rates set out in Section 7 of the Act, 2018. It was also provided that the provisions of Act 2018 shall have effect notwithstanding anything to the contrary contained in any other law for the time being in force. Therefore, the Federal Legislature was not competent to impose CVT on such foreign assets which are declared under Act 2018.

It would be appreciated that many of these residents have decided and leave Pakistan or are spending major time abroad to become Non-Residents in Pakistan, depriving Pakistan of their availability for the development of their existing businesses in Pakistan or venturing into new businesses. This is a very dangerous trend and this development could have a far-reaching impact if remedial measures are not taken immediately. Its repercussions are depriving Pakistan of not only valuable capital but also draining our entrepreneurial capital and brain drain of top Pakistani executives.

The above taxation measure has also witnessed an adverse impact on the flight of capital from Pakistan. Our economy has reached the brink of collapse and requires concerted efforts to rebuild from whatever we are left with.

A classic real example of that is recent news that surfaced online that a Pakistani businessman ranked second in joining the Dubai Chamber of Commerce in 2023. In simple words, if we compel a businessman to change his economic adobe, the capital that he has invested would move along with him. Against this backdrop and many more notional domestic problems, taxing declared foreign assets of residents is proving to be a nail in the coffin.

On the other hand, several jurisdictions in the world like Dubai are welcoming foreign investors with lots of incentives and no or reduced taxation. We must encourage our local investors to grow locally and globally.

One must understand that local investment in business is a must to show strength to foreign investors.

Recommendation: Therefore, we at FPCCI propose that in the forthcoming budget, CVT should be abolished on residents' foreign assets, and instead focus should be placed on broadening of the tax base.

IV. Tax on Deemed Income under Section 7E of the Income Tax Ordinance,

Tax on "Deemed Income" concerning immovable property has been introduced vide Finance Act, 2022 by inserting section 7E of the Income Tax Ordinance, 2001 **[the "Ordinance"]**. The newly inserted Section 7E read with Division (VIIIC) of Part (I) of the First Schedule to the Ordinance shows that immovable capital assets situated in Pakistan are to be taxed based on a deemed income derived there-form, which deemed income is to be an amount equal to twenty (20) percent of five (5) percent of the fair market value as defined under section 68 of the Ordinance of the said capital assets. The term "Capital Asset" has been defined as *"Property of any kind held by a person, whether or not connected with a business excluding movable assets"*.

The said levy is in violation and beyond the mandate of Entry 47 of Part I of the Fourth Schedule to the Constitution of the Islamic Republic of Pakistan 1973 **(the Constitution)** as there is no transaction nor any resultant income. It effectively attempts to levy tax on immovable property which is not permissible under Entry 50 of the Federal List of the Constitution.

The said "Tax on Deemed Income" is in pith and substance a wealth tax on immovable property which is beyond the constitutional authority of the Federal Government under Entry 50 of Part I of the Federal Legislative list of the Constitution lacks the legislative powers to levy tax on Capital assets i.e. immovable property.

After 18th Amendment Act, 2010, no provision in the Federal Legislative List empowers the Federal Legislature to impose taxes upon immovable property. Entry 50 of Part I of the Federal Legislative list (post 18th Amendment) provides that ***"taxes on the capital value of the assets, not including taxes on immovable property."***

The said provision of section 7E of the Ordinance is discriminatory and violative of Article 25 of the Constitution as all resident persons owning immovable property have not been charged to the said tax on so-called "deemed income", but only those resident persons who are in the tax net and filing Wealth Statement and Return of Income under the provisions of the Ordinance. Moreover, the exclusions of resident persons given in sub-section (2) to section 7E of the Ordinance is also manifestly discriminatory in that it exempts capital assets (immoveable properties) of certain persons listed in this section without any justification and is in violation of fundamental rights of the taxpayer guaranteed under Article 25 of the Constitution.

The definition of Income as contained in sub-section (29) of Section 2 of the Ordinance does not encompass "any sum deemed to be income" as Income. Hence the levy of "Tax on deemed Income" as per section 7E of the Ordinance is illegal. Under the provisions of the Ordinance, only actual rent is taxable, and "rent" has been defined under sub-section (2) to Section 15 of the Ordinance as "rent" means any amount received or receivable by the owner of land or a building as consideration for the use or occupation of, or the right to use or occupy, the land or building, and includes any forfeited deposit paid under a contract for the sale of land or a building." Interalia the above provision means that Income from a property can only be taxed if it is rented out. No other deemed income or incidence under the law can be created. The Senate of Pakistan made the following recommendations on the budget proposals contained in the Finance Bill, 2022 in respect of proposed section 7E of the Ordinance:

"Senate of Pakistan recommends to the National Assembly that the proposed provisions of section 7E, as added vide clause 5(5) of the Finance Bill 2022, may be omitted being unjustified and ultra-vires the Constitution."

