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Chapter 5

PAKISTAN FEDERAL
PUBLIC EXPENDITURE REVIEW 2023

Enabling a Modern and Efficient Tax System

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PAKISTAN FEDERAL

PUBLIC EXPENDITURE REVIEW

Chapter 5: Enabling a Modern and Efficient Tax System

2023

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Preface

The Pakistan Federal Public Expenditure Review (PER) 2023 was prepared by the Macroeconomics, Trade, and Investment Global Practice under the guidance of Najy Benhassine (Country Director, Pakistan), Mathew Verghis (Regional Director, Equitable Growth, Finance, and Institutions), Shabih Ali Mohib (Practice Manager, Macroeconomics, Trade, and Investment) and Tobias Akhtar Haque (Lead Country Economist and Program Leader, Equitable Growth, Finance, and Institutions).

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Abbreviations

AMT	Alternative Minimum Tax
AMTI	AMT income
BISP	Benazir Income Support Programme
CIT	Corporate income tax
DPO	Development Policy Operation
FBR	Federal Board of Revenue
GDP	Gross Domestic Product
IMF	International Monetary Fund
LPG	Liquefied petroleum gas
PDL	Petroleum Development Levy
R&D	Research and Development
SBP	State Bank of Pakistan
SME	Small and medium-sized enterprises
SRO	Statutory Regulatory Orders
VAT	Value Added Tax

Chapter 5: Enabling a Modern and Efficient Tax System

5.1 Introduction

Pakistan's revenue collection is low by international standards. In FY21, the Federal Government only collected 12.4 percent of GDP in total and 11.2 percent of GDP in tax revenue, two percentage points less than the South Asian average for the same year. As federal revenues consistently fall short of expenditures, thus driving persistent budget deficits, strengthening tax revenue generation is key for Pakistan to return to a path of fiscal sustainability.

This chapter asks how tax expansion can be achieved and managed in an inclusive and economically efficient manner. Pakistan's tax system is complex with various special provisions, concessional rates, and unorthodox approaches to tax policy. Many of these policy choices were implemented to balance the provision of fiscal support to certain groups or industries – small manufacturing businesses, sugar producers, and many others – with the need to maintain a minimum level of revenue collection. This has resulted in a system with many vested interests and has come at the cost of economic efficiency and the ability to sustainably raise revenue to a level that can finance Pakistan's spending needs. There is no silver bullet to resolve this situation. Instead, policy makers will need to make hard choices by reducing exemptions, softening the blow through time-bound transition arrangements, and communicating clearly that a fiscally sustainable Pakistan is in the national and the public's interest.

In addition to the federal revenue sources discussed in this chapter, Pakistan also has the potential to increase collection from provincial sources, which highlighted in the literature. Pakistan's provinces are assigned three significant sources of revenue: sales tax on services (Box 5.5), agricultural income taxation and property taxation. The World Bank's and the IMF's respective tax policy reviews[1] have analyzed agricultural income taxation, and have highlighted the resulting fractionalization of the tax base[2] and the exceptionally low revenue performance,[3] despite the agricultural sector's substantial contribution to GDP. As a potential remedy, the reports suggest the introduction of a presumptive tax on agriculture based on land holding and productivity characteristics. Property taxation, which is a shared responsibility between provincial, district and town governments, has also been shown to suffer from low collection rates, driven by outdated valuation tables[4] that understate current market values and/or the potential income from property, especially for self-occupied property[5]. More recent academic literature on provincial property taxation has also highlighted the potential of appropriately incentivizing property tax collectors in raising revenue.[6]

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[1] World Bank (2018). *Pakistan Tax System – Tax Policy Review*. IMF (2019). *Redesigning Pakistan's Tax System*. Fiscal Affairs Department Technical Report.

[2] The FBR estimates that the fractionalization of the tax base costs the Federal Government more than PKR 69 billion in foregone revenues in 2020. See Federal Bureau of Revenue (2020). *Tax Expenditure Report 2020*.

[3] Nasim, A. (2012). "Agricultural Income Taxation: Estimation of the Revenue Potential in Punjab." Pakistan Development Review. 51:4 Part II (Winter) pp. 321-337.

[4] With the support of the World Bank Resilient Institutions for a Sustainable Economy development policy operations, federal and provincial property valuations were recently adjusted higher to better reflect market valuations.

[5] World Bank (2017): "Annual Report 2016---17. Sindh Annex 6 – Property Tax Study", *Multi Donor Trust Fund for Accelerating Growth and Reforms*; World Bank (2018). *Pakistan Tax System – Tax Policy Review*.

[6] Khan, A. Q., Khwaja, A. I., & Olken, B. A. (2019). Making moves matter: Experimental evidence on incentivizing bureaucrats through performance-based postings. *American Economic Review*, 109 (1), 237-270. Khan, A. Q., Khwaja, A. I., & Olken, B. A.

The analysis presented here complements a rich literature of past policy reports and technical assistance (Box 5.1)**.** Although some results from previous work will be repeated here for completeness, the chapter adds to existing work in two ways. First, it provides novel quantitative assessments of key tax policy design aspects, which sheds light on possible new ways to enhance tax revenue collection and improve economic efficiency. For instance, existing work has thus far not assessed the fiscal cost of sales tax exemptions by sector, and empirical evidence on the economic distortions created by such exemptions is currently limited. This chapter fills this gap by employing the VAT gap analysis methodology that provides evidence on revenue potential, the sector-specific cost of tax expenditures, and the impact of tax exemptions on the distribution of the tax burden along the value chain. The chapter also provides novel evidence on excise duty potential for cigarettes and the distributional impact of key taxes. Second, the chapter provides a comprehensive comparison of Pakistan's tax code for the federal level's four main taxes (sales tax on goods, excise duty on cigarettes, and personal and corporate income taxes) with international practice, thus highlighting hitherto unexplored opportunities for tax strengthening.

The recommendations in this chapter focus on reducing the complexity of Pakistan's tax system, broadening its base and concurrently reducing the burden on compliant taxpayers. The estimated revenue impacts of the proposed measures amount to around 1.0 percent of GDP.[7]

- **Sales tax** recommendations emphasize the importance of gradually rationalizing concessions, including by harmonizing sales tax rates across products, removing zero-ratings for all but exported products, and limiting sales tax exemptions to only basic need items. This could raise 0.6 percent of GDP in additional revenue. This base broadening could allow Pakistan to lower its comparatively high standard sales tax rate. The impact of removing exemptions on poorer households could be compensated by allocating some of the additional revenue to the Ehsaas program. Institutional sales tax reforms could include making the issuance of tax concessions the prerogative of the parliament.
- **Personal income tax** recommendations highlight opportunities to close avoidance loopholes by harmonizing the tax schedules between salaried and non-salaried individuals and simplifying the tax schedules, such as by reducing the number of tax brackets. This simplification should be accompanied by the elimination of regressive income tax withholding on non-income transactions, such as telecom bills.
- **Corporate income tax (CIT)** recommendations suggest first harmonizing the existing concessional regimes into a single regime with a simple turnover-based eligibility threshold. As a next step, the standard regime could be harmonized to include a single rate. Tax-base broadening could be achieved by expanding thin-cap provisions, and by critically evaluating the cost-effectiveness of tax incentive schemes.[8]
- **Federal excise duty** reforms focus on the taxation of cigarettes and suggest instituting a uniform rate for all brands and an automatic mechanism to ensure that the rate adjusts for inflation. This, in combination with strengthened enforcement to close the collection gap through the effective roll-out of a digitized stamp system, could raise 0.4 percent of GDP in additional revenue. Recommendations also focus on tax enforcement.

(2016). Tax farming redux: Experimental evidence on performance pay for tax collectors. *The Quarterly Journal of Economics*, 131(1), 219-271.

[7] For some of the proposed revenue measures, the data available was insufficient to estimate a precise revenue gain. This applies to the recommendations on corporate income tax, capital gains tax, and on potential revenue gains from improved tax enforcement on sales and excise taxes. The potential revenue gains from these are likely to be sizable based on international experience but a precise number could not be estimated due to data limitations.

[8] Due to a lack of available data on the universe of firm incomes, the revenue impact of this reform could not be estimated.

Box 5.1: Reform recommendations from previous World Bank and IMF analytical work

Previous analytical work has identified an opportunity to enhance revenue collection, while concurrently improving the economic efficiency of the tax system. To this end, recommendations have prioritized an expansion of the tax base, coupled with a simplification of provisions and the elimination of costly and ineffective tax exemptions and incentives, over a further increase in tax rates. The table below provides a non-exhaustive summary of the recommendations:

World Bank	IMF
Overall	
Expand the tax base, simplify the tax system, and publish tax expenditure statements.	
Sales Tax	
Eliminate exemptions and zero rates. Consider reintroducing a broad-based and unified VAT system that consistently incorporates all goods and services traded.	Move toward a broad-base tax with a single standard rate by (i) eliminating zero-ratings on domestically sold goods, (ii) eliminating concessional rates, and (iii) limiting exemptions to a small group of basic food and medicine items.
Personal Income Tax	
Limit withholding taxes to the informal and undocumented sectors, while freeing formal taxpayers from the obligation of distortionary withholding. Apply a single rule to all capital gains and limit concessions and exemptions, especially those benefiting richer taxpayers.	Reduce the number of rates and brackets to increase tax progressiveness and reduce compliance costs. Harmonize the taxation of capital gains with the taxation of property income. Eliminate the (regressive) deduction of voluntary payments for pensions.
Corporate Income Tax	
Gradually reduce the standard CIT rate from 30 percent to 25 percent. The use of turnover taxation can help reduce tax evasion.	Simplify the system and limit exemptions by (i) reviewing all credits and incentive schemes and eliminating non-beneficial ones, (ii) repealing distortionary minimum taxes, (iii) redefining small businesses for tax purposes and implementing a comprehensive asset test to limit opportunities for tax planning, and (iv) replacing the thin cap rule with an earning stripping approach to protect the tax base.
Other Federal Taxes	
Customs: Enhance the revenue management system by focusing on risk profiling; strengthen pre- and post-clearance facilities; and include more traders into the domestic tax net by linking audits and registries between customs and inland revenue.	Excise: Limit excise to products with negative externalities, equalize rates on domestic and foreign cigarettes and un-manufactured tobacco, and increase excise on petrol derivatives or the petrol levy to reduce environmental externalities. Customs: Reduce tariff rates in general, starting a phase-out of tariffs on capital goods, intermediate products, and raw materials.

Sources: World Bank (2004). Pakistan Public Expenditure Management. Report No: 25665-PK. Washington, D.C.: World Bank.
World Bank (2011). Pakistan: From Raising Spending to Spending for Results: A Review of Public Expenditure and Financial Management Practices. Report No: 52442-PK. Washington, D.C.: World Bank (unpublished mimeo)
World Bank (2018). Pakistan Tax System – Tax Policy Review.
IMF (2019). Redesigning Pakistan's Tax System. Fiscal Affairs Department Technical Report.

The analysis in this chapter proceeds in three parts. Section 2 provides a stylized overview of Pakistan's tax system and revenue performance. Section 3 provides an analytical deep dive into the design of the sales, personal income tax, and CITs, analyzing their base and rate structure and the availability of

concessional provisions. Section 4 provides a policy roadmap that aims at enhancing revenue and economic efficiency while reducing the impact on those adversely affected by reforms. Consistent with the theme of this report, this chapter focuses on the three main federal taxes, including sales tax as well as personal and CITs. Where possible, the report also provides estimates on potential revenue gains. A detailed analysis of production and trade-related taxes is available in World Bank (2022).[9]

5.2 Overview of the Tax System

5.2.1 Structure of the tax system and reform dynamics

Pakistan's tax code contains provisions for direct and indirect taxation. The legal framework for direct taxation is based on the 2001 Income Tax Ordinance, which differentiates between a large variety of income sources (Table 5.1). The personal income tax schedule is progressive, with marginal tax rates ranging between 2.5 and 35 percent on taxable income above a tax-free allowance of PKR 600,000 for salaried individuals[10] and PKR 400,000 for all others, at the time of writing. Corporate profits are taxed at a standard 29 percent rate, reduced from 35 percent in 2021, with various preferential tax schemes available depending on firm size and other characteristics. Dividend taxes are withheld at source at a rate between 7.5 and 25 percent, and interest income is taxed through a withholding scheme that levies a 15 percent rate. The income tax ordinance also contains multiple provisions for tax withholding, including on salaries, trade, cash withdrawals, electricity and mobile phone bills, and others. In addition, Pakistan has an advance tax regime that requires taxpayers whose income in the previous year exceeds PKR 1 million to remit estimated tax payments on a quarterly basis.

Indirect taxes are levied on sales, imports, and production. The sales tax is Pakistan's main indirect tax source that is levied on registered firms' imports and sales. Sales tax on goods is collected at the federal level, whereas sales tax on services is collected by the provinces.[11] Registration requirements differ by sector and are complex. Pakistan also maintains a tax regime for non-registered taxpayers, whose sales tax revenue is collected through their electricity bills. The standard sales tax rate is 18 percent, with multiple exemptions and concessional rates for products and sectors. Exports and some domestically traded goods are zero-rated. Imports are also taxed through import duties whose rates vary by product. The production and import of select items, including tobacco, cigarettes, cement, and certain oils, are taxed through excise duties.

