Tax Policy Challenges for the New Administration

Accelerating Tax Reform
A Real, Relevant and Owned Perspective
WB FBR Conference

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Presentation Outline

• Key Trends
• Key issues in Tax Policy in Pakistan
• Menu of Piecemeal and Comprehensive Reforms
  – Corporate Income Tax
  – Personal Income Tax
  – Sales Tax
  – Federal Excises
  – Custom Duties
  – Provincial Taxes
• Sequencing and Revenue Potential
• Implementation Essentials
## Tax/GDP Components of FBR Revenue

<table>
<thead>
<tr>
<th>FY</th>
<th>CBR Taxes</th>
<th>Direct</th>
<th>Indirect Taxes</th>
<th>Total Indirect</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Taxes</td>
<td>Sales Tax</td>
<td>Customs</td>
<td>Excise</td>
</tr>
<tr>
<td>1999-00</td>
<td>9.2</td>
<td>3.0</td>
<td>3.1</td>
<td>1.6</td>
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<tr>
<td>2000-01</td>
<td>9.4</td>
<td>3.0</td>
<td>3.7</td>
<td>1.6</td>
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<td>2001-02</td>
<td>9.2</td>
<td>3.2</td>
<td>3.8</td>
<td>1.1</td>
</tr>
<tr>
<td>2002-03</td>
<td>9.6</td>
<td>3.1</td>
<td>4.0</td>
<td>1.4</td>
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<tr>
<td>2003-04</td>
<td>9.4</td>
<td>3.0</td>
<td>4.0</td>
<td>1.6</td>
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<tr>
<td>2004-05</td>
<td>9.0</td>
<td>2.8</td>
<td>3.7</td>
<td>1.8</td>
</tr>
<tr>
<td>2005-06</td>
<td>9.4</td>
<td>3.0</td>
<td>3.9</td>
<td>1.8</td>
</tr>
<tr>
<td>2006-07</td>
<td>9.8</td>
<td>3.8</td>
<td>3.6</td>
<td>1.5</td>
</tr>
<tr>
<td>2007-08</td>
<td>9.8</td>
<td>3.8</td>
<td>3.7</td>
<td>1.5</td>
</tr>
<tr>
<td>2008-09</td>
<td>9.1</td>
<td>3.5</td>
<td>3.6</td>
<td>1.2</td>
</tr>
<tr>
<td>2009-10</td>
<td>8.9</td>
<td>3.5</td>
<td>3.5</td>
<td>1.1</td>
</tr>
<tr>
<td>2010-11</td>
<td>8.6</td>
<td>3.3</td>
<td>3.5</td>
<td>1.0</td>
</tr>
</tbody>
</table>

*Source: FY 1999-00 to 2004-05 - CRB Year Book 2004-05
FY 2005-06 to 2010-11 - World Development Indicators*
Individual and Total Taxes over time

Figure 2
Pakistan: Composition of Consolidated Central Government Revenue
1990-2007

Source: GFS CD Rom 2011
International Comparison

**Tax Ratio (Tax Collection/GDP), 2006-2010 Average**

Source: Cyan and Martinez-Vazquez, forthcoming
Key Issues in Tax Policy

Adequacy:
- Revenue inadequacy
- Narrow tax base due to exemptions

Efficiency:
- Preferential treatment of certain sectors generates excess burden

Equity:
- Mild progressivity (partly due to high threshold of PIT)
- Horizontal inequity and higher tax incidence on some sectors complicated by differential collection effort
- Provincial taxes underutilized (0.4 percent of GDP)

Compliance:
- Complicated tax structures resulting from ad hoc decisions, excessive use of withholding taxes and exemptions
- Low compliance and weak enforcement
- High compliance cost (e.g., 5 types of PIT returns)
Success Parameters for Reforms

• Administrative feasibility
• Demonstrable revenue gains
• Early winners
• Piecemeal or comprehensive
• Coordinated reforms in tax policy and tax administration
• Political support
Corporate Income Tax

Piecemeal
• Narrow definition of small businesses by reducing turnover threshold in real terms
• Make small businesses withholding agents
• Do away with company age classification for small businesses
• Limit use of tax exemptions and tax incentives for industrial policy

Comprehensive
• Reduce rate for large businesses and broaden the base
Personal Income Tax

Piecemeal
• Taxation of short term stock market capital gains
• Broaden base by reducing zero-rate income thresholds in real terms
• Remove notch problem by progressive rates
• Reduce number of income brackets
• Reduce type of forms

Comprehensive
• Adopt a flat or flatter tax structure with a common exemption
• Dual income tax (to cater to capital mobility)
• Adopt a flat and higher rate for presumptive taxes
• Broaden base by removing many exemptions
General Sales Tax

– Overall reform with a federal-provincial shared tax on goods and services with federal administration
  OR

– Expand base successively in federal GST with higher effort by provinces on provincial sales tax on services

– Plan with specific revenue costs of exemptions
Revenue Impact of GST Broadening: Four Scenarios

Source: Martinez-Vazquez and Richter, 2008
Excises

– For tobacco products, convert ad valorem to in rem rates, with full price indexation
– Ad valorem taxes on certain luxury goods and additional services
– Simplify rate structure of petroleum products
– ‘Green taxes’ to deal with externalities
Customs Duties