Section 7E (1) of the Ordinance expressly states that it is to impose the said tax "for the tax year 2022 and onwards ... ", which means it was to be applied retrospectively, starting from the tax period of 01.07.2021 to 30.06.2022. As such, the imposition of the tax has put heavy financial burden upon the existing taxpayers. In addition to its being ultra vires the Constitution of Pakistan 1973, negatively affects the vested right already accrued upon the bonafide taxpayer. The tax on the fair market value of the subject immovable properties is past and closed transactions and the same violates well-established principles of tax laws.

Based on the above illegalities number of writ petitions were filed in the High Courts of the Country, where several conflicting judgments have been passed. Now such conflicting judgments are pending before the Honourable Supreme Court of Pakistan for adjudication and to finally settle this legal issue.

Recommendation: We at the FPCCI are of the firm view that tax under section 7E of the Ordinance is not on real income at all but tax on immovable properties, as such it is unconstitutional, unlawful, illegal, void ab initio, and ultra vires the Constitution of Pakistan, 1973; as such liable to be abolished. We, therefore propose that in the forthcoming Budget Section 7E of the Ordinance should be abolished

How Taxes Shape our Financial World

2

2. How Taxes Shape our Financial World

Taxes play a pivotal role in shaping our financial world, influencing economic decisions at every level – from individual households to multinational corporations they broadly fall into two categories: distortionary and non-distortionary taxes, each influencing economic behaviour uniquely. Indirect taxes, an integral part of fiscal measures, have a notable effect on consumer behaviour and prices.

Distortionary taxes, like excise taxes and VAT, discourage activities such as consumption and investment, reducing economic growth and productivity. They create inefficiencies, leading to a deadweight loss that hinders economic efficiency and growth. Reducing distortionary taxes, while ensuring adequate revenue collection, is often a key policy objective to promote economic growth and efficiency.

On the other hand, non-distortionary taxes, also known as neutral or lump-sum taxes, do not alter economic behaviours and decisions, meaning they do not create incentives or disincentives for specific activities. Non-distortionary taxes can have a more favourable impact on economic growth compared to distortionary taxes because they do not introduce inefficiencies or alter economic incentives significantly. These taxes can be less harmful to economic growth since they do not lead to deadweight losses and distortions in resource allocation, making them a preferred choice for tax policies aimed at promoting economic efficiency and growth.

2.1. Balancing Tax Revenues: Re-Thinking Tax Composition

Pakistan relies heavily on regressive indirect taxes, constituting about 60% of total taxes. On average, Pakistan meets 88% of its direct tax and 95% of its indirect tax targets, revealing ongoing challenges in tax collection.

The government is experiencing a considerable revenue gap, particularly in direct taxes (Table 1), despite setting conservative targets. Analysis shows that approximately 4,349 billion of the total revenues in 2022-23 come from indirect taxes. To address this, Pakistan needs a comprehensive strategy for revenue mobilization across direct and indirect taxes, focusing on improving compliance, expanding the tax base, and establishing an equitable tax system.

1.A study by Arnold Harberger in 1962, commonly referred to as the "Harberger Triangle," The Incidence of the Corporation Income Tax. Journal of Political Economy, 70(3), 215-240).

2.Research by Fullerton and Rogers (1993) Who Bears the Lifetime Tax Burden? American Economic Review, 83(3), 568-577)

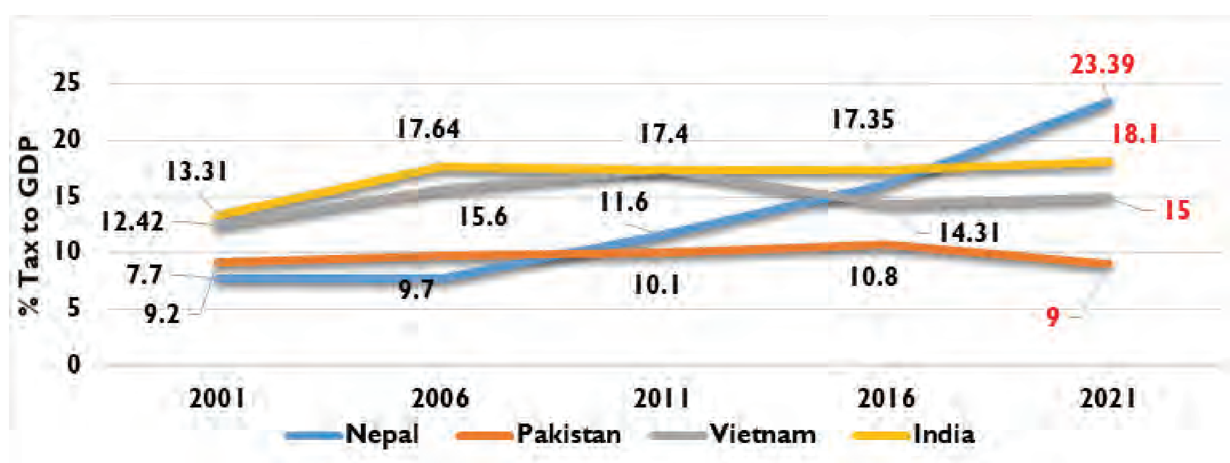
Table 1: Comparison of Target and Actual Tax Revenues (Rs. Billions)