Pakistan also collects significant revenue from non-tax sources and through levies collected by line ministries. In FY21, Pakistan collected 2.7 percent of GDP through levies imposed by government agencies and through non-tax revenue. Two sources were especially important. First, collections from the Petroleum Development Levy (PDL) provide a steady source of revenue and accounted for 0.8 percent of GDP in FY21. The PDL is collected by the Ministry of Energy and is levied on petrol, diesel, kerosene, LPG, and fuel production inputs. At the time of writing, the PDL rates stood at PKR 37.50 per liter on petrol, PKR 7.50 on diesel, and PKR 10 on kerosene, with a commitment by the authorities under an IMF-supported program to continue raising rates on petrol and diesel by PKR 5 per month until taxes on both reach PKR 50 per liter.[12] Second, the Government receives revenue through profit transfers from the State

[9] World Bank 2022. *From Swimming in Sand to High and Sustainable Growth: A roadmap to reduce distortions in the allocation of resources and talent in the Pakistani economy*. Pakistan's Country Economic Memorandum 2022. Islamabad: The World Bank.
[10] Defined as individuals for whom more than 75 percent of earnings are derived from salary.
[11] This chapter will focus on the sales tax on goods, considering the report's focus on federally collected revenue and expenditure.
[12] https://www.dawn.com/news/1712678.

Bank of Pakistan (SBP). These transfers are volatile, reaching for instance from a low of 0.03 percent of GDP in FY19 up to 2 percent of GDP in FY20. Most revenue by the central bank is earned from lending operations to the sovereign[13]. Profit transfers are expected to decline after an IMF-supported moratorium on the purchase of government securities by the SBP.

Table 5.1: Overview of main taxes (not exhaustive)

Tax	Tax base	Marginal rate	Revenue as share of GDP, FY21 (%)
Direct taxes			
Corporate income tax	Corporate earnings (paid on-demand, voluntarily, or through advance taxation)	29 percent.	1.6[14]
Personal income tax	Withholding on income from salaried individuals	2.5 to 35 percent, distributed in 12 slabs based on earnings.	0.27
Dividend taxes	Withholding on dividend earnings	7.5, 15, and 25 percent, depending on who distributes the dividends.	0.11
Interest income	Withholding on income earned from loans and deposits	15 percent.	0.24
Other withholding taxes	Withholding on various transactions (partially creditable against income tax liability)	Varies by type of transaction.	1.6
Indirect taxes			
Federal Sales Tax	Sales of goods (input tax credit available for both goods and services)	18 percent.	3.57
Federal Excise Tax	Production and import of excisable items, including tobacco, cigarettes, selected petroleum products, aerated water, cement, natural gases, air conditioners, imported motor vehicles, and air travel services.	Varies by product.	0.5
Import duties	Import of goods and services	Varies by product.	1.37

Source: World Bank staff elaborations, based on Pakistani Tax Law.

The authorities have undertaken continuous efforts to modernize tax policy and administration, but efforts have so far produced limited results. Reforms were supported by international development partners, including the World Bank and the IMF, and can be categorized into five phases (Box 5.2). Reform efforts were designed to be comprehensive, targeting tax policy and administration in parallel, with a clear vision of simplifying the tax regime and compliance procedures, broadening the tax base, and enhancing enforcement. The implementation of this vision has, however, been uneven and inconsistent.

[13] https://www.sbp.org.pk/reports/annual/arFY21/Vol-1/Chapter-8.pdf

[14] There is no formal definition of CIT revenue in the data provided by the FBR. For the purpose of this exposition, it is defined as all voluntary payments plus advance taxes minus voluntary capital gains taxes plus withholding taxes on corporate transactions (e.g., imports). All figures are gross revenue, including refunds, as refund data does not distinguish between personal and corporate taxpayers.

Box 5.2: Tax policy priorities since 2000

Phase-I: 2000

In FY00, the authorities launched the "Tax Survey and Registration Scheme" to broaden the tax base. As part of this, authorities initiated a survey of taxpayers in prosperous urban areas and a campaign to issue new national tax numbers as a unique ID for all taxes. The authorities also established a computerized process to select up to 20 percent of all tax returns for audits. The tax survey and registration drive brought approximately 25,000 new taxpayers into the sales tax net and added over 100,000 direct taxpayers.[15] At the same time, national tax numbers were issued to 90 percent of taxpayers.

Phase-II-2001-2005

The period from FY01 to FY05 witnessed significant tax policy reform efforts, including the promulgation of a new income tax ordinance and the inclusion of agricultural income in the tax net (with jurisdiction assigned to the provinces). The authorities also eliminated sales tax exemptions on all fertilizers and other commodities. This was complemented by continued improvements to tax administration procedures, including the updating of taxpayer databases, the registration of new taxpayers, and functional and personnel reforms within the Federal Board of Revenue.

Phase-III: 2009-2012

The IMF's stand-by arrangement, in place between 2008 and 2011, supported a transformation of the sales tax into a value-added tax with a simplified rate schedule. On the tax administration side, the authorities continued to improve their systems through the adoption of an integrated IT system in 2009 and the preparation of risk-based compliance strategies.

Phase-IV: 2013-2016

Between 2013 and 2016, Pakistan, with support from various World Bank DPOs, eliminated exemptions and concessions embedded in Statutory Regulatory Orders and in the law.[16] Reforms also focused on eliminating the power of the executive to grant preferential tax treatment through SROs, with the goal of further moving the sales tax towards an integrated VAT. Tax administration measures focused on improving the national data warehouse.

Phase-V: 2019-2022

Tax policy reform discussions centered around the removal of sales tax exemptions and preferential rates, except for basic food and medicines, and a harmonization of the sales tax across provinces and between the federal and provincial level. However, to date, the authorities have not reached an agreement with the provinces on a concrete plan to harmonize the sales tax regimes.

The Government has also rationalized 12 withholding lines under the income tax and has added federal excise duties on select products while increasing the rate on others, including cigarettes, sugary drinks, and cement.

Phase-VI: Recent tax developments

On January 13, 2022, the National Assembly passed a supplementary finance act that focused on enhancing revenue mobilization by broadening the tax base and improving tax administration. Selected measures included an additional sales tax on imported mobile devices exceeding USD 200 in value, the elimination of some GST exemptions, an increase of federal excise duty on imported and locally manufactured vehicles and the introduction of advance taxes on dividends paid to non-real estate investment trust investors.

On June 29, a new budget and finance bill was approved by the parliament, which aimed to boost revenue collection through progressive measures in line with the objectives of the ongoing IMF program. Key income tax measures included a reduction of income tax slabs that increased the tax burden on higher earners as well

[15] IMF, 2001. Letter of Intent of the Government of Pakistan and Memorandum on Economic and Financial Policies.
[16] SROs refer to all kinds of government regulations carried out by FBR and different ministries through delegated powers. For FBR, SROs include concessionary and procedural regulations on inland revenue services (income tax, sales tax, federal excises) and customs.

as the introduction of a "super tax" on incomes exceeding PKR 150 million and an additional "poverty alleviation tax" of 10 percent on individuals and firms in select sectors with income above PKR 300 million. The bill introduced a super tax to raise the CIT rate on banking companies from 35 percent to 45 percent and additional taxes for banks generating income from holding government securities. In addition, withholding tax (WHT) rates were expanded, for instance on electronic payments made outside the country (1 percent for filers, 2 percent for non-filers) and on electricity bills (fixed amounts between PKR 3,000 and PKR 10,000). Income taxes for real estate holdings were also expanded. Finally, the Government also announced a gradual increase in PDL rates.

5.2.2 Revenue performance

Despite various reform efforts, revenue collection has been stagnant over time and remains low in international comparison. In FY21, federal aggregate revenue stood at 11.2 percent of GDP (Figure 5.1). Tax revenue stood at 9.4 percent of GDP in the same year, primarily collected by the FBR, and has also only increased modestly over the last decade. This puts Pakistan squarely behind regional and international peers. In FY18, for instance, Pakistan's tax revenue generation was 2.8 percentage points of GDP lower than the South Asian average and 3.5 percentage points lower than the average of low and lower-middle income countries (Figure 5.2). Pakistan lags behind its peers' tax performance across revenue sources, including indirect consumption and trade taxes, as well as direct corporate and personal income taxes.

Figure 5.1: Total revenue, by source and year (% of GDP)

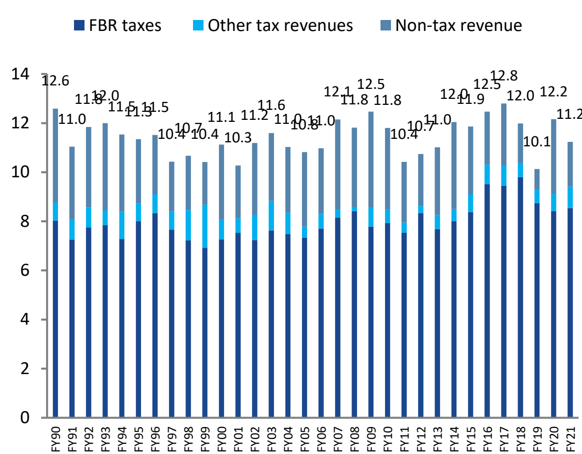
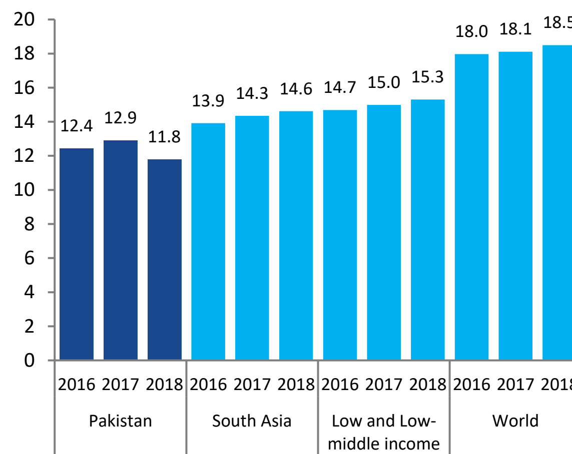


Figure 5.2: Tax revenue in international comparison (% of GDP)



Source: FBR Yearbook, IMF Government Finance Statistics and World Bank Staff calculations.

Tax revenue collection is balanced between direct and indirect sources. Direct taxes include all forms of income taxes and accounted for 3.1 percent of GDP in FY21, 0.5 percentage points lower than the sales tax revenue collection in the same year (Figure 5.3). The proportion of sales and direct taxes in total tax revenue have remained markedly constant over time, and both have acted as the central drivers of nominal tax revenue growth. Customs are the third most important tax revenue source, accounting for 1.3 percent of GDP in FY21, whereas excise duties only accounted for 0.5 percent of GDP. In FY21, 3.8 percent of GDP (or 44 percent of total tax revenue) was collected at the border through custom duties, sales tax, and withholding of corporate and personal income tax on imports (Figure 5.4).

Figure 5.3: FBR-collected tax revenue, by source and year (% of GDP)

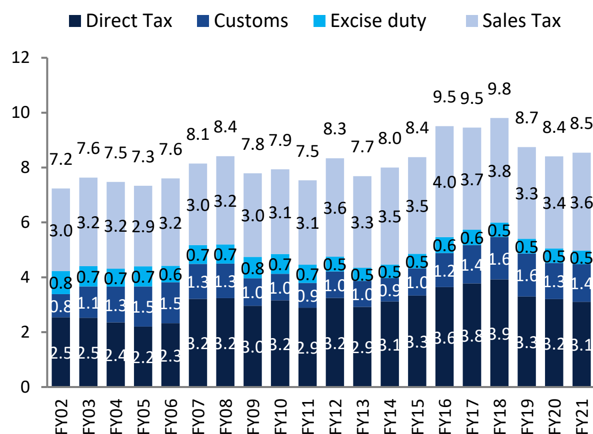
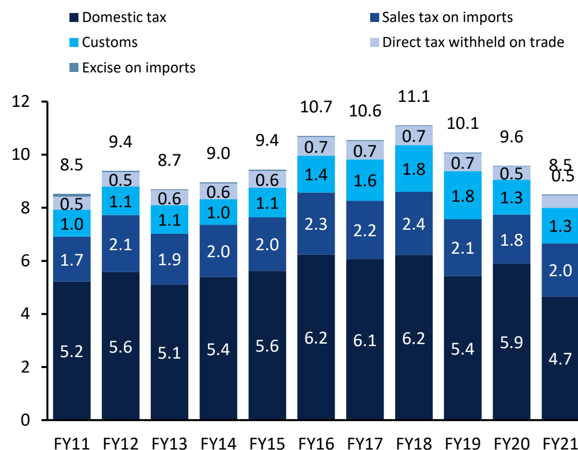


Figure 5.4: FBR-collected tax revenue, by origin and year (% of GDP)



Source: FBR Yearbook, IMF Government Finance Statistics and World Bank Staff calculations.

