REFORMS FOR A BRIGHTER FUTURE
TIME TO DECIDE

POLICY NOTE 6

STRENGTHENING GOVERNMENT REVENUES

Towards an Equitable, Efficient, and Sustainable Tax System

WORLD BANK GROUP

TIME TO DECIDE:

Pakistan is at a critical decision point. "Muddling through" the current economic crisis, and continuing to avoid urgent, fundamental, and long overdue policy shifts will bring major costs and risks. If the political will for once-in-a-generation changes does not materialize, this crisis could "go to waste", as many have before. The same old pattern of slow development and recurrent crises would be repeated, as climate and other shocks mount in severity and frequency.

Alternatively, the current crisis could be a turning point, if it leads stakeholders and decision makers to realize that the current model of development has failed, leaving a large proportion of the population behind.

At this critical juncture, and as a long-standing partner of Pakistan, the World Bank has a responsibility to recommend a set of fundamental policy shifts that we believe are required to durably change Pakistan's development course. These policy notes outline required policy shifts and are intended to steer debate and build consensus around the urgent adoption of a new development framework. Recommended policy shifts would require those who have gained from the status quo to give up undue benefits, through eliminating distortions that favor a minority while muting broad-based growth, and mobilizing resources from the wealthy to finance much needed expansions of basic services for those most deprived (including education, health, and access to water). These changes would ultimately benefit all, leading to faster and more sustainable and inclusive growth and development, and allowing Pakistan to realize its potential to reach upper-middle income status by its centennial in 2047.

The World Bank, December 2023.

Towards an Equitable, Efficient, and Sustainable Tax System

Pakistan's fiscal deficit has been persistently large and growing, posing risks to fiscal sustainability. Relatively low tax collections, extracted from a small number of taxpayers, contribute to fiscal sustainability challenges, and constrain resources available for priority investments, including in human capital. Potential to raise further revenues from increasing rates for the major current tax instruments is limited and would likely exacerbate inequities and distortions. Instead, a major change in approach is needed, with federal and provincial governments working together to expand the tax base. This approach should include:

1. **Closing distortionary and regressive exemptions;**
2. **Improving the functionality of the GST (including through base and rate harmonization and administrative improvements) as a means of raising revenues and encouraging formalization—particularly in the retail sector that remains largely untaxed;**
3. **Supporting compliance through simplification of tax structures and the closing of income tax loopholes;**
4. **Substantially increasing the taxation of both agriculture income and property;** and
5. **Introducing new taxes on environmentally and socially harmful products.**

Effective implementation of such a strategy would require coordinated action between federal and provincial governments, potentially involving a broader revision of fiscal federalism arrangements. These efforts could help increase revenues from around 10.5 percent of GDP in FY22, to the range of 15-18 percent of GDP.

Potential Benefits From Strengthening Revenues

GDP

~3.7% of GDP
in revenues from federal tax reforms to reduce tax expenditures, increase excises, and harmonize the GST.

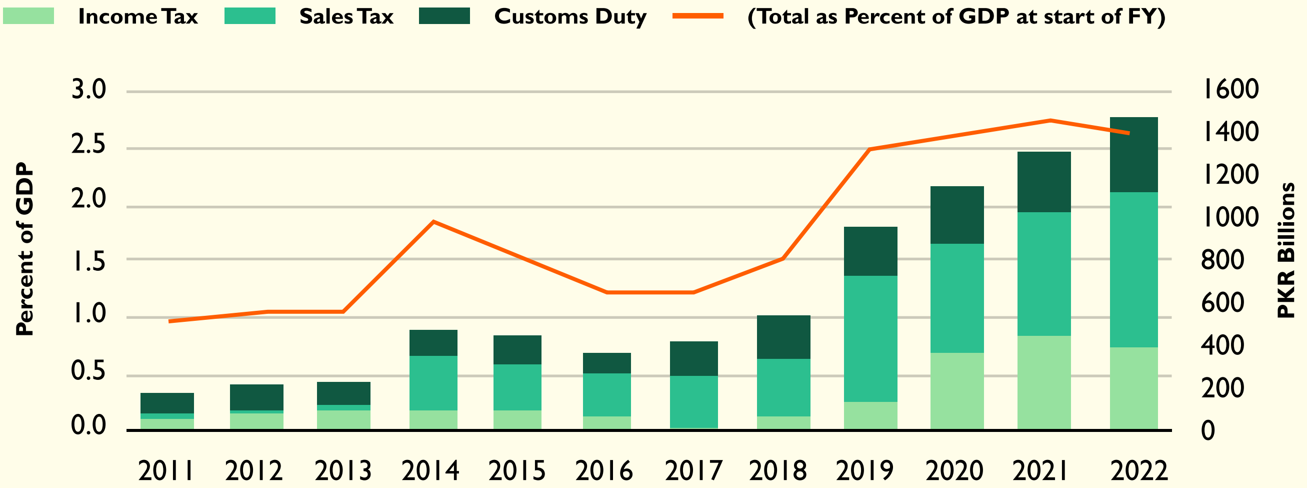
Up to 2% GDP
in revenues from reforming taxes on land and property.