		2019-20	2020-21	2021-22	2022-23	2023-24
Tax Revenue Receipts						
	Target	5,555	4,963	5,829	7,470	9,415
	Actual	3,997.4	4,734.3	6,050	7,200	
Surplus (+)/Shortfall (-)		-1,557.6	-228.7	221	-270	
Actual as % of Target		71.9%	95.3%	103.8%	96.4%	
Direct Taxes						
	Target	2,081.9	2,043	2,182	3,039	4,255
	Actual	1,523.4	1,726	2,234	2,851	
Surplus (+)/Shortfall (-)		-558.5	-3170	52	-188	
Actual as % of Target		73%	84%	102%	93.8%	
Indirect Taxes						
	Target	3,473	2,920	3,647	4,431	5,160
	Actual	2,474	3,008.3	3,816	4,349	
Surplus (+)/Shortfall (-)		-3919	88.3	169	-82	
Actual as % of Target		71%	103%	105%	98%	

2.2. Falling Behind: Pakistan's Tax-to-GDP Ratio versus Peer Countries

Pakistan's tax-to-GDP ratio lags behind its peer countries, namely India, Nepal, and Vietnam, as evident from Figure 2 below. The tax-to-GDP ratio is a critical measure of a country's ability to generate tax revenue in proportion to its economic output. As of Figure 2, India has experienced a steady increase in its tax-to-GDP ratio, rising from 13.3 percent in 2001 to 18.1 percent in 2021. Similarly, Vietnam has shown improvement, with its ratio increasing from 12.4 percent to 15 percent from 2001 to 2021 respectively. Nepal stands out with a remarkable leap, with its ratio soaring from 7.7 percent in 2001 to an impressive 23.5 percent in 2021. In contrast, Pakistan's tax-to-GDP ratio has fluctuated within the range of 8 to 10 percent during the same period.

Figure 1: Comparison of Tax to GDP Ratio of Pakistan with India, Vietnam and Nepal



Source: Finance Division, Pakistan, Ministry of Finance, India, World Bank

To boost tax revenues and improve its tax-to-GDP ratio for sustainable economic growth, Pakistan must prioritize taxreforms and bolster tax administration. Learning from successful models in other nations that have widened their tax bases and implemented robust compliance measures, Pakistan can overcome its challenges and enhance revenue generation.

lesson to be learned from Nepal

Over the past two decades, Nepal has made substantial strides in revenue generation despite facing ongoing political and economic challenges. The country's domestic revenues nearly doubled in proportion to its GDP during this period. Nepal's successful enhancement in Domestic Resource Mobilization (DRM) stems from a well-executed, long-term approach involving tax policy and administration reforms

His journey commenced with the introduction of value-added tax (VAT) in 1997, replacing the focus on sales tax. Additionally, a new income tax act was enacted in 2002. These legislative changes were coupled with administrative advancements, such as the swift adoption of Information and Communications Technologies (ICT) through initiatives like the Permanent Account Number (PAN) for taxpayers. Alongside, organizational restructuring and improved taxpayer services were implemented to bolster the tax system

Broadening the Tax Base

3

3. Broadening the Tax Base

Issue:

In Pakistan, a substantial part of economic activities operates in the shadows of the formal economy, evading taxes and eluding detection by tax authorities. This covert spectrum of activities collectively termed the "black economy," encompasses practices like smuggling, corruption, and other illicit activities aimed at dodging taxes. Tax evasion encompasses any illegal actions taken to avoid legitimate tax payments, and contributes to the expansion of the informal economy.

The estimated size of Pakistan's untaxed economy stands at Rs. 50,000 billion. Estimatdly a flat tax rate of 10 percent to those previously evading taxes could potentially yield Rs. 5,000 billion in revenue for the Federal Board of Revenue (FBR) within a year totalling Rs. 14,000 billions. This projected revenue could significantly surpass the FBR's collection of Rs. 9,400 billion in the current fiscal year.