Figure 5.5: Tax revenue prediction, total tax revenue (actual vs. predicted)

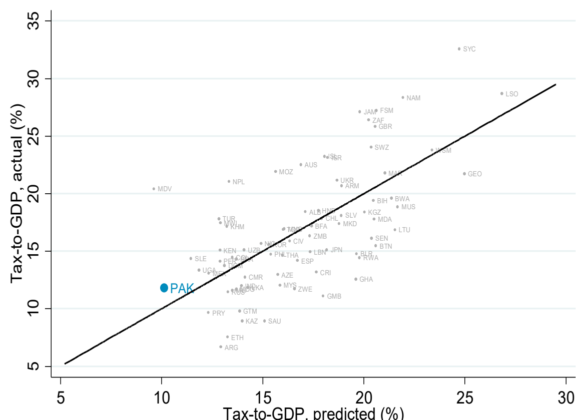
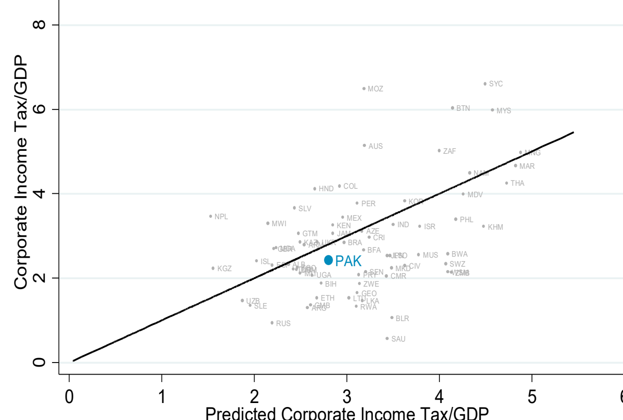


Figure 5.6: Tax revenue prediction, corporate income tax revenue



Source: Authors' elaboration based on Le, Moreno-Dodson and Bayraktar (2012).
Note: Predictor variables include [1] Agri: share of agricultural value added in GDP, [2] Trade: trade share (imports plus exports) as percentage of GDP, [3] Pop: annual population growth of those 15–64 years old, [4] Corrup: control of corruption index from the World Governance indicators, [5] Locked: dummy variable taking the value 1 if the country is land locked and 0 otherwise, [6] Remit: Personal remittances received (as percent of GDP), [7] Region fixed effects, [8] Year fixed effects. Data was obtained from the IMF's Government Finance Statistics, World Development Indicators, World Governance Indicators, and World Bank TCdata360.

Weak revenue performance is at least partially driven by fundamental characteristics of Pakistan's economy. A regression approach that estimates a country's expected tax-to-GDP ratio based on macroeconomic, demographic, and institutional characteristics highlights that Pakistan in FY20 collected marginally more total tax revenue than would be expected given its fundamentals (Figure 5.5). The analysis does, however, also highlight that Pakistan has among the lowest predicted tax revenue in the sample. The aggregate figure masks differences between tax types: whereas Pakistan collects close to its potential in indirect taxes, corporate income taxation falls below its potential by approximately 0.5 percentage points of GDP (Figure 5.6).

In addition to fundamental characteristics, tax expenditures also contribute to revenue losses. As mandated by a new public finance act passed in 2019, the FBR has instituted a tax expenditure analysis

that provides estimates of revenue losses as part of the annual budget presentation to parliament. Tax expenditures are estimated using tax return data that is not publicly available, relying on a revenue-foregone methodology that compares actual tax collection under concessions with a benchmark concession-free system on an ex-post basis. The estimates show that past efforts to broaden the tax base have not resulted in tangible outcomes: in FY22, Pakistan lost a total of 2.6 percent of GDP to tax concessions, 0.2 percentage points more than in FY20 (Figure 5.7). Tax expenditures accounts for a substantial share of revenue potential. According to the official figures, Pakistan lost an average of 26, 18, and 30 percent of sales tax, income tax, and custom duty revenue potential per year between FY20 and FY22 (Figure 5.8).

Figure 5.7: Tax potential, by revenue and expenditure (% of total potential)

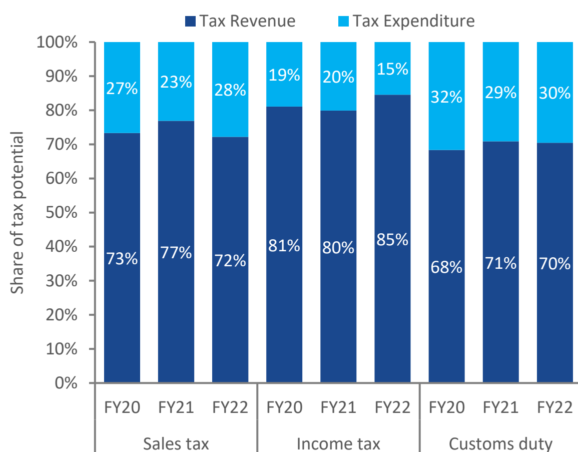
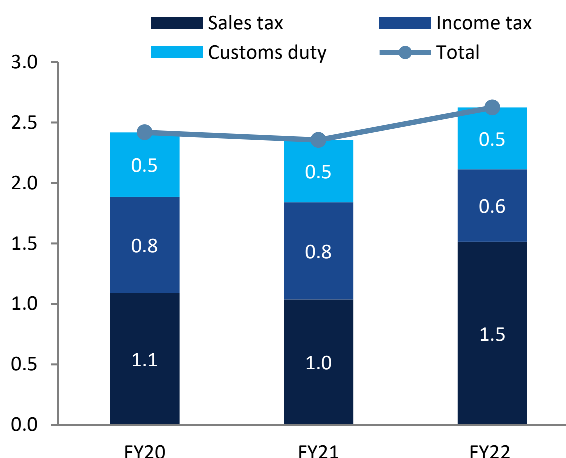


Figure 5.8: Cost of tax expenditures, by tax (% of GDP)



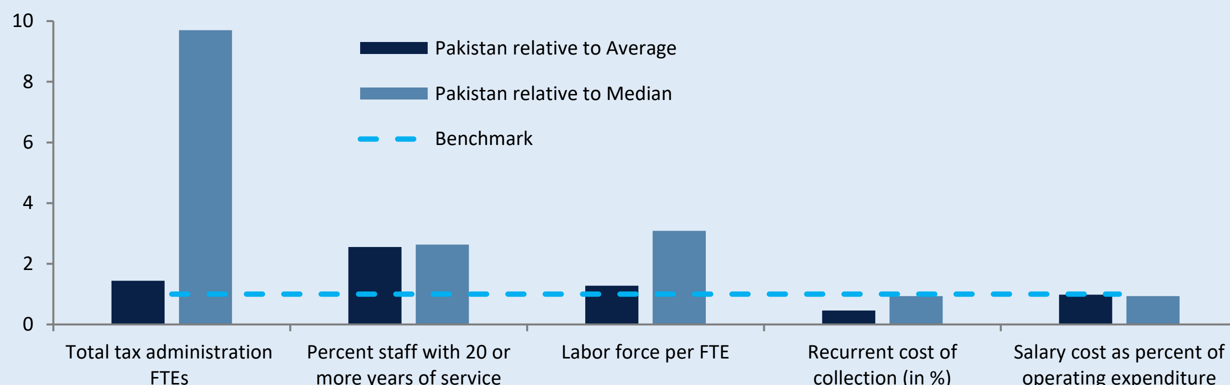
Source: Ministry of Finance, Tax Expenditure Statement, various years; and World Bank Staff calculations.

Box 5.3: Tax administration performance

Pakistan's tax administration is under-resourced. Figure B3.1 below compares resources available to the FBR with those in the average and median country around the world. A value greater than 1 implies that Pakistan has more of a given factor than the average or median country. The figure illustrates three facts. First, Pakistan's tax administration has more staff than in the average or median country, exceeding full time employees (FTEs) in these by a factor 1.4 and 9.7, respectively. This staff is also more experienced than in other countries. Second, considering the size of Pakistan's labor force as a proxy for tax administration workload, Pakistan has 1.3 and 3.1 more potential taxpayers per full-time employee than the average and median country. Third, Pakistan's recurrent cost of collection (expressed as a share of revenue) is lower than in other countries. Taken together, these factors highlight that even though Pakistan's tax administration has many staff, it has less resources available than tax administrations in other countries of comparable size.

Expanding the FBR's resource and staff envelope may raise revenue collection. Figures B3.2 and B3.4 link two tax administration inputs metrics (operating costs and worker-to-tax administration staff ratios) to revenue collection (an output metric). The figures highlight that tax administrations with a higher operating budget and lower taxpayer to tax administration employee ratios tend to collect more revenue. The figures also highlight that Pakistan, shown as the red dot in the figures, collects less revenue than other countries with similar inputs. These factors imply that there is potential to raise revenue collections by (i) investing in tax administration inputs and (ii) raising the efficiency of FBR to ensure that more revenue with a constant input mix can be collected.

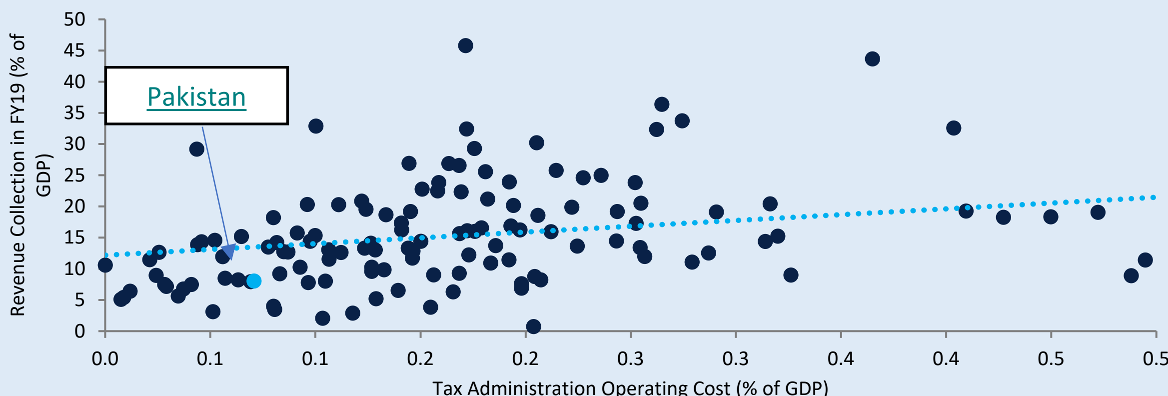
Figure B3.1: Tax administration resources in international comparison.



Source: World Bank staff calculations based on data from the International Survey on Revenue Administration Database (data.rafit.org).

Past tax administration reforms have focused on the legislative framework and the digitization of tax administration operations. Past reforms include a restructuring of FBR along functional lines, a modified oversight structure that moved the tax administration under the oversight of a Cabinet Committee on Finance and Revenue and the approval of a previously nonexistent human resource management policy framework, including a rationalization plan for nonessential FBR staff. Investments in tax administration have included the establishment of Large and Medium Taxpayer Units and investments into IT infrastructure and business process automation. With regards to digitization, the FBR has established databases for reporting and audit purposes, an online tax registration system and a self-assessment system for filing tax returns. It has also integrated retail, restaurants, and textile retail point of sale systems with its own to ensure data exchange.

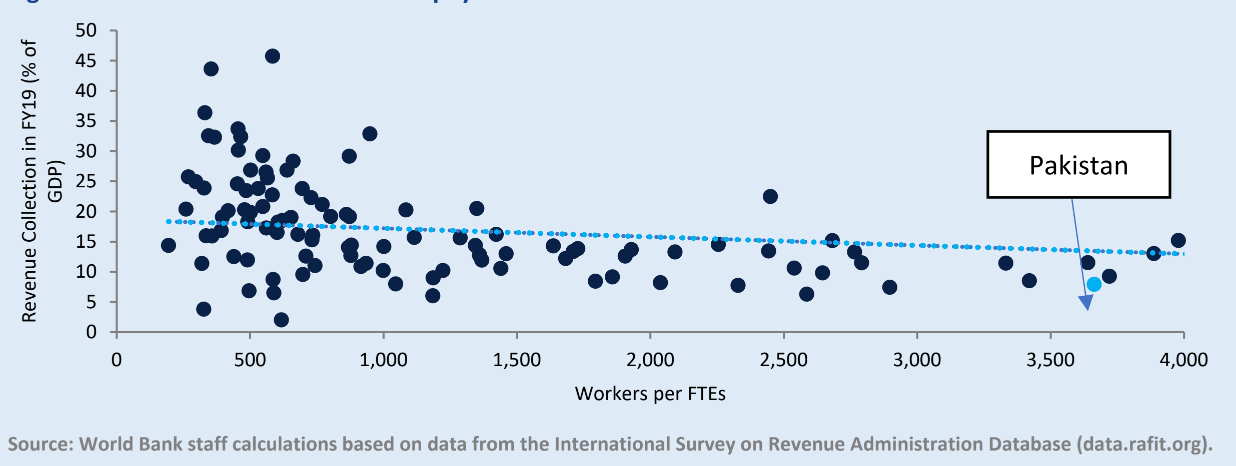
Figure B3.2: Revenue collection vs. operating costs



Source: World Bank staff calculations based on data from the International Survey on Revenue Administration Database (data.rafit.org).

Going forward, priority investment areas include data exchange and staff incentives. Although initial steps toward establishing tax enforcement databases have been taken, the FBR would benefit from an integrated data system that combines provincial and federal data on a real-time basis. This could be complemented by a fully automated system without human interface for taxpayers that automatically processes tax returns and refunds, thus fostering accountability and preventing moral hazard between tax administrators and taxpayers. Equally important is a focus on investing in FBR's human resources by identifying and hiring qualified staff, effectively managing performance, and providing incentives for performance. Setting up a dedicated and well-trained revenue cadre could be a potential avenue to this end.