Piecemeal

• Combine tariff reductions with a sequence of measures to avoid overall revenue losses including elimination of tariff exemptions, increase in excisable imports and expansion from GST
• Reduce tariff dispersion, esp at disaggregated level

Comprehensive

• Introduce 3 tariff rates for unprocessed, intermediate and processed products and calibrate rates and revenue effects over time with impact of other tax reforms
Provincial Taxes

- Property tax (broaden base, indexation)
- Transfer of property taxes
- Taxes on Motor vehicles
- Agricultural income tax
- Professions tax and other taxes
- Sales tax on retails to local governments
- Revenue incentives in NFC
Sequencing Tax Policy Reform Across Taxes and Issues

Potential gains: Tax policy (3.8 percent of GDP) and Tax administration (7.2 percent of GDP)
The Revenue Potential of Tax Policy Reforms

• Earlier analysis and simulated effects of reforms demonstrate potential collections of 3.8 percent of GDP (on 2007 data)

• In the short run, out of 6 taxes, 4 gainers, 2 losers
• Most significant gains from GST reform
• Provincial tax reform the second most important revenue winner
• Others: PIT, Federal Excise, CIT, Customs

Note: numbers are indicative and rely on crucial assumptions
Revenue Potential from Tax Policy Reform

2007/08 Revenue Potential from Tax Policy Reform and Tax Gap (Rs. Billion)

Source: Martinez-Vazquez and Richter, 2008
## Analytic Preparation of Tax Policy Reform

<table>
<thead>
<tr>
<th>All Taxes</th>
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<tbody>
<tr>
<td>- Harmonize tax definitions and tax procedures for all domestic taxes</td>
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<tr>
<td>- Conduct economic analysis of specific proposals for tax policy changes, including expansion of the tax bases and adjustment in rates. This work includes the following:</td>
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<table>
<thead>
<tr>
<th>Individual Income Tax</th>
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<tbody>
<tr>
<td>- Develop reformed system of tax credits</td>
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<td>- Develop transition plan from current system of multiple tax brackets to two-tier tax rates</td>
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<table>
<thead>
<tr>
<th>Corporate Income Tax</th>
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<tbody>
<tr>
<td>- Establish clear attribution of withholding tax collections across types of taxpayers</td>
</tr>
<tr>
<td>- Review each withholding tax with regard to its revenue impact, base, rate and adjustability</td>
</tr>
<tr>
<td>- Evaluate treatment of debt and equity</td>
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<tr>
<td>- Assess potential to widen corporate income tax base through the elimination of exemptions, investment incentives and special treatments</td>
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<th>General Sales Tax</th>
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<tbody>
<tr>
<td>- Develop plan for widening successively the tax base</td>
</tr>
<tr>
<td>- Develop revenue sharing formula between federal government and provincial governments</td>
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<thead>
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<th>Federal Excise Duties</th>
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<tr>
<td>- Assess scope for increasing taxation of luxury goods and services</td>
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<tr>
<td>- Develop reformed system of petroleum products</td>
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<th>Custom Duties</th>
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<tbody>
<tr>
<td>- Assess scope for expanding the base of dutiable imports</td>
</tr>
<tr>
<td>- Develop transition plan from current multiple duties rates structure to three-tier duty rate structure</td>
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<thead>
<tr>
<th>Provincial Taxes</th>
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<tbody>
<tr>
<td>- Conduct provincial tax policy analyses in light of 18th Amendment and following provincial tax policies</td>
</tr>
<tr>
<td>- Develop reform proposals for National Finance Commission that include incentives for provincial revenue effort</td>
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</tbody>
</table>
Implementation Essentials

• Administratively feasible; political consensus required—this is the right time to begin
• Three core stakeholders (tax administration, taxpayer and policy maker) to be on-board
• National Tax Reform Commission or Parliamentary Commission to evolve broad national consensus
• Provide technical and analytic support
• Strengthen fiscal analysis capacity at FBR and Revenue Division of Ministry of Finance
• Twin track reforms of tax policy and tax administration
CHALLENGE QUESTIONS

- Main Issues. What are the three most serious problems with Pakistan’s tax policy? Why is tax collection so low and cumbersome? Are tax rates too high/low? Please rank them in order of importance.

- Vision. What should be the central objectives of tax policy in the decade? What are the priorities of the tax reform agenda?

- Making of Tax Policy. How can FBR better coordinate with the Ministry of Finance in the making of tax policy? Would an external advisory committee on tax policy also help?
CHALLENGE QUESTIONS

- Using Tax Policy to Facilitate tax Collection. Can you suggest simple measures that would make collection on every tax (GST, income tax—corporate and personal, tariff duties, withdrawal, provincial taxes) more effective?

- Sectoral Taxation and SROs role. What key reforms would you suggest for each of the main economic sector manufacturing, industry, services? Do you think SROs providing special tax concessions and zero rates should be removed? How to create political support to withdraw them so as to broaden the tax base and achieve higher tax collection efficiency?
Timing. What would be the right sequencing of tax policy reforms? If so, what would be a reasonable roadmap for the successful reform on each major taxes?