Pakistan has struggled to significantly increase its registered tax base, which has remained stagnant at less than one percent of the total population for many years. The introduction of the concepts of filers and non-filers in recent years aimed to incentivize increased filing of income tax returns, but these measures have failed to achieve the intended expansion of the tax base. Over one million non-filers have been identified besides unregistered persons. If unregistered persons are also included in the data, the FBR will bring nearly 2 million new taxpayers into the tax net till June 2024.

In comparison to neighbouring India, Pakistan exhibits a much narrower tax base, with a significantly lower percentage of individuals contributing to total income tax and a vastly lower proportion of return filers. Out of the 3.6 million registered individuals who filed tax returns, 2.2 million reported taxable income, while the remaining 1.4 million declared zero income in their annual tax returns.

During the tax year 2021-22, the Federal Board of Revenue (FBR) collected Rs1.6 trillion in income tax. Shockingly, a mere 13,958 taxpayers contributed a significant 75% of this total income tax collection, amounting to Rs1.194 trillion. These 13,958 individuals represented only 0.39% of return filers and a minuscule 0.005% of the total population.

Discription	Pakistan	India
contribution to total income Tax	75%	90%
Percentage of return filers	0.39%	22%

These findings underscore Pakistan's shallow tax base, necessitating urgent measures for broader tax compliance.

Report184-libre.pdf (d1wqtxts1xzle7.cloudfront.net)
https://tribune.com.pk/story/2430919/tax-reforms-commission-unceremoniously-sent-packing
https://www.theigc.org/blogs/taxing-effectively/why-does-pakistan-tax-so-little
Resource Mobilization Commission (PRMC). Report
FBR
Income Tax Department India

Recommendations:

1. The different rates for non-filers unintentionally discourage them from filing taxes. There is a need to convert non-filer tax rates across the board into a five-to-six-year scheme subsequently abandoning non-filer tax status.

2. The existence of 31 separate, local, provincial, and federal tax authorities in Pakistan presents significant obstacles to tax compliance, leading many individuals to avoid filing their taxes altogether. To address this challenge and promote tax compliance, it is suggested that all tax authorities consolidate their databases into a unified platform.

3. Broadening the tax base is a crucial aspect of tax policy aimed at increasing the number of taxpayers contributing to government revenue. Therefore, the government may define the measures related to property valuation in broadening the tax base.

4. Ease up the tax return filing process so that non-expert persons can also submit their tax returns without incurring tax compliance costs. Effective tax management and administration play a vital role in fostering business growth and formalization. Pakistan's position in the ease of paying taxes indicator, as per the World Bank's Doing Business-2020 report, underscores challenges in tax administration. Ranked at 161 out of 190 countries, Pakistan's system falls behind countries like India (115), China (105), Bangladesh (151), Cambodia (138), Ethiopia (132), and Vietnam (109).

5. To bolster tax compliance and broaden the tax base, the government should prioritize collaboration with professional associations, such as those representing doctors, accountants, lawyers, engineers, pharmacists, chartered accountants, CFA charter holders, ACCA affiliates, and other professional bodies. By leveraging these associations as conduits for tax information, the government can effectively bring more professions into the tax net. Additionally, considering that many of these professionals require licenses or certifications to practice, the government can tie tax compliance requirements to the renewal or maintenance of these licenses. Implementing such measures would incentivize professionals to fulfill their tax obligations promptly, thereby enhancing overall tax compliance and revenue collection. This collaborative approach not only strengthens the partnership between the government and professional associations but also fosters a culture of tax compliance and accountability within these professions.

6. To foster a culture of tax compliance, the progressive levies on non-filers could be escalated significantly.

7. To mitigate the risk of fraudulent transactions, a maximum ownership threshold of 12 cars per individual may be imposed for filers, thus deterring benami purchases by non-filers.

Report184-libre.pdf (d1wqtxts1xzle7.cloudfront.net)

8. To uphold tax accountability, individuals who remain non-compliant with income tax filing for two consecutive years despite registration should face travel restrictions, including the blocking of their passports.

9. To address the misuse of tax registration for short-term benefits, measure should be implemented to prevent individuals from deregistering within five years of initial registration, except under circumstances such as death or bankruptcy, thereby discouraging opportunistic behaviour and ensuring sustained compliance.