Figure B3.3: Revenue collection vs. taxpayer to staff ratios.



Source: World Bank staff calculations based on data from the International Survey on Revenue Administration Database (data.rafit.org).

5.3 Discussion of Specific Taxes

5.3.1 Indirect Taxes

5.3.1.1 Sales Tax

Resident businesses in the manufacturing, importing, services, distribution, wholesale, and retail sectors that supply taxable transactions are required to register for and charge sales tax on their supplies. Manufacturers and retailers with taxable turnover below PKR 5 million during the past twelve months are exempted from the registration and payment of sales tax. Since 2021, cottage industries with an annual turnover exceeding PKR 10 million are required to register for the sales tax which, in nominal terms, is comparable to value added tax (VAT) thresholds in other countries. All firms registered for the sales tax and remitting tax payments on their sales are eligible for credit on sales tax paid on inputs, making the sales tax a de jure VAT. Sales tax collection has increased modestly over the last twenty years, from 3 percent of GDP in FY02 to 3.6 percent of GDP in FY21 (Figure 5.9). This increase was aligned with the overall increase in revenue, with the sales tax accounting for just above one-third of total tax revenue (Figure 5.10).

Figure 5.9: Goods sales tax revenue (% of GDP)

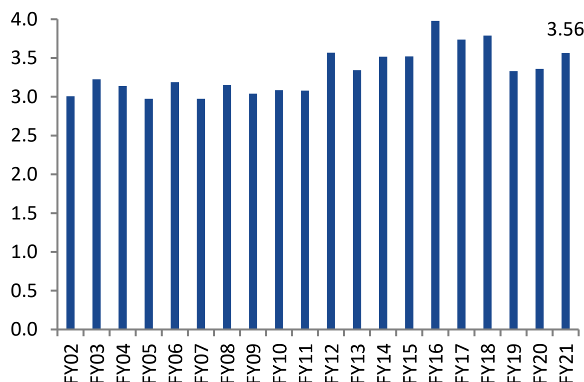
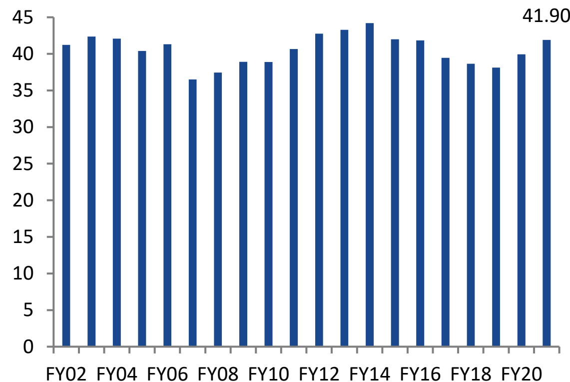


Figure 5.10: Goods sales tax revenue (% of total tax revenue)



Source: FBR revenue division yearbook 2020-21.

The sales tax base definition is narrow, as Pakistan allows for multiple exemptions, which are granted with or without links to other legislation or designated economic zones. Examples of exempt items include pesticide production inputs registered under the Agriculture Pesticides Ordinance (1971), plant, machinery, equipment, and raw materials supplied for special technology zones, and certain types of electric and internal combustion engine vehicles.

In addition to exemptions, the sales tax system also allows for concessionary rates for select products and sectors. Pakistan's standard goods sales tax rate is 18 percent.[17] However, the sales tax act's 8th schedule allows for multiple reduced rates, for instance for locally manufactured electric vehicles (subject to a rate of just 1 percent) and locally manufactured cars up to 1000cc (12.5 percent). Certain domestic supplies in five export-oriented sectors (textile, leather, footwear, surgical goods, and sport goods) are also granted reduced rates. The fact that beneficiary sectors are both relatively easy to tax and mostly do not qualify as merit or basic goods suggest that exemptions and zero-ratings were motivated by the desire to provide a fiscal transfer to certain sectors. This interpretation is corroborated by the fact that an additional sales tax of 3 percent is levied on commercial imports, acting as protectionary measure for domestic industries.

The 5th schedule of the sales tax rate allows for a broad list of zero-rated products, consisting of both exported and—in contrast to international practice—domestically sold goods. The provision of zero-ratings for domestically sold goods violates the destination principle of VATs, which emphasizes that only exported items should be zero-rated. Examples of zero-rated items in Pakistan include select food items and milk. In addition to products mentioned in the 5th schedule of the sales tax act, zero-ratings are also available for local supply of inputs, plant, and machinery to registered exporters under an export facilitation scheme introduced in 2021, and for the supply to exporters in export processing zones.

Figure 5.11: C- Efficiency in international comparison

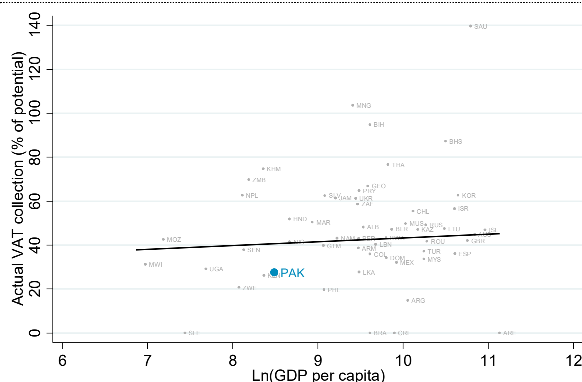
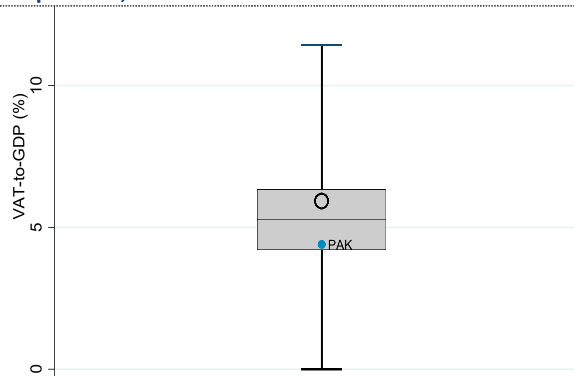


Figure 5.12: Sales tax revenue in comparison with countries that have a sales tax rate between 16 and 18 percent, 2019



Source: Data from KPMG, World Development Indicators and World Bank Staff calculations.
Notes on the left-hand-side box plot: The bar in box highlights median revenue collection in the sample and the circle shows the mean. The upper and lower ends of the box visualize the third and first quartile. The whiskers show the upper and lower limit of the range of collections. In 2019, the reference year for this graph, Pakistan's sales tax rate was 17 percent.

The fractionalized design of the sales tax has resulted in low revenue efficiency. One way to benchmark the effectiveness of a sales tax system in an internationally comparable manner is by calculating C-efficiency. This is defined as the proportion of actual to potential collection, where the latter is the

[17] Provinces service sales tax rates range from 13 to 16 percent.

statutory sales tax rate multiplied by aggregate final consumption expenditure in the economy. This calculation highlights that Pakistan's sales tax is comparatively inefficient: in FY20, its C-efficiency lay below 30 percent, significantly below the level expected considering its per capita income (Figure 5.11). This result is even more striking when considering that Pakistan has a relatively high standard sales tax rate, but 75 percent of comparator countries—which had sales tax rates between 16 and 18 percent in FY19—achieve higher collection rates (Figure 5.12).

Figure 5.13: Sales tax revenue, by origin (% of total revenue)

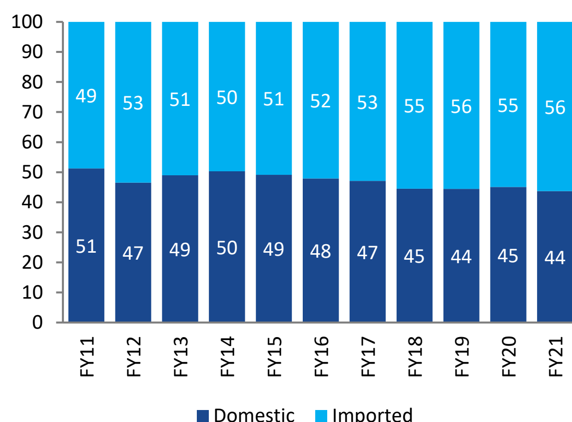
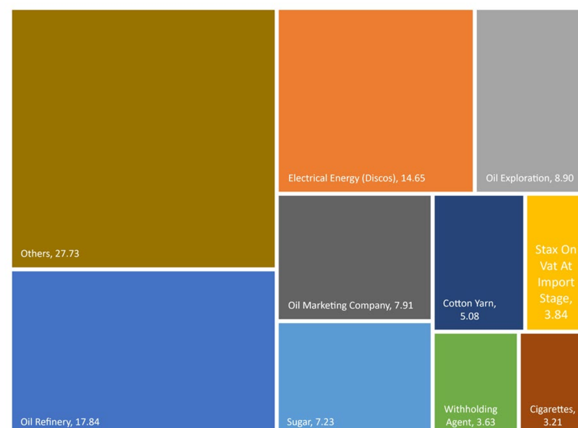


Figure 5.14: Domestic sales tax revenue, by sector (FY21, % of total revenue)



Source: FBR Yearbook and World Bank Staff calculations.

The narrow base definition has also contributed to a concentration on imports and select sectors. In FY21, Pakistan collected 56 percent of total sales tax revenue at the border (Figure 5.13). This share has grown over time, with sales tax on imports accounting for the majority of sales tax revenue growth over the last ten years.[18] The sales tax base is concentrated not only by origin, but also by product. Refined oil, oil exploration, oil marketing, and electrical energy jointly account for 49 percent of domestic sales tax revenue, and petroleum products account for 23 percent of imported sales tax revenue (Figure 5.14).

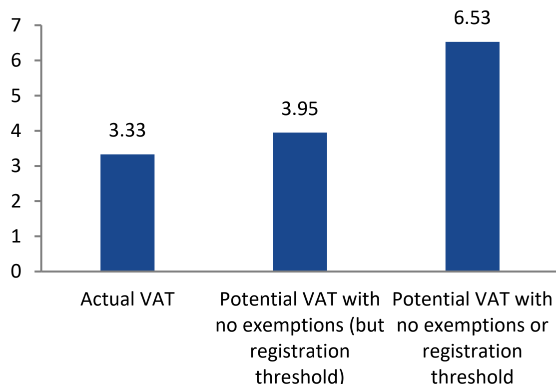
A VAT gap analysis, conducted with reference to FY19 GDP and using parameters of the FY19 tax system, reveals that concessionary tax rates, exemptions, and zero-ratings for non-exported products cost Pakistan 15 percent of its revenue potential. In FY19, had Pakistan not allowed for any concessionary rates, exemptions, or zero-ratings, and had it registered all firms in the tax net, it would have had a total sales tax revenue potential of 6.53 percent of GDP (Figure 5.15). Similarly, when considering that only a subset of firms is required to register for the sales tax, its potential in FY19 stood at 3.95 percent of GDP in the absence of concessions on tax rates and tax exemptions. The manufacturing sector accounted for 37 percent of this potential, followed by the livestock sector, mining and quarrying, and the crop sector. By contrast, Pakistan collected 3.33 percent of GDP in FY19, about 51 percent of its total sales tax potential and 85 percent of its registered sales tax potential. Tax losses from exemptions and other concessionary rates accrued primarily in the petroleum sector, in which collection losses amounted to PKR 284 billion, followed by chemicals, oils and fats, and machinery.

These results are broadly consistent with the Government's published tax expenditure figures, which highlight that most revenue losses are driven by exemptions and concessionary rates. Due to differences

[18] In addition to tax policy factors discussed in this chapter, this trend can also be explained by a continuous currency depreciation.

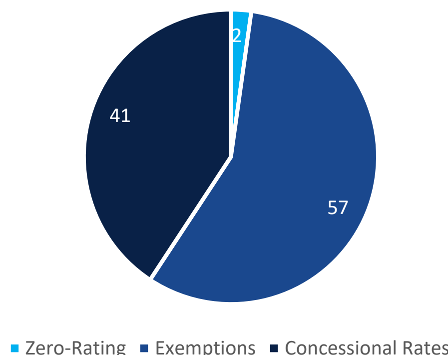
in methodology, estimates of the sales tax gap differ slightly between the Government's estimate published in the annual budget documents and the estimates derived from the sales tax gap analysis. According to government figures, Pakistan lost between 23 and 28 percent of potential revenue in the last three years, slightly above the estimate of 15 percent obtained for FY19 in this report's analysis. The government figures also highlight that 57 percent of total losses are caused by exemptions, whereas concession rates account for most of the remaining losses (Figure 5.16). By contrast, zero-ratings for domestic supplies only play a minor role.

Figure 5.15: Potential compared to actual sales tax collection in FY19 (% of GDP)



Source: World Bank Staff calculations based on the IMF VAT gap analysis methodology.

Figure 5.16: Cost of different sales tax exemptions in FY20 (% of total sales tax expenditure)

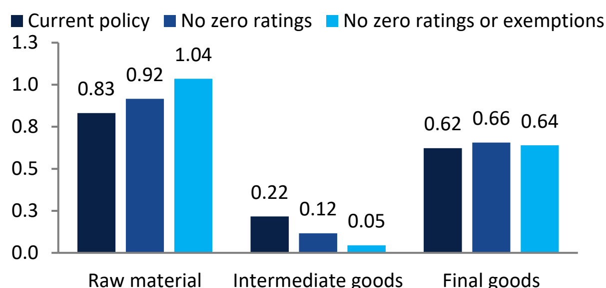


Source: Ministry of Finance, Tax Expenditure Statement; and World Bank Staff calculations.