1% of GDP
in revenues from reforming taxes on agriculture

The Problem

Pakistan's tax-to-GDP ratio has been declining, with revenues well short of what could be expected under an optimal tax system. Pakistan's tax capacity (overall capacity of the economy to generate revenues) has remained largely unchanged at a little over 22 percent of GDP over the past decade. Despite this, there has been a longer-term trend of declining collections, with taxes falling from around 14 percent of GDP in the 1980's to around 10 – 12 percent of GDP today. Tax collected in FY22 was only 10.4 percent of GDP. This decline in tax-to-GDP is associated with rising tax expenditures, which at the federal level, rose from 1.3 percent of GDP in FY16 to 2.7 percent of GDP in FY22.

Figure 1: Tax Expenditures By Type
(PKR Billion And % Of GDP)



Source: Federal Board of Revenue tax expenditure reports

Revenues are collected overwhelmingly at the federal level. In FY16, 92.3 percent of tax revenues were collected by the federal government. The proportion of taxes collected by the federal government has fallen marginally to 91.2 percent by FY22, partly due to increased taxation of services by provincial governments. Despite this increase, total provincial revenue collection remains less than one percent of GDP. Instead, provincial governments rely heavily on revenues transferred from federal government, in the form of general transfers, in accordance with the National Financing Commission (NFC) award.

A large portion of the tax base is not captured. For example, of the approximately 114 million people employed, just under 8 million people are registered for personal income taxes due to widespread informality. Agricultural income tax revenues remain very small, as over 90 percent of farmers in some large provinces are untaxed due to their land holdings falling below the acreage exemption threshold[1].

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[1] Agricultural income is subject to a minimum tax based on the size of land holdings according to a fixed schedule of per acre rates. In some large provinces, farmers with land of less than 12½ acres are exempted from taxation, while those owning up to 25 acres of land pay PRs 100 per acre and the per acre rate increases to PRs 250 for land holdings between 26 and 50 acres and to PRs 300 for over 50 acres of land. Farmers with over 50 acres of irrigated land are also required to file for income tax. Estimates suggest that over 90 percent of farmers appear to have land holdings less than 12½ acres, thus agricultural income remains largely untaxed. Additionally, agricultural land used for non-agricultural purposes continues to be taxed under the agricultural income tax scheme.

Similarly, the number of active CIT filers is 27,334 out of more than 60,000 companies registered for CIT. This represents a mere 0.8 percent of commercial / industrial electricity users (an illustrative pool of potential entities liable for taxation). Only 178,190 entities are GST registered, from about 1.4 million retailers and 3.4 million commercial and industrial electricity users[2].

Under taxation of urban land leads to revenue loss and economic distortions. Significant potential exists to improve taxation of urban land. The current tax rate creates several market distortions and raises equity issues: (i) lower tax rates make it more profitable to invest in real estate relative to manufacturing or tradable services, thereby distorting the allocation of capital and reducing growth potential; (ii) lower effective tax rates for the Urban Immobile Property Tax (UIPT) on vacant plots rewards unproductive holding of land and speculative investments in real estate, thereby distorting land and housing markets; (iii) large differences in effective tax rates between rented and owner-occupied properties distort housing and rental markets; (iv) inadequate progressivity in land taxes benefits owners of high value properties at the expense of equity.

Tax administration also remains complex and hinders revenue mobilization efforts. Revenue in Pakistan is managed by the Federal Board of Revenue (FBR) as well as 12 provincial revenue entities (three for each of the four provinces). Overlapping jurisdictions, multiple regulatory and tax requirements, and regular changes make the Pakistan tax system difficult to navigate for individuals and firms. The multiplicity of taxes and rates, and jurisdictional overlaps increase compliance and administrative costs. This complexity also provides opportunities for rate shopping and rent seeking, including by tax collectors.

In the context of overall very low compliance and weak enforcement, government has relied heavily on the withholding tax regime. Withholding taxes on income are overall an efficient and progressive means of raising revenues. However, withholding on non-income transactions, including telecommunication and energy payments is highly regressive.