Rationale:

The proposed amendments would result in increased visibility of potential taxpayers and incentivize registration with the tax authorities without increasing the burden on existing taxpayers

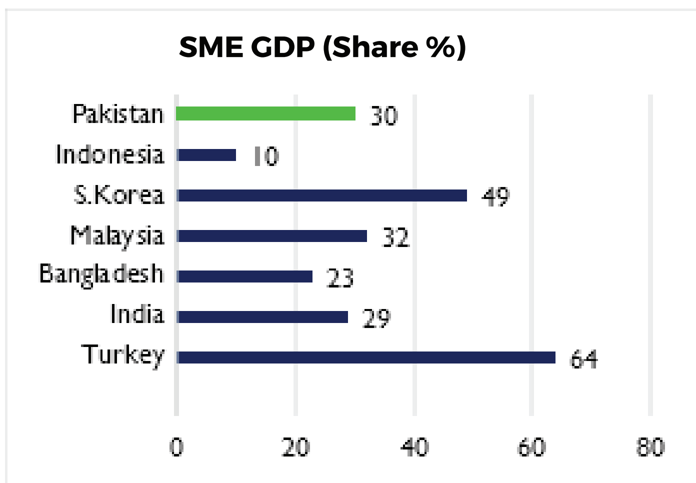
Micro, Small & Medium Enterprises

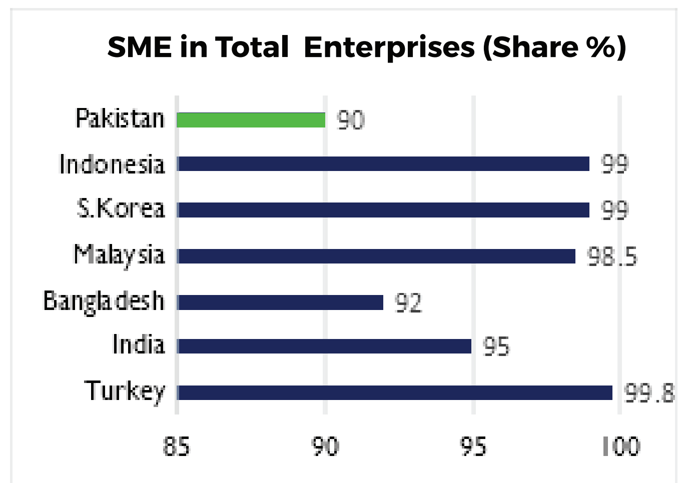
4

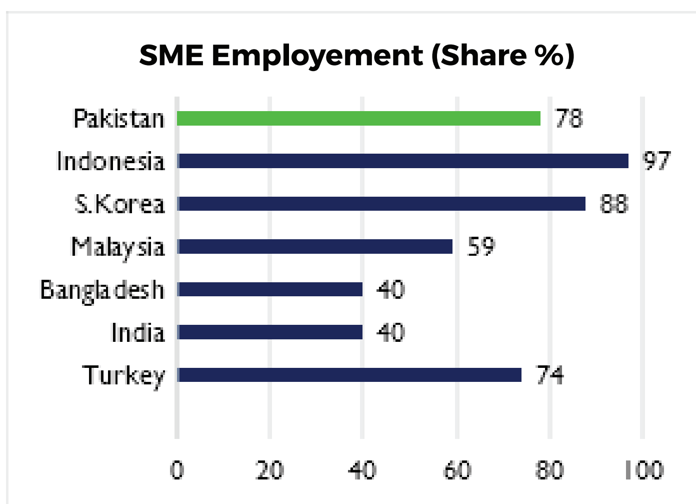
4. Micro, Small and Medium Enterprises

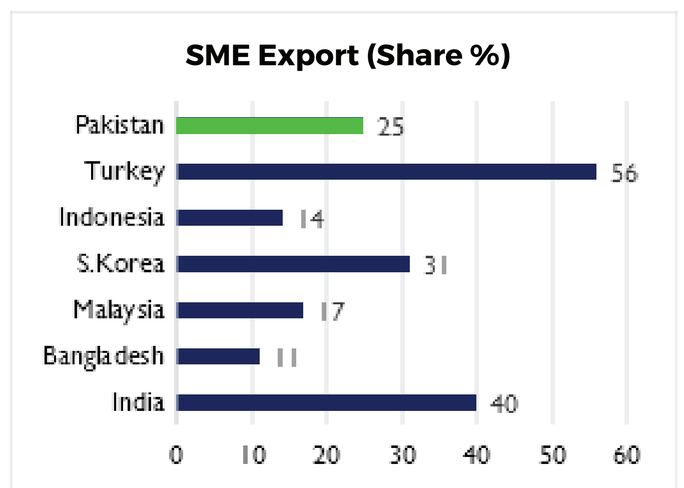
Small and medium-sized enterprises (SMEs) possess significant potential to make substantial contributions to Pakistan's economy. Much like in emerging economies worldwide, SMEs in Pakistan dominate the business landscape, comprising over 90% of the total business establishments. They play a crucial role in driving employment, boosting exports, and fostering economic growth.