In addition to revenue losses, concessionary rates and exemptions also contribute substantially to factor misallocation by redistributing the sales tax burden along the production chain. Sales tax exemptions have two effects on taxpayers. First, they relieve producers of exempt items from the obligation to remit sales tax. Second, unless exemptions are sequentially applied through the production chain, they also preclude producers at later stages of the value chain from claiming input tax credit for exempt items. Sales tax exemptions on raw materials thus do not, ceteris paribus, cause a revenue loss, but rather increase the tax obligation for producers of intermediate goods and thus generate a cascading effect. This changes relative prices across the production chain and contributes to factor misallocation.

In Pakistan, concessionary rates and exemptions place an exceptional burden on the production of intermediate goods. Zero-ratings are primarily applied on raw and final products, whereas exemptions primarily benefit raw and intermediate products. Considering these characteristics, the domestic sales tax potential in Pakistan's current system was 0.83 percent of GDP for raw materials, 0.22 percent of GDP for intermediates and 0.62 percent of GDP for final goods (Figure 5.17).[19] Removing zero ratings would increase the revenue potential for raw materials and final goods, but approximately halve the revenue potential of intermediates.

Figure 5.17: Sales tax revenue potential by production stage, baseline, and reform scenarios (% of GDP)



Source: World Bank Staff calculations based on the IMF VAT gap analysis methodology.
Notes: The classification into raw materials, intermediate goods and final goods follows the UN TRAINS classification and its adaption by the World Bank for Pakistan.

[19] The sum of these figures is lower than the total potential because it excludes the sales tax potential of imports.

This indicates that, in the current system, zero-ratings redistribute a substantial share of the sales tax burden from raw materials to intermediates.[20] Taken together, concessionary rates and exemptions thus place a large burden on producers of intermediates and risk distorting competitive neutrality along the value chain.

As is typical for indirect taxes, Pakistan's sales tax imposes an equal burden on richer and poorer households. A fiscal incidence analysis[21] highlights that the sales tax is neither progressive nor regressive: while a 34 percent of all sales tax revenue is paid by the top 20 percent of households in the income distribution, the Kakwani index[22] of the sales tax—a measure that increases with the tax' progressiveness—is only 0.02.[23] Due to its neutral redistributive properties, the indirect tax imposes a substantial burden on the poor: all else being equal, poverty in Pakistan would be 4 percentage points lower in the absence of the sales tax.

5.3.1.2 Federal Excise Duty on Cigarettes

The taxation of cigarettes is an effective tool to achieve dual policy objectives. Cigarette taxation typically attempts to achieve a dual policy objective by raising revenue and discouraging smoking to improve health outcomes. This dual objective can be achieved because cigarette consumption has a low short-term elasticity of demand that allows for the realization of revenue, but a high long-run elasticity. Similarly, although cigarette taxation is typically regressive, it also generates larger health benefits for poorer consumers, which can outweigh the regressive impact of the tax.[24] As such, cigarette taxation can act as a stop gap measure to fill short-term revenue needs and concurrently realize longer-term health benefits.

In Pakistan, cigarettes are taxed through the federal excise duty. Pakistan collected 0.5 percent of GDP in federal excise duty revenue in FY21. The taxation of domestic cigarettes was the main contributor to this and accounted for 0.19 percent of GDP, which has remained steady in recent years (Figure 5.18). By contrast, the taxation of imported cigarettes is negligible. Cigarettes are taxed through a dual rate, with cigarettes that have a final market price of less than PKR 6.7 liable for a tax of PKR 5.05 per cigarette, and those sold above this price, for a tax of PKR 16.5. The system was reformed in FY22, when the number of tiers was reduced from three to two and the tax rates on both tiers were increased. The tax rates for both tiers were increased again in FY23.

[20] Similarly, removing tax exemptions in addition to zero-ratings would marginally lower the revenue potential of final goods, emphasizing that exemptions on intermediates redistributed some burden to final goods. More importantly, however, removing exemptions would further lower the revenue potential on intermediates. This highlights that the benefit accruing to producers of intermediate products from being able to claim input tax credit on raw material inputs outweighs the increase in tax burden from the removal of exemptions for them.

[21] Amjad, B., Carrasco, H. and Meyer, M. (2022). The Effects of Fiscal Policy on Inequality and Poverty in Pakistan. World Bank Working Paper.

[22] The progressivity of a tax is measured by the Kakwani index, which is calculated as the difference between the concentration coefficient of a tax and the Gini coefficient of a reference income. A positive Kakwani index means a tax is progressive, and a negative one means it is regressive. A Kakwani Index close to 0 means neutral.

[23] A larger discrepancy between contribution to revenue and incidence arises because of significantly higher incomes and consumption levels at the top of the distribution.

[24] See (i) World Bank. Tobacco tax reform at the crossroads of health and development: technical report of the World Bank Group global tobacco control program (Vol. 2): Main report. Washington, D.C.: World Bank Group and (ii) Fuchs, A., González Icaza, F. and Paz, D. 2019. "Distributional Effects of Tobacco Taxation: A Comparative Analysis." Policy Research Working Paper; No. 8805. World Bank, Washington, DC.

Federal excise duty collection on cigarettes lies below its potential. The tax potential analysis highlights that the reform undertaken in FY23 raised revenue potential by 0.5 percent of GDP (Figure 5.19). The analysis also highlights that Pakistan's tax potential in FY19 (under the previous three-tier system) was 0.23 percent of GDP, which exceeds actual collection by about 0.04 percentage points. This points to potential enforcement gaps that can be filled. As discussed further below, a further simplification to a single tier and applying the current premium excise rate of PKR 16.50 per cigarette to all would raise to the tobacco excise revenue potential to 1.09 percent of GDP.

Figure 5.18: Federal excise duty revenue, by source (in % of GDP)

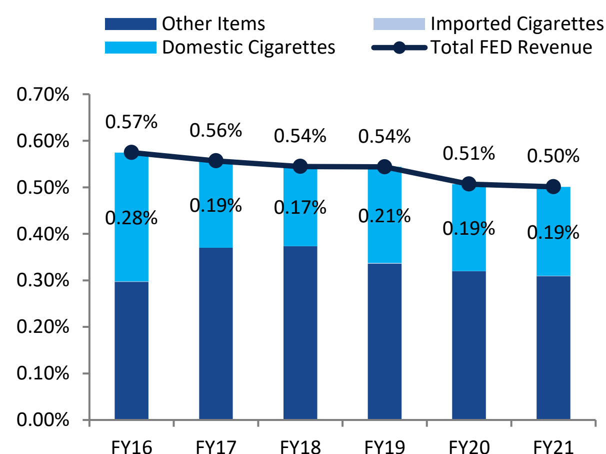
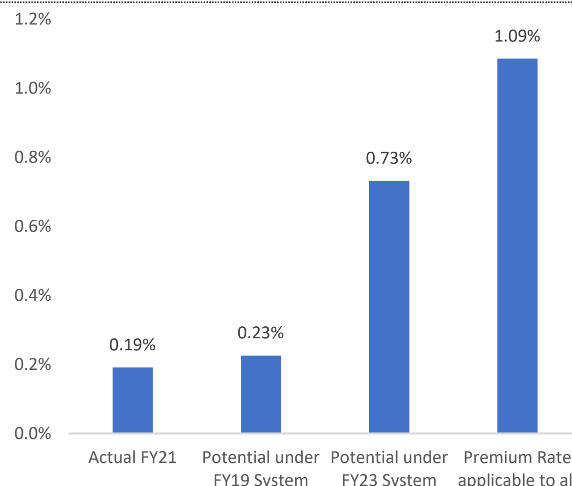


Figure 5.19: Tobacco excise revenue potential under alternative scenarios (in % of FY21 GDP)



Source: FBR Yearbook and World Bank Staff calculations.
Note: In the righ-hand-side figure the middle two bars show revenue potential before and after the FY19 reform to cigarette taxation.

Although Pakistan's choice of applying a nominal specific rate on cigarettes is consistent with international practice, a regular update to account for inflation is needed. Cigarette taxation can be applied on an ad-valorem basis or through a specific nominal tax, with countries approximately equally likely to adopt either system (Figure 5.20). Pakistan has opted for a specific nominal tax, which allows it to adequately address the health objective of the tax and safeguard revenue from cigarette price fluctuations while not requiring the estimation of ex-factory cigarette prices. However, nominal taxes must be adjusted over time to account for inflation. Pakistan currently does not have an automated system for tax rate adjustments in place as any inflation adjustment of cigarette duty rates requires a vote by parliament.

Revenue collection could be increased by harmonizing the system to a single unified rate. Pakistan's cigarette taxation system differs from international practice by applying a dual rate structure (Figure 5.21). This reduces revenue potential and enables tax evasion by allowing producers to apply the cheaper rate on premium cigarettes. A substantial revenue gain could be achieved if the current rate on premium cigarettes (PKR16.50 per cigarette) was also applied to standard cigarettes. In this case, tobacco excise revenue potential would increase to about 1.09 percent of GDP, which could – if accompanied by appropriate enforcement measures – increase total excise revenue by a factor 2.5.[25]

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[25] Total federal excise revenue collection was 0.5 percent of GDP in FY21. The transition to a single tier with an excise tax of PKR 16.50 per cigarette will raise total federal excise potential to 1.39 percent of GDP, ceteris paribus.

Figure 5.20: Number of countries that have adopted different types of excise designs

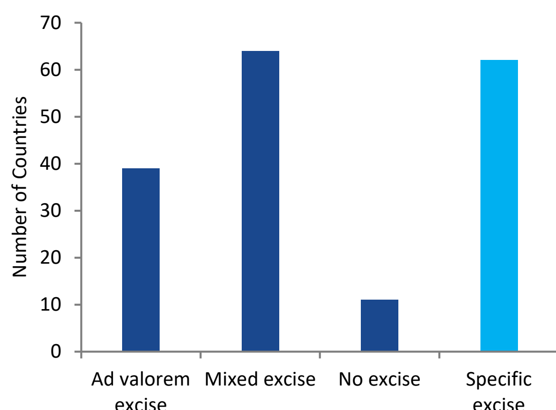
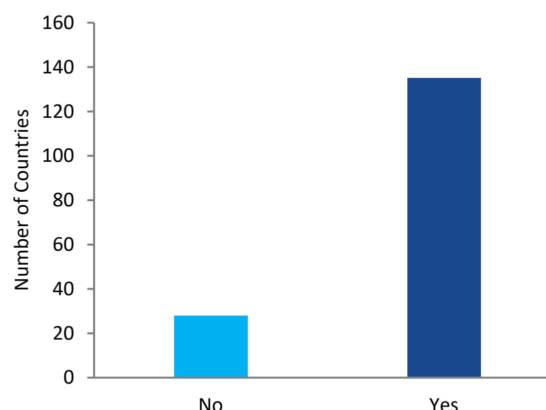


Figure 5.21: Number of countries that have a single ("yes") or multiple ("no") excise rate on tobacco



Source: WHO Tobacco Tax Design Database and World Bank Staff calculations.

Pakistan's envisioned track and trace system presents a good opportunity to strengthen excise duty administration. Pakistan has embarked on establishing a track and trace system for excise duty enforcement, which involves the application of stamps on cigarette packages to signal that the duty was paid. This system is eventually planned to evolve into a technology-based tracking system that would allow the FBR to enforce taxation throughout the value chain. In practice, the system has been met with legal and practical challenges involving, for instance, court challenges to resolve the question of whether producers should be liable for the cost of applying stamps. In practice, most cigarettes sold do not include an excise stamp. There is also anecdotal evidence that stamps are prone to falling off and that stamps for standard cigarettes are applied to premium packages. There are two pathways to alleviating these challenges. First, Pakistan could adopt QR codes that are printed directly on the packages instead of physical stamps. This would reduce the cost of stamp application and could facilitate enforcement. Second, Pakistan could offer cash incentives to consumers—possibly paid directly through mobile phone—to report cigarettes sold with no or incorrect excise stamps.

5.3.2 Direct Taxes

Direct revenue depends overwhelmingly on withholding and advance taxes. In FY21, the country collected a total of 3.1 percent of GDP in direct tax revenue (Figure 5.22). Approximately 1.6 percent of GDP was collected through a total of 52 withholding schemes on non-income transactions, including the purchase of airline tickets, electricity bills, car registration, exports, and imports. The contribution of most withholding schemes is small, averaging just 0.04 percent of GDP each in FY21. The most important withholding line was income tax withholding on imports (Figure 5.23) and payment on contracts for the delivery of goods and services (0.39 and 0.49 percent of GDP in FY21, respectively). Advance taxes contributed a further 0.74 percent of GDP and are collected based on historical incomes and on un-realized capital gains on a quarterly basis. Despite the high share of withholding and advance taxes, refunds play a relatively minor role in the direct tax system, accounting for only 5 percent of total direct tax revenue in FY21. This is consistent with anecdotal evidence that income taxes withheld through non-income transactions are rarely credited in final tax returns and refunded in even fewer cases. As a result, direct tax collection through withholding on non-income sources acts as a de-facto sales tax on select transactions, which induces economic production distortions typically not associated with an income-based direct tax.