Recommendations

A new tax strategy is needed. Pakistan has typically sought to meet revenue shortfalls by increasing tax rates imposed on the relatively narrow compliant base. Continuing with this approach is likely to yield limited revenues, while increasing inequities and distortions in the tax system. Instead, federal and provincial governments should work together to broaden the tax base and raise revenue from undertaxed activities. This approach should include: i) closing distortionary and regressive exemptions; ii) improving the functionality of the GST (including through base and rate harmonization and administrative improvements) as a means of raising revenues and encouraging formalization; iii) supporting compliance through simplification of tax structures and the closing of income tax loopholes; and iv) substantially increasing the taxation of both agricultural and urban land.

Improving federal-provincial coordination is critical.

Tax administration and policy reforms should be immediately pursued to ease compliance and mitigate constraints arising from the current fragmented structure. Within the current constitutional framework, efforts should continue towards coordination of tax bases, creating a single tax market, and reducing the number of required interactions between taxpayers and revenue authorities (important gains have recently been achieved on harmonization of GST rules and definitions, including through coordination at federal-provincial revenue roundtables).

[2] IMF Working Paper, Unlocking Pakistan's Revenue Potential, Serhan Cevik, August 2016.

Ongoing digitization efforts should be accelerated to reduce compliance costs and minimize the need for interactions between taxpayers and collectors. This should include faster progress with: (i) data sharing between tax agencies; (ii) making mandatory use of Computerized National Identity Cards (CNIC) for transactions, particularly of assets; (iii) development of a single portal for the sales tax; and (iv) digitization of land records and digital imagery of urban and rural lands.

At the federal level, reform efforts should focus on closing exemptions, simplifying the tax structure, and raising new revenues through excises.

The following reforms should be undertaken:

- **Close corporate tax exemptions.** Revenues equivalent to around 0.1 percent of GDP could be generated by closing regressive corporate tax exemptions that impose large fiscal costs while bringing few economic benefits. Specifically, this could include exemptions for power generation projects, which amounted to PKR 37 billion in FY21 and exemptions for real estate investments, which amounted to PKR 26 billion. Savings would be sufficient to fund 35,000 teachers on the average public sector salary, over two-thirds of Balochistan's teacher population.
- **Reduce tax expenditures in the energy sector and for COVID-19 response.** Tax exemptions and concessions resulted in tax expenditures of 2.7 percent of GDP in FY21. Government should wind back exemptions and other concessionary rates in the petroleum sector (PKR 280 billion); close exemptions on machinery imports to power generation and transmission (PKR 100 billion); and close costly exemptions introduced during the COVID-19 pandemic in the pharmaceuticals and energy sectors and for specific food items (PKR 40 billion on imports and PKR 100 billion on local supplies).
- **Close exemptions for basic household items.** Removing exemptions for food items including oil, pulses, animal, fruit, and dairy, could save PKR100 billion in revenues. Current concessionary rates on fertilizer impose fiscal costs of PKR 90 billion.
- **To encourage compliance and close loopholes, the personal income tax should be simplified.** This should include harmonizing the tax schedule between salaried and non-salaried individuals, and reducing the number of tax brackets.
- **To both raise revenues and bring health and environmental benefits, excise duties should be increased on socially harmful goods**. Excise duties on cigarettes could be applied with a uniform rate for all brands and an automatic inflation adjustment. This, in combination with strengthened enforcement to close the collection gap through the effective roll-out of a digitized stamp system, could raise up to 0.4 percent of GDP in additional revenue. Additional excises could be considered in future on other goods that are associated with environmental damage or negative health outcomes.
- **The poor should be protected from the price impacts of closing tax exemptions.** Untargeted social relief through tax expenditures is regressive, with the bulk of the benefits flowing to the better off who consume and spend more. Poor households could be shielded from the impact of price increases associated with tax reform through increased temporary transfers or tax rebates via existing social protection programs, such as the Benazir Income Support Program (BISP). The poor would also benefit from a gradual phasing out of withholding taxes on non-income transactions, including telecommunication and electricity payments.

At the provincial level, reform efforts should focus on improving own source revenue and accountability, including taxation of land and agriculture income.