According to the latest findings from the Asian Development Bank (ADB), SMEs contribute to 30% of Pakistan's GDP compared to 29% in India, and 23% in Bangladesh. Given that 78% of Pakistan's labour force is employed by the SME sector, a stark contrast to 40% in both Bangladesh and India and considering that the SME sector in Pakistan contributes 25% to the country's total exports, compared to 11% in Bangladesh and 40% in India, these figures underscore the significance of the SME sector in shaping the country's economic landscape. Therefore, it is imperative to provide incentives to bolster the SME sector.









Issues:

However, a notable challenge lies in the fact that many Pakistani SMEs predominantly operate in the informal sector. Estimates suggest that Pakistan's undocumented or shadow economy constitutes a substantial portion of the country's official gross domestic product (GDP), ranging from 40% to 56%. The extent of informality is further highlighted by the Labour Force Survey (LFS) data, which indicates that the informal sector accounts for more than 70% of non-agricultural employment as of the 2020-21 survey.

A compelling indicator of informality emerges from the data provided by the Federal Board of Revenue (FBR). While a recent census of business establishments is not available, proxy data suggests the presence of nearly 5.2 million SMEs in Pakistan. Surprisingly, FBR's 2018 filing data reveals that only around 64,000 associations of persons (AOPs) filed tax returns. This stark contrast signifies that only a small fraction of SMEs are formally registered with the national tax collection agency.

In essence, the available data strongly indicates that a considerable number of Pakistan's SMEs primarily operate within the informal sector, with approximately 74% of SMEs operating outside the formal tax net presenting a noteworthy challenge and an opportunity for policy intervention and formalization efforts..

The complexity of Pakistan's tax structure exacerbates the problem, with multiple taxes are often difficult for SMEs to comprehend and comply with. Additionally, many SMEs lack financial literacy and proper record-keeping practices, hindering tax assessment and collection efforts. Furthermore, Pakistan's tax administration faces capacity constraints, including a shortage of trained tax officials and outdated technology. Corruption and bureaucratic hurdles further discourage SMEs from formalizing their operations and paying taxes.

As per the findings from the SME Finance Access Survey conducted by the State Bank of Pakistan, SMEs face a considerable challenge due to restricted access to finance. This limitation stems from high collateral requirements, intricate loan procedures, and elevated interest rates, which collectively hinder SMEs' ability to secure the necessary funding for their operations and growth.

Khuong, Nguyen Vinh, Malik Shahzad Shabbir, Muhammad Safdar Sial, and Thai Hong Thuy Khanh. 2020. "Does Informal Economy Impede Economic Growth? Evidence From an Emerging Economy." Journal of Sustainable Finance and Investment 11 (2): 103–122. https://doi.org/10.1080/20430795.2020.1711501

Pakistan Bureau of Statistics. 2022. Key Findings of Labour Force Survey 2020–21. Islamabad: Ministry of Planning, Development, and Special Initiatives. https://www.pbs.gov.pk/sites/default/files/labour_force/publications/lfs2020_21/Key_Findings_of_Labour_Force_Survey_2020-21.pdf

The FBR does not separately categorise SMEs—they are part of the two categories defined by the FBR, i.e. AOPs and small companies

The Informal Economy in Developing Nations: A Hidden Engine of Growth?" by S. Arby and M. Tahir (PIDE Working Papers, 2017)

Financial Literacy and SME Performance: Evidence from Pakistan" by S. Shujaat and M. Ahmad (Journal of Small Business and Enterprise Development, 2018)

Tax Administration Reforms in Pakistan: Challenges and Way Forward" by A. Khan and M. Amjad (Pakistan Development Review, 2020)

Corruption and Tax Evasion: Evidence from Pakistan" by S. Abbas and M. Farooq (The Pakistan Development Review, 2016)

Recommendations:

1. Introduce an online system tailored for SMEs to streamline compliance with Withholding Tax (WHT) requirements. This initiative aims to reduce the administrative burden on SMEs, enhance tax compliance, and foster SME development. This digital platform will provide SMEs with a user-friendly interface to fulfill their tax obligations efficiently and accurately. By reducing the administrative workload associated with tax compliance, SMEs can allocate more resources towards business development and growth initiatives. Additionally, enhanced tax compliance resulting from the ease of use of the online system will contribute to a more transparent and robust tax environment, benefiting both SMEs and the broader economy.

2. Launch a 5-year Tax Formalization Scheme for SMEs to expand the tax base. Under this scheme, SMEs may be incentivized to formalize their businesses and file income tax returns. This will include:

    i. Providing a tax holiday or break for SMEs in the year following income tax return filing, incentivizing them to comply with tax regulations

    ii. Introducing a subsidized business loan scheme specifically tailored for new SME tax return filers. This scheme will offer favorable terms and conditions to facilitate access to finance for SMEs transitioning into tax-compliant entities.