Figure 5.22: Direct tax, by source (in % of GDP)

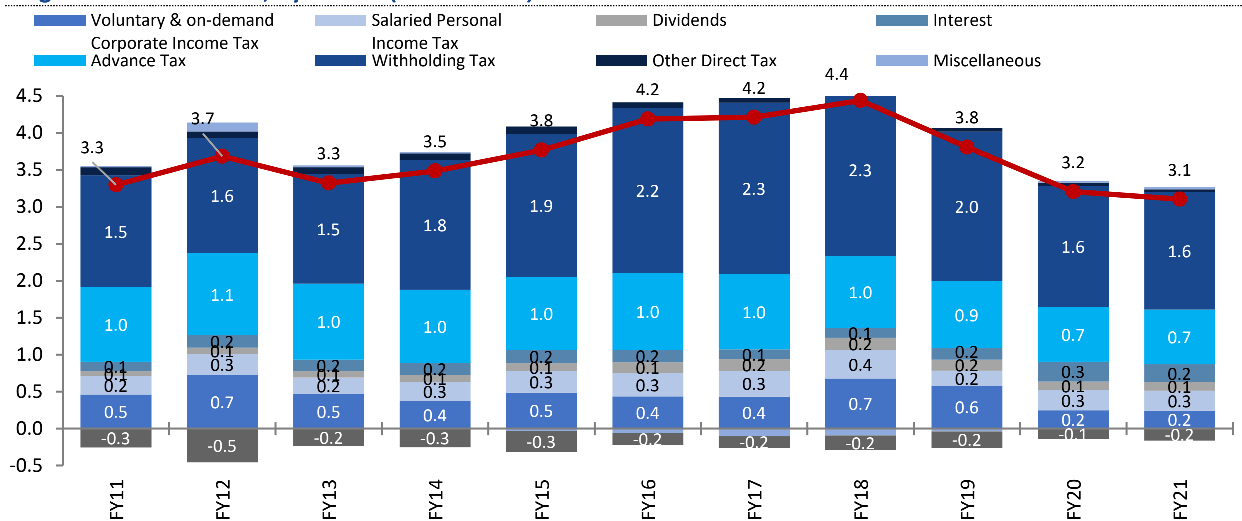
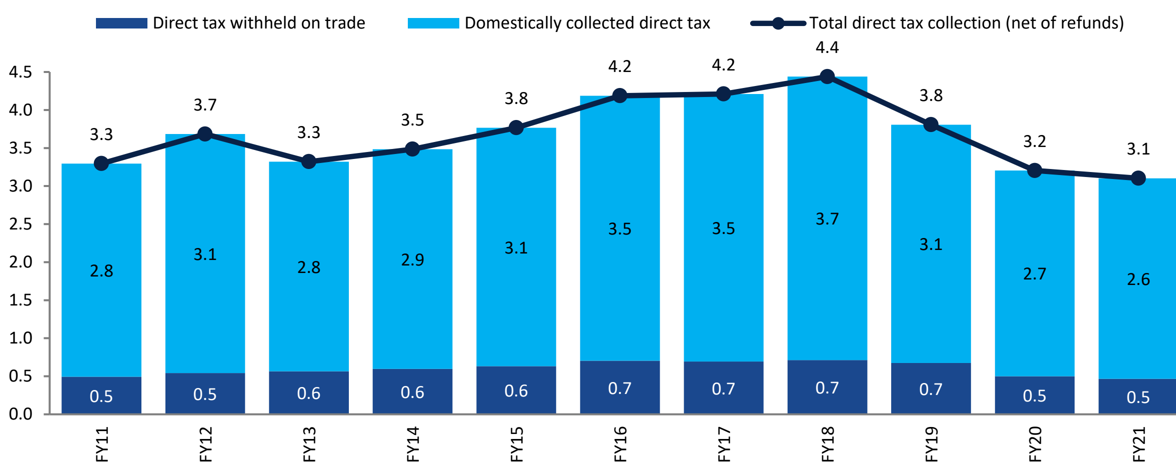


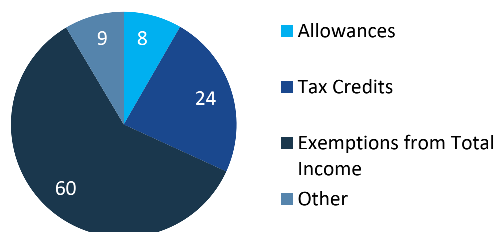
Figure 5.23: Direct tax, by origin (in % of GDP)



Source: FBR Yearbook and World Bank Staff calculations.

Income tax collection is constrained by tax expenditures. Pakistan lost an annual average of 0.7 percent of GDP to income tax exemptions over the last three years. Most of these losses are caused by exempting certain types of incomes or select groups of taxpayers from a tax obligation, which accounts for 60 percent of all tax expenditures (Figure 5.24). Tax credits that are provided to encourage certain behaviors, such as investments, accounted for 24 percent of tax expenditures, whereas allowances, for instance for interest deductions or education expenses, accounted for 8 percent.

Figure 5.24: Cost of different income tax exemptions in FY20 (% of total income tax expenditure)



Source: Ministry of Finance, Tax Expenditure Statement; and World Bank Staff calculations.

5.3.2.1 Personal Income Tax

Pakistan's personal income tax base definition is comprehensive. The personal income tax system recognizes five different types of income: salary, property income, business income, capital gains, and income from other sources.[26] The definition of taxable salary is likewise broad, including direct compensation for work in addition to leave pay, overtime pay, bonuses (monetary and non-monetary), commissions, fees, gratuities, work condition supplements, and allowances.[27] Pakistan taxes the worldwide income of its residents, whereas non-residents are only taxed based on income sourced from Pakistan.

Personal income tax collection at source only plays a minor role but has grown considerably in recent years. Personal income tax—defined as income tax collected through salary withholding—accounted for only 0.27 percent of GDP in FY21. This tax base has, however, experienced significant growth in recent years, accounting for 10 percent of total nominal direct tax revenue growth between FY15 and FY20. Pakistan also applies a 15-percent WHT to earnings from dividends, interest, royalty, and fee for technical services derived from Pakistani sources. Collections through such WHTs on interest and dividends stood at 0.24 and 0.11 percent of GDP in FY21.

The personal income tax differentiates between salaried and non-salaried individuals. Tax-free allowances and tax brackets and rates differ significantly between salaried individuals and other taxpayers. At the time of writing, the exemption threshold for salaried individuals is PKR600,000 and the highest marginal tax rate of 35 percent kicks in for salary exceeding PKR 12 million. By contrast, non-salaried individuals' tax-free allowance is PKR 400,000, with the highest marginal tax rate applied on all income above PKR 6 million.

The differentiation between salaried and non-salaried individuals risks two unintended consequences. First, it generates economic distortions by providing an incentive to shift occupations and income towards salaried sectors, without consideration of production efficiency. Second, the differentiation creates opportunities for tax avoidance through income shifting as, for example, the wealthy can create a company and extract income in terms of salary to benefit from lower marginal tax rates.

Figure 5.25: Personal income tax schedule

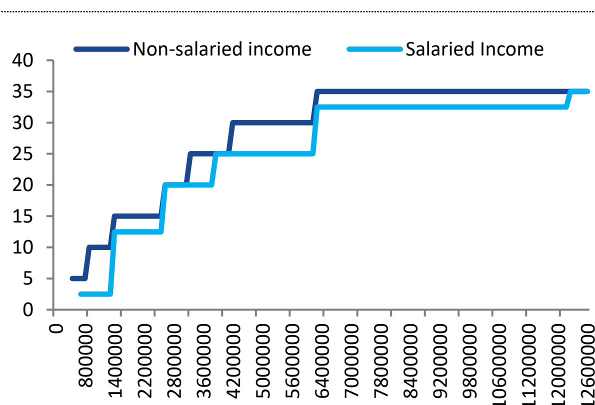
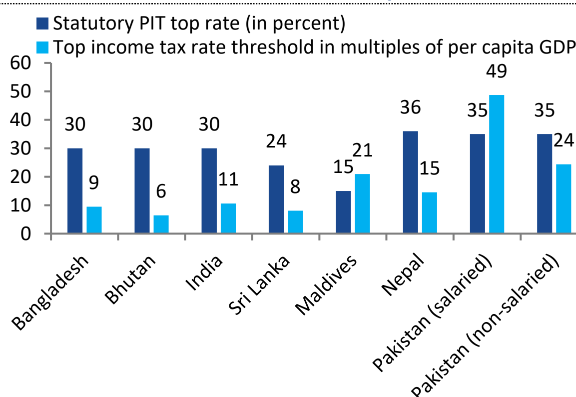


Figure 5.26: Statutory top personal income tax rate and threshold in international comparison



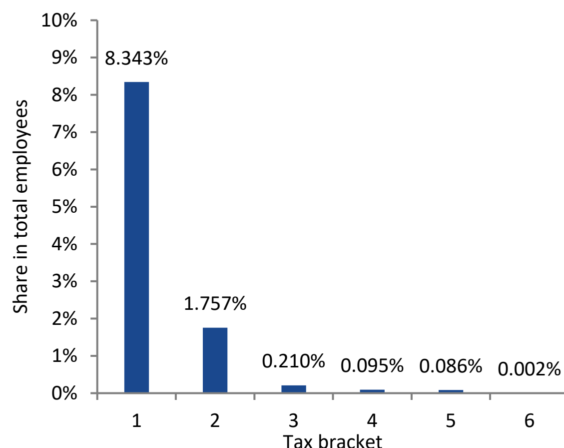
Source: World Bank staff elaborations.

[26] Income from other sources comprises, inter alia, income from dividends, royalties, profit on debt (interest), ground rent, sub-lease of land or building, lease of building inclusive of plant or machinery, prize money, and winnings.
[27] Certain deductions, exemptions, and credits are available, for instance for medical expenses and mortgage interest payments.

The personal income tax schedule is also complex within taxpayer categories, raising compliance and administration costs. The tax schedule for salaried and non-salaried individuals contains 6 and 7 brackets, (Figure 5.25). The number of tax brackets not only raises compliance costs by making the system complex, but also provides ample opportunity for income shifting toward lower brackets to optimize tax liabilities.

The threshold for the top income tax bracket for salaried individuals is very high and is likely to only capture a very limited number of taxpayers. Salaried taxpayers are only required to pay the top income tax rate of 35 percent for income exceeding PKR12 million, or approximately 49 times the per capita GDP (Figure 5.26). This figure is significantly higher than in Pakistan's peer countries and results in a low coverage of the top income tax brackets. In Pakistan's current system, about 10.5 percent of all salaried individuals earn sufficient income to have a positive income tax liability. Almost all fall into the first and second brackets of the income tax schedule, for which modest marginal tax rates of 2.5 and 12.5 percent are applied. By contrast, only 0.002 percent of all salaried individuals have sufficient income to qualify for a marginal rate of 35 percent (Figure 5.27).

Figure 5.27: Share of total employees by income tax bracket



Source: World Bank staff calculations, based on Pakistan Bureau of Statistics LFS Data, 2019.
Note*:* Employees are defined as respondents who report (i) a regular monthly salary with a contract and (ii) employment by an employer that maintains written records.

The reliance on income tax withholding on non-income-generating transactions undermines the redistributive properties of the personal income tax. An analysis of the fiscal incidence[28] highlights stark differences between the redistributive impacts of different WHTs. On the one hand, with a Kakwani index of 0.52, withholding on salaries is highly progressive and reduces inequality by 0.05 Gini points. The richest 20 percent of households pay 82 percent of all revenue collected through the WHT on salaries and the contribution of the poorest households is negligible, so that the imposition of the WHT on salaries neither increases nor decreases poverty. On the other hand, income tax withholding on telecommunication bills, a non-income-generating transaction, acts like a regressive sales tax, as it marginally increases inequality and has a Kakwani index of -0.25. Taken together, these results highlight that Pakistan's reliance on non-salary withholding for personal income tax reduces the ability of a traditionally progressive tax instrument to redistributive income. [29]

Like salary taxation, the current regime of taxing capital gains is very complex. The system features multiple rates that are determined based on the size of the gains and the holding period. The tax schedule

[28] Amjad, B., Carrasco, H. and Meyer, M. 2022. "The Effects of Fiscal Policy on Inequality and Poverty in Pakistan." World Bank Working Paper.
[29] Other reasons for not employing withholding taxes for revenue collection include:
1. Many withholding lines collect an insignificant amount of revenue and is a burden for withholding agent;
2. An excessive use of withholding taxes is equivalent to shifting the tax collection responsibility onto withholding agents, who have to bear the collection cost. This extensive practice tends to deteriorate the business climate;
3. There are certification issues as to whether the withholding agent remitted the full collection;
4. Excessive withholding has consequences for business cash flows, such as the case when collecting withholding.