Provincial governments can significantly increase revenues through more progressive agricultural income taxation. Reforms should immediately be pursued to: (i) reduce or refine the current 12 ½ acre tax exemption threshold to bring more agricultural land into the tax net and reduce incentives for tax evasion through breaking up land holdings; and (ii) ensure appropriate categorization of land—taking account of size, location irrigation status, and area-based productivity aspects into tax rates. Simulations of an acreage-based tax indicated potential to generate additional provincial revenues of around **one percent of GDP.**

Provincial governments can significantly increase taxation of land. The following actions should be immediately pursued, generating up to two percent of GDP in revenues: i) continue or complete the establishment of reliable records of land ownership linked to NCICs and TINs; ii) harmonize the three valuation systems being used for different land related taxes, with taxable values based on capital values and equivalent to market prices[3]; iii) increase property tax rates to match those applied in peer economies (in Punjab, for example, the UIPT rate is currently set at 5 percent of the ARV, which translates into a Capital Value-based tax rate of 0.07 percent, compared to 0.5 percent in many low-income countries); and iv) improve the policy and legal framework to ensure that sizable and growing peri-urban settlements outside current notified municipal boundaries are also subject to appropriate land taxation.

Reforms to current fiscal institutional arrangements should be pursued over the medium-term.

Over the medium-term, further GST harmonization could bring substantial revenue gains. Pakistan is now one of the only federated states where the GST base remains fragmented, creating leakages and complexities for taxpayers[4]. A recent World Bank estimate suggest that further rate and base harmonization complemented by administration reforms could yield up to 1¾ percent of GDP. GST administration responsibilities should be consolidated with a comprehensive agency. Federal and provincial governments could agree to the establishment of a comprehensive administration, with a board of directors representing all federating entities. This, together with further IT advancements (e.g., data integration, single filing portal and e-invoicing) would radically ease compliance costs and foster further harmonization. Revenues collected by the comprehensive tax authority would continue to be distributed according to the 18th Amendment.

Current fiscal federalism arrangements under the National Finance Commission and 18th Constitutional Amendment should also be reviewed for consistency with core principles of public finance. Federating units should be provided with the access to resources commensurate with their service delivery responsibilities and expenditure needs. The current system of federal transfers and assignment of tax responsibilities (GST on goods, and personal and corporate income taxation with the Federal Government; GST on services, property tax, and agricultural tax with the provinces) does not achieve this objective. The mismatch between available financing and formal service delivery responsibilities leads to de facto overlaps in service provision, undermining accountability and weakening incentives for efficiency in spending and revenue mobilization.

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[3] The FBR and BoR currently use capital value as the basis, which is updated annually. The ENTD's rental valuation tables use plot size and covered area as inputs and are required to be updated every five years. Basing all land-related transfer and recurring taxes on a single base value (BoR valuation tables) would promote harmonization. In parallel, actions taken over the medium term to bring the BoR valuation at par with market values would also improve other revenues that use these as a valuation basis, such as stamp duties, TTIP, and conversion fees. For recurrent taxation of non-commercial property, ongoing work to establish property values by the FBR can be used to establish a simple area-based system of imputed property value bands based on location and size, with provinces collecting rates applied against these estimated values.

[4] India's GST reforms, involving harmonization of the GST base and rates together with administration simplifications resulted in the c-efficiency ratio rising from under 0.4 in 2017 to around 0.6 in 2020 (Revenue Performance Assessment of Indian GST, Sacchidananda Mukherjee, NIPFP Working Paper Series 392).

Further, the current division of taxing powers creates opportunities for tax arbitrage and tax evasion, and enormous complexity for business compliance. Following a detailed review and appropriate consultations, institutional and/or constitutional reforms should be pursued to align revenue generation capacities with expenditure needs, considering administration and compliance factors (see Policy Note 8: Strengthening Institutions for Effective Implementation).

Reforms to grow the economy and encourage formalization will also support sustainably higher revenues.

Pakistan's revenue potential is limited by the current structure of its economy. Revenue potential is ultimately constrained by Pakistan's relatively low levels of income, large agricultural sector, and widespread informality. While the measures discussed in this discussion note can bring major benefits, attempts to extract increasing revenue from a stagnant economy can eventually become counterproductive if they lead to a heavy tax burden being imposed on a limited tax base. Revenue policy and administration reforms should therefore be combined with broader measures to encourage investment, economic growth, and formalization, including through reforms to improve the business enabling environment, remove the anti-export bias in trade policies, and reduce the presence of the state within the economy (see Policy Note 3: Transforming the Private Sector).