Rationale:

Alleviate the administrative burden on SMEs, improve tax compliance, and facilitate the development of SMEs

Formalizing the Retail & Wholesale Sector in Pakistan

5

5. Formalizing the Retail and Wholesale Sector in Pakistan

Pakistan's economy relies significantly on its retail and wholesale sectors, serving as integral components of the nation's economic framework. These sectors not only contribute substantially to the country's Gross Domestic Product (GDP) but also form essential links within the supply chain. Retail trade primarily involves direct sales to consumers, while wholesale operations focus on the bulk distribution of goods to retailers, businesses, and various institutions. It comprises 31% of the service sector, which accounts for 58% of Pakistan's economy, the combined contribution of wholesale and retail to the GDP stood at 18% in FY23. However, it's worth highlighting that their combined contribution to the overall tax revenue is less than 1%

Obstacles in Reforming Pakistan's Wholesale and Retail Trade Sector: A Chronicle of Reform Attempts and Hindrances

- **June 1998:** Efforts to include the retail sector in the General Sales Tax (GST) faced protests and were overturned.
- **2000-2001:** Attempts by the military administration to assess the retail sector's turnover value were met with widespread opposition, including prolonged shutter-down strikes in Punjab and Sindh, preventing its implementation.
- **2011-2016:** Substantial opposition and effective resistance against tax-related reforms targeting the retail sector were witnessed in various years.
- **2019:** The introduction of CNIC submission for transactions above PKR 50,000 faced strong trader resistance, leading to its suspension and eventual rollback in the 2022 budget.
- **2022:** Proposal for a fixed tax on non-Tier 1 retailers through electricity bills was retracted following opposition from WRT sector representatives and changes in finance ministry leadership.

Issues:

The prevalence of informality within the Wholesale and Retail Trade (WRT) sector holds considerable fiscal implications, particularly when compared to the more structured Manufacturing sector. In terms of direct taxes, the Manufacturing sector contributes significantly, representing 34.5% a substantial 22% higher than its GDP share. Conversely, the Wholesale and Retail Trade sector contributes a mere 2.9% towards direct taxes, indicating a 15% deficit compared to its GDP share.

There exists a noticeable disparity in domestic sales tax collection between the Wholesale and Retail Trade (WRT) sector and the manufacturing sector. Data drawn from non-manufacturing, non-importing business sales tax returns provided by Associations of Persons (AOPs) and Individuals reveal that the overall percentage contribution of the WRT sector to domestic sales tax stands at a meagre 1.65%. In stark contrast, the manufacturing sector contributes significantly, exceeding 75% of the total domestic sales tax collection.

A significant division exists within the sales tax regulations, separating enterprises into Tier 1 retail and non-tier retail categories. These tiered regulations, initiated in 2014, mandate mandatory registration under the existing sales tax rules at specified rates outlined in the Sales Tax Act.

a) Complex Tax Structure

Moreover, the taxation system in Pakistan is complex and can be burdensome for businesses in the wholesale and retail sectors. Multiple taxes, including sales tax, value-added tax (VAT), income tax, and local taxes, create a convoluted structure, making compliance difficult. According to the World Bank's Ease of Doing Business Index, Pakistan ranks relatively low in the "Paying Taxes" indicator, indicating the complexity and burden of tax compliance.

b) Supply Chain Disruptions and Inflation

Political instability, natural disasters, and global economic fluctuations in Pakistan impact tax collection in the wholesale and retail sectors. Additionally, global economic shifts affect imported goods' costs, squeezing profit margins and impacting tax obligations. Furthermore, inflation reduces purchasing power, affecting sales volumes and tax revenues from these sectors. Collectively, these factors pose challenges to tax enforcement and revenue collection efforts in Pakistan's wholesale and retail industries.

c) Compliance Challenges

The compliance requirements, including filing tax returns, maintaining records, and adhering to tax collection mechanisms, pose challenges for small and medium-sized businesses in the wholesale and retail sectors. The bureaucratic procedures and paperwork involved in tax compliance can be overwhelming for businesses with limited resources and capabilities.

The data on domestic sales tax collection from the Wholesale and Retail Trade sector and the manufacturing sector were derived from non-manufacturing, non-importing business sales tax returns submitted by Associations of Persons (AOPs) and Individuals

Institute of Business Administration. (2020). Impact of Inflation on Purchasing Power, Sales Volumes, and Tax Revenues in Pakistan's Wholesale and Retail Sectors

Recommendation:

1. Countries that have effectively reduced tax informality within the wholesale and retail trade sector have employed a mix of incentive-driven interventions. Strategies involve strengthening state capabilities for market intelligence, enforcing mandatory business registration, and implementing value-chain documenting technologies (e.g., Point-of-Sale systems, similar to the initiative being pursued by the FBR).