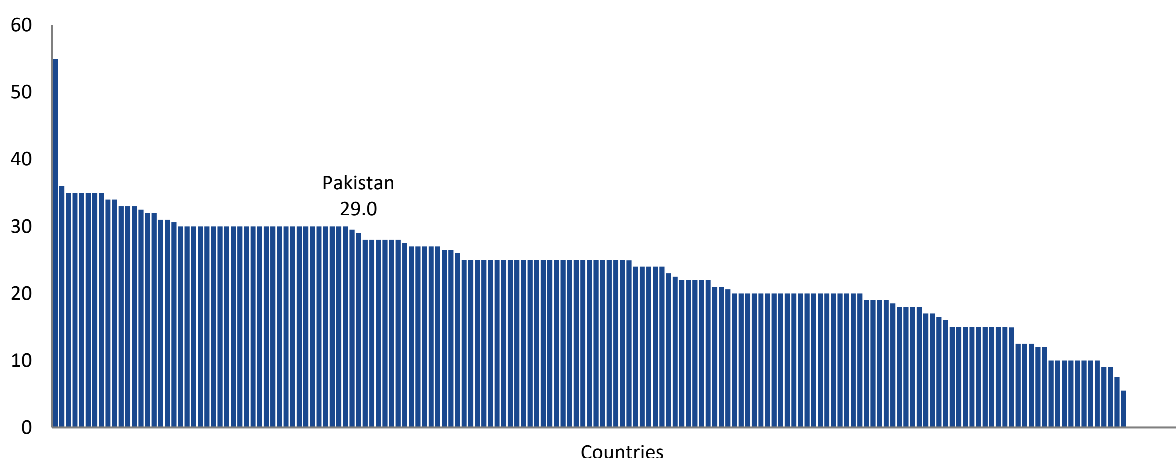
is progressive, with rates ranging from 3.5 percent on gains up to PKR 5 million to 15 percent on gains exceeding PKR 15 million. The rate decreases with the holding period of the asset and is set at 0 for holding periods exceeding 4 years. This risks distorting asset allocation by giving potential sellers an incentive to hold assets for an extended amount of time to minimize their tax liability, even when market condition would encourage an earlier sale. The progressive schedule also provides strong incentives for sellers and buyers to collude on under-reporting of asset values to reduce applicable tax rates. It is for these reasons that most countries opt for a flat capital gains schedule or, if systems are more advanced, decide to tie capital gain taxation into the progressive salary tax schedule.

5.3.2.2 Corporate Income Tax

The definition of the CIT base is consistent with international practice. CIT is levied on revenues minus costs of goods sold, depreciation, interest expenses, and overheads. Companies are allowed to carry forward losses for six years.[30] Pakistan taxes the global corporate income of resident companies and has introduced key anti-avoidance provisions, governing transfer pricing, foreign debt interest expense, and foreign-controlled companies. Pakistan has also signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

Pakistan's thin-cap provisions only have limited coverage, opening opportunities for firms to reduce their tax liabilities. Thin-cap provisions regulate firms that are financed by a relatively high portion of debt compared to equity. In such circumstances, interest expenditure is high, which reduces firms' tax liability. Thin-cap provisions limit the amount of interest that can be deducted in calculating the taxable profits to prevent companies from avoiding tax liabilities through excessive debt, for instance by defining a maximum debt-equity ratio and disallowing tax deductions on interest paid on debt exceeding this ratio. Pakistan's thin-cap provisions are limited as they only apply when the foreign debt to foreign equity ratio of a company exceeds 3:1, in which case interest paid on debt above this ratio is not eligible for a deduction. The lack of thin cap provision, especially on domestic loans, creates options for transfer pricing and an incentive for over-leveraging.

Figure 5.28: Corporate income tax rate in international comparison



Source: KPMG data and World Bank staff calculations.

[30] Resident companies in the hotel business (classified as an 'industrial undertaking') are allowed to carry forward losses for up to eight years.

CIT rates differentiate between three different regimes. Different tax rates and special provisions apply to standard companies, small firms, and small and medium-sized enterprises (SMEs) in the manufacturing sector:

- **Standard regime:** All firms not eligible for a preferential scheme are subject to a 29-percent flat tax rate. This rate is high by international standards and places Pakistan in the top 30 percent globally (Figure 5.28).[31] A higher standard rate of 35 percent is applied to the banking sector, with "super taxes" applied on an ad-hoc basis to fill revenue needs.[32] Firms in the standard regime are also subject to two special provisions. First, the minimum tax scheme requires firms to pay either the standard tax liability on net income or 1.25 percent of turnover, whatever is larger. Second, the alternate corporate tax requires firms to pay at least 17 percent of accounting income in corporate taxes. In summary, firms either pay the standard rate multiplied by revenue minus deductions, 1.25 percent of turnover or 17 percent of accounting profits, whichever is larger.
- **Small companies:** These are defined by a complex list of factors, including equity, number of employees, and turnover.[33] Many of the thresholds are comparatively high and encompass what would typically be considered a medium-sized company in other countries. Small companies benefit from a reduced CIT rate of 21 percent.
- **SME in the manufacturing sector:** The tax regime for manufacturing SMEs is distinct from that for small companies. Manufacturing firms whose turnover does not exceed PKR 250 million are eligible for this scheme. A qualified company can elect to either be taxed on a progressive scale based on its taxable income or to be taxed on turnover, also on a progressive scale (Table 5.2). Firms in this regime are not subject to the minimum tax and, if they opt for the turnover tax, are not subject to audit.

Table 5.2: SME tax categories and options

Categories	Normal Tax Regime	Final Tax Regime
Category 1: Annual turnover below or at PKR 100 million.	7.5% of the taxable income.	0.25% of the gross turnover.
Category 2: Annual turnover above PKR100 million but capped at PKR250 million.	15% of the taxable income.	0.5% of the gross turnover.

These systems generate incentives for firms to split or stay small. The objective of special tax regimes for smaller companies is to encourage formalization and corporatization through the reduction of compliance costs. At the same time, the generosity of the special regimes encourages firms to comply with their requirements, which generates economic distortions if firms adjust their scale to benefit from the beneficial schemes. This is especially relevant for the small firm regime, where caps on the number of employees risk incentivizing firms to stop hiring or rely on informal labor instead, and where caps on equity may lead firms to rely on debt financing instead, inducing financing risks and, in the absence of thin-cap provisions, reducing tax liability. Firms also have an incentive to split to comply with the requirements, especially in the SME scheme for manufacturing firms, where smaller firms benefit from a substantial reduction in applicable tax rates.

[31] The rate was lowered from 35 percent previously, which was the third highest corporate income tax rate in the world.
[32] In June 2022, the Government imposed a 10 percent super tax on banks.
[33] A small company is defined for tax purpose as one that: (1) is registered on or after 1 July 2005, (2) has a paid-up capital plus undistributed reserves not exceeding PKR 50 million; (3) has no more than 250 employees; (4) has an annual turnover not exceeding PKR 250 million; and (5) is not formed by splitting up or the reconstituting a business already in existence (PWC, 2021).

The unequal treatment of firms distorts competition. The CIT system provides substantial implicit fiscal transfers to select sectors and firms, with applicable tax rates ranging between 7.5 percent of income for small manufacturing firms to 45 percent for firms in the banking sector. The unequal application of CIT system distorts the neutrality principle of taxes and generates an uneven playing field for firms, with potentially adverse impacts on competition-induced growth.

Provisions for turnover tax reduce incentives to invest in accounting and tax administration. Firms with inadequate accounting practices are taxed on turnover under the minimum tax scheme. In addition, back of the envelope calculations suggest that the final tax regime under the manufacturing SME regime is a dominant choice for almost all firms. For instance, for category 1 firms with a 30 percent profit margin, the turnover tax would result in a tax liability of 0.25 percent, compared with 2.25 percent under the normal tax regime, which is only attractive for firms with profit margins at 3 percent or lower (Table 5.3). With most firms likely to opt in to the turnover tax regime, and due to the rule that SME's under this regime are not audited, they are disincentivized from investing in better book-keeping, a potential constraint to both firm growth and revenue potential. The reliance on turnover taxes also risks discouraging FBR from investments into the effective administration of a profit-based income tax. Finally, the minimum tax exposes genuine loss-making firms to tax liabilities, potentially worsening their situation because there is no provision to transfer to a profit-based tax instead.

Table 5.3: Tax liabilities under the normal and final tax regime, category 1

Scenarios	Turnover	Profit	Normal tax regime (7.5% on profit)	Final tax regime (0.25% on turnover)
1. **Standard case:** 30 percent profit margin	100	30	2.25	0.25
2. **Break-even case:** 3 percent profit margin	100	3.3	0.25	0.25

There is evidence that the minimum tax yields enforcement benefits. Turnover taxes provide fewer opportunities for tax evasion as they do not require audited estimates of costs. Thus, while they may be less desirable from an economic efficiency perspective, turnover taxes can yield enforcement benefits. Estimates for Pakistan suggest that the minimum tax scheme has reduced evasion by between 60 to 70 percent of corporate profits, and that switching to a full turnover scheme could raise corporate tax revenue by 74 percent without reducing after-tax profits.[34]

Pakistan's CIT regime also provides for various tax incentives. They include outright tax holidays, reduced rates, credits, and exemptions granted by sector, investment type, and location. Many tax holidays run for a long time. For instance, profits derived from an electric power generation project are exempt from tax without a sunset period, new deep-conversion refineries enjoy a 20-year tax holiday, and 10-year income tax holiday are awarded to certain transmission line projects and to enterprises set up in special economic zones. In addition to outright tax holidays, the income tax code allows for generous reductions of tax liabilities, for instance up to 90 percent for low-income housing projects and the provision of a reduced 20 percent tax rate (and tax exemption for dividends) for select builders and developers. Reduced minimum tax rates are also available for certain industries, such as sugar, cement, edible oils, and fertilizer. To attract investment, a tax credit of 25 percent of the amount invested is available to a green

[34] Best, M. C., Brockmeyer, A., Kleven, H. J., Spinnewijn, J. and Waseem, M. 2015. "Production versus revenue efficiency with limited tax capacity: theory and evidence from Pakistan." *Journal of Political Economy* Vol. 123 No.6: 1311-55.

field industrial undertaking. Such incentives are an additional provision in the income tax to conduct implicit fiscal transfers to select industries while undermining the tax base at the same time. They also generate complex incentives through their interaction with the alternate corporate and minimum tax regimes.

5.4 Policy Recommendations

Pakistan's tax system needs a well-structured overhaul that simplifies its provisions, closes loopholes, and ensures an equitable distribution of the tax burden. Despite the development of strategies and proclaimed intentions over the last two decades, successful outcomes remain to be attained. Instead of a complete system overhaul, which may be infeasible from a political economy perspective, a carefully prioritized approach that bundles reforms with compensation mechanisms, stakeholder consultations, and continued investments in taxpayer services may be more promising. In the long run, reforms should aim to create (i) a simple CIT regime with a single, simplified provision for smaller companies, (ii) a simplified personal income tax system focused on taxing income only at source and (iii) a non-distortionary comprehensive sales tax system. The following roadmap outlines key step towards this goal.[35]

Box 5.4: The political economy of tax reform in Pakistan

Tax policy reform is at risk of being influenced by a diverse set of stakeholders whose priority is not the restoration of fiscal sustainability in Pakistan. Pakistan's current tax system provides preferential treatment to a range of economic and political interest groups through concessions, exemptions, and other policy measures. Table B4.1 provides an overview of the main stakeholders and their motivation to influence tax reform and tax administration. It argues that tax policy is influenced by a negotiation within the public sector on the one hand—between federal and provincial governments and the bureaucracy—and on the other hand, between the public and the private sector, including businesses, traders, elites, associations, broader civil society, and media. Elites exert influence and resist reform through a variety of channels, including by mobilizing their political connections, threatening to obstruct businesses, or staging public protests. In doing so, they create a system in which narrow interests determine policy and undermine the interest of the public. It also creates a situation in which policy outcomes are significantly more responsive to the preferences and priorities of the wealthy than the bottom 40 percent.

Overcoming the challenging political economy requires convincing those that are set to lose from tax reforms that a more stable Pakistan is central to their own interests. Dercon (2022)[36] argues that meaningful reform, and therefore growth, is contingent on a country's elites' acceptance that growth is in their self-interest. For Pakistan, this requires highlighting to the elites that currently oppose tax reform that their personal costs associated with Pakistan's boom–bust growth cycle outweigh their benefits from narrow preferential tax treatment, and that they (and their businesses) are set to gain more from a stable and fast-growing Pakistan with an equitable and efficient tax system than under the status quo. Public pressure on elites through transparency can also help, for instance through the publication of detailed beneficiary reports that highlight which firms and beneficiary owners take advantage of certain tax incentives.

The Government itself may be reluctant to undertake reforms that impose short-term transition costs in exchange for longer-term revenue gains. An example of this is the WHT regime on non-income transaction which, as discussed in this chapter, is prevalent in Pakistan. This system, while economically distortionary and limited in

[35] The introduction of new types of taxes, specifically the wealth, inheritance, and gift taxes, should be deferred. While it is tempting to introduce such instruments to tax richer segments of the wealth distribution, such taxes have not feature in the authorities' recent reform agendas. With the segregated databases across federal and provincial levels (and more so, the property tax is under the purview of provincial governments by Constitution), the introduction of new taxes on net wealth and/or inheritance tends to be unrealistic and cloud over other more critical reform actions.