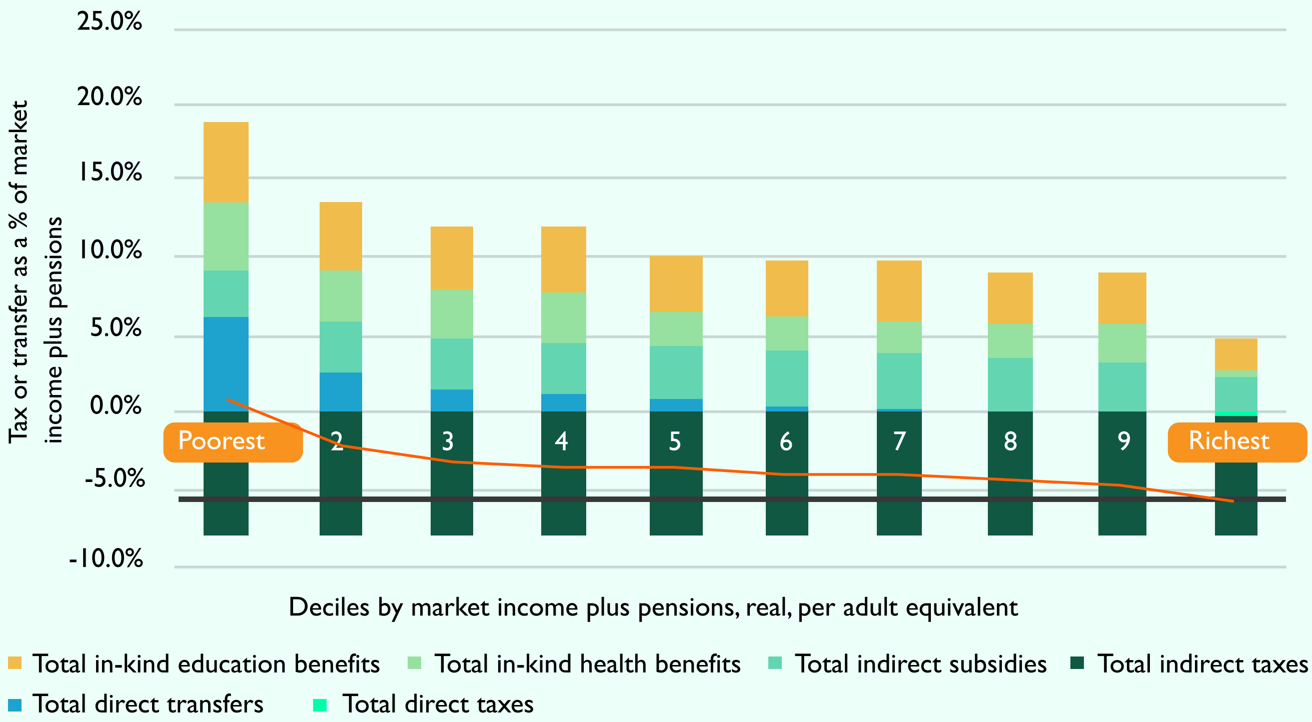
ABOUT THE "REFORMS FOR A BRIGHTER FUTURE" POLICY NOTES:

"Reforms for a Brighter Future" is an initiative of the World Bank, aimed at fostering debate and dialogue on critical economic development policy issues facing Pakistan. Further information is available from the World Bank Pakistan website at **https://www.worldbank.org/en/country/pakistan/brief/reforms-for-a-brighter-future-time-to-decide.** This note was prepared by Lucy Pan (Senior Economist) with inputs from Irum Touqeer (Public Sector Specialist) and Tobias Haque (Lead Country Economist).

Pakistan's fiscal system is uniquely regressive

Findings from the Pakistan Commitment to Equity (CEQ) Assessment fiscal incidence analysis demonstrate that households (except those in the very poorest decile) are net payers into the fiscal system (Figure 2), which means that they pay more in cash terms in taxes than they receive in either subsidy or direct transfer benefits. The CEQ Assessment also revealed that in cash terms and relative to pre-tax incomes, the poorest 10 percent of the population in Pakistan pays a greater share of income in taxes than the richest 10 percent[5]. That poor households in Pakistan can expect a larger total tax burden (relative to pre-tax incomes) than rich households is unique among the set of countries that have undertaken a CEQ Assessment and points to the deleterious social and welfare impact of Pakistan's current domestic revenue mobilization efforts[6].

Figure 2: Net Cash Position Of Households By Decile



Source: World Bank calculations based on HIES 2018-19 and fiscal administrative data

[5] This can be attributable to: (i) people whose circumstances are the same, not paying equal taxes given narrow tax base and multitude of exemptions; and (ii) higher tax burden not being placed on individuals with a greater capacity to pay, partly linked to political economy challenges. According to ILO estimates, of the approximately 114 million people employed, just under 8 million people are registered for personal income taxes. Furthermore, 90 percent of agriculture landowners do not pay taxes due to the 12½ acres exemption and the Urban Immovable Taxes and Sales Taxes are riddled with exemptions

[6] Net payers and net recipients as well as absolute and relative tax burdens for most countries that have undertaken a CEQ Assessment are available for comparison at CEQ Data Center: https://commitmentoequity.org/datavisualization/country/IND