   Additionally, to encourage compliance, these countries have provided greater incentives, including improved access to formal-sector finance, reduced tax rates, and increased allowances for input-tax adjustments. These measures are intended to enhance compliance within the sector and promote a shift towards formalization.

Strategies Implemented	Results from Adoption
• Market Intelligence Enhancement • Mandatory Business Registration • Value-Chain Documenting Technologies • Digitization of the retail and wholesale sector	**Bangladesh** experienced a significant 25% increase in tax revenues from the retail trade sector within two years of implementation. **Sri Lanka** observed an impressive 30% surge in tax collection from wholesale and retail trades, demonstrating the efficacy of these strategies in enhancing compliance and tax revenue in similar contexts. **India's** retail and wholesale sectors leverage QR codes, transforming traditional methods. QR codes enable swift, secure digital payments from small vendors to large businesses. This move aims to formalize the economy, reducing cash reliance and fostering transparency.

The government can employ both penalty and incentive mechanisms to bring 2.3 million Wholesale and Retail Trade (WRT) entities under the tax net.

2. The expansion of the Point of Sale (PoS) initiative holds significant promise for creating comprehensive sales documentation, especially if it extends its reach beyond major cities to include regional tax offices. It's important to note that cities beyond Karachi, Lahore, and Islamabad make substantial contributions in terms of population growth and economic activity.

   Incentivizing consumers plays a crucial role in seamlessly integrating PoS systems. Implementing a program that rewards consumers—such as offering points or specific benefits upon presenting a PoS slip after purchase—can drastically reduce transactions from unregistered retailers and wholesalers. This not only encourages the adoption of PoS machines but also promotes better compliance among retailers and wholesalers with tax regulations. Therefore, facilitating a mechanism for banks to provide rewards or points to buyers for transactions made through the PoS system could further boost its usage. *In addition 5% cashback on sales tax may be awarded as an incentive to consumers which will also encourage merchants to get benefit through adoption of POS machines.*

Strengthening state capabilities for market intelligence to track and monitor retail transactions more effectively.

Enforcing mandatory business registration for all retailers to bring them into the formal tax system

Implementing value-chain documenting technologies like Point-of-Sale systems (similar to the initiative pursued by the FBR) to create transparent transaction records.

Additionally, for retailers outside the tier-1 category, the government could consider utilizing a QR system.

Furthermore, there's a pressing need to modernize and simplify the process of filing tax returns. The current complexity of the FBR system often compels tier-1 retailers to engage experts solely for filing returns. Simplifying this process could significantly alleviate this burden.

3. Through the provisions in the Finance Bill of 2022, changes were introduced in Section 235 of the Income Tax Ordinance (ITO), proposing a simplified tax structure for retailers (excluding Tier-I) and specified service providers leveraging commercial electricity connections. These modifications aimed at implementing flat tax rates, primarily focusing on augmenting tax revenue without an explicit goal of broadening the tax base.

4. Consider introducing reduced Income Tax Rates, offering a 20% to 50% tax credit for small merchants for 3 to 5 years, to encourage fully integration of retailers with FBR. This measure can help in broadening the tax base, fostering confidence and viability for compliant retailers

Rational:

Countries have successfully reduced tax evasion in wholesale and retail sectors by combining incentives and penalties, improving market intelligence, and mandatory business registration. Expanding initiatives like the Point of Sale system and simplifying tax filing processes can further boost compliance. Proposed changes in tax structures, alongside incentives and simplified processes, aim to broaden the tax base and promote formalization, fostering economic growth

The Federation of Pakistan Chambers of Commerce and Industry

FPCCI HEAD OFFICE,KARACHI
Federation House, Main Clifton, Karachi, Pakistan
Tel: 021-35873691-94 Fax: 021-35874332

FPCCI CAPITAL HOUSE, ISLAMABAD
E-mail: islamabad.capital@fpcci.org.pk

FPCCI REGIONAL OFFICE, LAHORE
E-mail: lahore.regional@/fpcci.org.pk

FPCCI REGIONAL OFFICE, PESHAWAR
E-mail: peshawar.regional@fpcci.org.pk

FPCCI REGIONAL OFFICE, QUETTA
E-mail: quetta.regional@fpcci.org.pk

FPCCI REGIONAL OFFICE, GILGIT BALTISTAN
E-mail: gilgit.regional@fpcci.org.pk

FPCCI REGIONAL OFFICE, GWADAR
E-mail: gwadar.regional@fpcci.org.pk