[36] Dercon, S. 2022. *Gambling on Development: Why Some Countries Win and Others Lose*. London: Hurst and Company.

revenue potential, provides an assured stream of revenues to the tax administration, and thus enables them to meet their (narrowly defined) revenue target. Similarly, anecdotal evidence suggests that obtaining refunds for either income tax withheld or for excessively paid sales tax is difficult in Pakistan, as FBR uses the collected revenues to meet their revenue targets. Overcoming this short-term inertia, for instance by redefining FBR's annual targets to include tax system efficiency measures, or by separating the tax administration from the tax policy function, is instrumental for meaningful tax reform.

Table B.4.1. Stakeholders Influencing Tax Policy

Stakeholders	Motivation	Influence	Example actions taken by stakeholder that prevent reform
Political Elites • Executive/Cabinet • Parliament • Political Parties • Finance Ministers • Cabinet Committees • Standing Committees	• Raising tax revenues to finance public policies • Attracting foreign direct investment • Consolidating power and narrow political interests • Political survival through reelection while maintaining public image as a reformist • Patronizing political and economic allies • Deepening rent-seeking opportunities • Fundraising for election campaign financing	Very strong	• Politization of tax system through higher-level appointments of political allies in revenue authorities • Backing off from tax reforms opposed by lobbies and associations • Designing complicated tax laws to make their enforcement non-transparent and require judicial interpretations • Ideological battles at Cabinet level that slow down reform
Sub-national governments • Provincial Governments • Local Governments	• Securing large share of the divisible pool to meet increasing expenditure needs • Quest for more political, financial, and administrative autonomy	Very strong post 18th Amendment	• Negotiating revenue compensation mechanisms to offset potential revenue losses • Undermining fiscal reforms by resorting to ad hoc fees for additional, off-budget revenue generation • Opposing own-source revenue reforms that could alleviate fiscal pressure on federal level
Bureaucracy • Revenue Authorities • Ministry of Finance	• Maintaining discretionary powers for rent-seeking • Networking for promotion • Protecting interests of ruling coalition, their financiers, and lobbies/businesses	Strong	• Creation of informal rules • Cumbersome administrative requirements facilitating rent-seeking • Hiring and staffing policies that encourage high staff turn-over, often under political influence
Economic Elites • Industry • MNCs • Exporters • Service Sectors	• Business benefits through lower taxation and compliance costs, e.g., through exemptions	Strong	• Lobbying and networking for exemptions, incentives, special regimes (zero-rated sectors) and informal benefits through

• Traders/Retailers • Landlords/Agribusiness • Business Associations • Chambers of Commerce and Industry • Trade Unions	• Avoid audits • Improve business environment • Prompt refund payments		business associations (APTMA, APSMA, Fertilizer, Cement) • Financing political campaigns • Leveraging promises of job creation and investment to obtain preferential tax treatment • Staging public protests to influence tax negotiation outcomes or against tax reforms
Civil Society • Media • Civil Society Organizations • Tax Professionals	• Equitable and fair tax system • Promoting transparency in tax administration • Advocating transparency in governments expenditure	Moderate	• Complete monopoly of some media houses over the ways and means of influencing public opinion gives them unmatched access and intrusion into the policymaking process by exerting pressure on the political structures
Development Partners • IMF • World Bank Group • Asian Development Bank • FCDO • USAID	• Increasing tax revenues for financing national development priorities and fiscal stability • Promoting equity, efficiency, and fairness in tax system	Strong	• Foreign capital inflows from development partners lower tax effort

5.4.1 Sales Tax

<u>Immediate Priority:</u> Unifying the rate structure and eliminating zero-ratings on domestically sold products.

- As outlined in this chapter, Pakistan's sales tax on goods is complex and highly distortionary. Rectifying this could initially involve unifying the rate structure by removing concessional rates through the elimination of the 8th schedule of the sales tax act and applying the standard rate on all goods subject to reduced rates.
- This could be complemented by limiting the list of goods subject to zero-rating exclusively to exports. All domestically sold goods mentioned in the 5th schedule of the sales tax act could initially be moved to the exempt list under the 6th schedule before exemptions are gradually rationalized (see medium-term priority).

<u>Medium-Term Priority:</u> Reduction of sales tax exemptions while concurrently lowering the overall rate.

- In the medium-term, Pakistan could strive to reduce the items included in the 6th schedule of the sales tax act, limiting exemptions only to those considered as basic food, basic public health services, and selected financial transactions.
- To buffer the social impacts of such exemption removal and prevent an increase in poverty, some of the savings could be used to increase BISP transfers to targeted households.
- A broadened tax base could also be leveraged to lower the currently high sales tax rate to garner support for the reforms.

Long-Term Priority: Unifying and aligning the sales tax registration threshold with the CIT threshold and harmonizing the provincial and federal sales tax systems.

- A simplification of the sales tax system could involve a unification of the registration threshold for all industries, in close coordination with an updated threshold for the small companies' concessional CIT (see recommendations in section 4.3).
- A unification of provincial sales tax on services and federal sales tax on goods is also critical, but beyond the scope of this chapter (Box 5.5).

Box 5.5: Challenges and options for sales tax harmonization in Pakistan

Under Pakistan's constitution, the Federal Government is tasked with collecting federal sales tax on goods, while provinces levy sales tax on services. This leads to fragmentation with regard to legislation and administration and has resulted in five different sales tax regimes and multiple taxing authorities. Such segregation breaks down the flow in tax administration processes and risks posing additional challenges to FBR and provincial tax authorities, including:

- Increased complexity in managing refunds for cross state transactions.
- Increased compliance cost and reduced enforcement effectiveness: Complications in dealing with proportioning the same inputs produced for exempts and non-exempts when transactions transverse provinces; non-uniform definition of taxable supplies (especially when businesses are engaged in both services and manufacturing or trading).
- Heightened risk of double taxation when the definition of goods and services are not consistent across jurisdictions.

Such challenges are not uncommon in federal systems, which typically choose one of three approaches to address policy interdependencies:

1. **Ideal case:** Completely harmonizing the base, rates, and administration at the central level, in combination with an agreed-upon formula for revenue allocation (example: Australia). In Pakistan, this would simplify and minimize the administration and compliance costs in taxing inter-provincial supplies but would require a constitutional change.
2. **Realistic case:** Harmonizing the base while allowing rates to vary across provinces (example: the EU). This is a compromise that preserves some subnational autonomy but increases compliance costs and entails a risk of leakage for inter-state supplies (e.g., through carousel VAT evasion) when compared to the ideal case.
3. **Current case:** Co-existence of multiple bases and rates that erode tax bases and discourage inter-provincial trade.

To move towards the second or first approach, the following steps will be critical:

I. Creating a joint Federal-Provincial Review Committee (this has been instituted with the National Tax Committee).
II. Determining transitional policy actions, including specifying intergovernmental compensation mechanisms, institutional and procedural preparation of policy and administration reviews, and setting reform milestones.
III. Harmonizing federal and provincial sales tax base definitions, regimes, place of supply rules, administrative procedures, tax interpretation, and audit and enforcement activities.
IV. Concurrence of and operationalizing information exchange.

5.4.2 Personal Income Tax

Immediate Priority: Unifying and simplifying the personal income tax schedule.

- Pakistan's tax system features some low-hanging fruits to enhance equity and increase personal income tax collection. The authorities could consider merging the tax schedules for salaried and non-salaried taxpayers and simplifying the tax schedule by reducing the number of brackets. This would equalize tax treatment across income sources, reduce economic distortions, and reduce opportunities for tax planning.
- These measures to simplify the tax schedule could be combined with a gradual reduction of withholding lines on non-salary transactions, thus reducing the tax burden, enhancing equity, and improving economic efficiency.

Medium-term Priority: Reducing the time-dependence of capital gain tax liability. Pakistan's current system reduces taxable capital gains to zero after 4 years of asset holding, encouraging investments in relatively unproductive assets, including real estate, and opening tax avoidance opportunities. Redesigning this system will require a careful balance that provides some tapering of tax rates to discourage speculation for short-term gains, while preventing lock-in effects into non-productive assets as experienced under the current system. One option could involve a two-tier system, where assets held for one year or less would be subject to the standard capital gain tax rate, and a separate concessional rate applies to a subset of assets, such as property, that is held for a longer time and for which public policy wants to decrease the incentive for speculation.

Long-term Priority: Calibrating the taxation of capital and labor income. Over the longer-term, Pakistan could consider establishing a dual income tax regime that only differentiates income by two sources: labor and capital. A distinction between these two sources adequately considers that capital should be taxed for redistributive purposes, but that lower taxation than for labor income can encourage savings and investments. Under such a system, labor would be subject to the progressive schedule outlined above, whereas any other income from capital would be subject to the two-tier structure mentioned previously. A standard rate for 15 percent for capital gains would be appropriate.

5.4.3 Corporate Income Tax

Immediate Priority: Creating a unified and simplified concessional tax regime for small companies.

- The current co-existence of two concessional CIT regimes for manufacturing SMEs and other small companies is ineffective and inefficient. Instead, Pakistan could consider creating a unified concessional tax system for small enterprises that replaces the existing structure. Eligibility for this system should only be based on annual turnover, and the threshold should be equivalent to the sales tax registration threshold. All firms above the threshold would be required to comply with the normal CIT regime.
- Firms below the threshold could benefit from a simplified tax regime that reduces compliance costs, for instance through a single turnover tax that encompasses both sales and income tax liabilities and simplified book-keeping requirements. The tax rate in the turnover scheme would need to be calibrated in such a way that firms' tax liability is a continuous function of turnover at the registration threshold to minimize any tax-induced incentives for firms to remain small. In such a system, firms would only gain a compliance and not a tax advantage.

Medium-term Priority: Unifying the standard rate regime, expanding thin-cap provisions and rationalizing tax incentives.

- To enhance economic efficiency, reduce misallocation, and improve equity, Pakistan should consider establishing a single tax rate for all sectors, including abolishing "super taxes" for the banking sector.
- A simplification of the CIT regime would also involve a close look at tax incentives by conducting a rigorous cost–benefit analysis of each incentive scheme, abolishing those tax incentives that provide few positive externalities to the wider economy, and switching towards well-targeted incentives that reduce investment costs for firms.[37] To garner political support for a rationalization of tax exemptions, this reform could be designed in a revenue-neutral manner by lowering the CIT rate.
- To ensure policy consistency, Pakistan should also consider eliminating the legal authorization for the executive to grant tax exemptions or concessions through Statutory Regulatory Orders (SROs) without prior National Assembly approval.
- In terms of transparency, Pakistan could consider enforcing and capacitating sectoral ministries to prepare their own estimates of revenue loss from tax expenditure provisions in their domain as part of the annual budget proposal to involve them in evaluating trade-offs between tax expenditures and sectoral budget allocations.
- Finally, Pakistan could consider expanding thin-cap provisions to all firms and all forms of debt.

Long-term Priority: Resolving inconsistencies between the turnover and alternative tax regimes. The alternate corporate tax and the minimum tax deserve a comprehensive review to align them with a reformed rate, regime, and incentive structure. Initially instituted to stabilize CIT collection in the light of enforcement loopholes and various tax incentives, it is worth experimenting with a gradual reduction of these alternative regimes as the tax system matures. One option could involve removing the minimum tax regime while uniformly applying the alternate corporate tax across all sectors and firm sizes.[38] This would enable the FBR to directly compare the tax liabilities calculated under alternative and standard regime and form a basis for a more comprehensive reform of the system. During the transition phase, firms would still be taxed on the larger of the alternate or standard tax liability but could be allowed to carry any difference forward into future tax cycles by using the provisions for loss-carry-forward.

5.4.4 Federal Excise Duty on Cigarettes

Immediate Priority: Creating an automated mechanism to adjust excise rates for inflation. Pakistan taxes cigarettes through nominal specific rates. Although this approach is consistent with international practice, inflation risks eroding the tax base over time when nominal taxes are not adjusted upwards. Adjusting cigarette tax rates currently requires a vote of the parliament. To safeguard against an inflation-induced tax base erosion Pakistan could consider introducing an annual automatic adjustment mechanism that updates cigarette tax rates in line with inflation.

[37] Pakistan's existing investment tax credit granted to greenfield industrial undertakings is a good example of a cost-efficient tax incentive. Other types of cost-effective tax incentives would include those granted as income tax exemptions or credit for R&D, technology acquirements, national workers training, etc.

[38] The practice in the USA is illustrative. There, the alternative minimum tax (AMT) is based on the calculated AMT income (AMTI). The AMTI in turn is computed by adjusting regular taxable income with adding back certain tax preference items. In addition, the net operating losses may reduce AMT by up to 90 percent, compared to a potential full reduction for regular tax purposes.

Medium-term Priority: Rolling out an effective digitized stamp system. While Pakistan has taken initial steps towards establishing a track and trace system, implementation challenges remain. These should be overcome as quickly as possible to allow for a uniform enforcement of the excise duty. To overcome practical challenges with the application of stamps, Pakistan could consider adopting QR codes that link directly to a verifiable database within the FBR. This could be complemented by offering cash incentives to consumers and retail sellers to report cigarette packages sold without or with incorrect QR codes imprinted on them.

Long-term Priority: Unifying the tax system to increase its revenue potential. Pakistan's system of dual taxation for cigarettes based on their final retail price opens evasion opportunities and differs from international practice. Pakistan could consider applying a single rate to all cigarettes independent of their price. This would not only raise revenue but would also align the taxation of cigarettes with the WHO's recommended practice.

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