Pakistan – Government’s Fiscal Year
July 1 – June 30
Currency Equivalents
Currency unit: Pakistani Rupees (PKRs) or Rs.
US$1 = 83.14 PKR as of July 2009

ABBREVIATIONS AND ACRONYMS

AETR  Average Effective Tax Rate
AIT   Agriculture Income Tax
AYSPS Andrew Yang School of Public Policy
BOR  Board of Revenue
CD   Customs Duties
CGE  Corporate Income Tax
KSE  Karachi Stock Exchange
DFID  Department for International Development
LFS  Labor Force Survey
MEETR Marginal Effective Tax Rate
NFC  National Finance Commission
NTCR  North-West Frontier Province
NWFP  North-West Frontier Province
OECD  Organization for Economic Cooperation and Development
PRSP  Poverty Reduction Strategy Paper
PTLM  Pakistan Living Standard Measurement Survey
PSLM  Provincial Taxes
FATA/PATA Federally Administered Tribal Areas/
Provincially Administered Tribal Areas,
Federal Board of Revenue
FED  Federal Excise Duty
GDP  Gross Domestic Product
SAARC  South Asian Association for Regional Cooperation
GST  General Sales Tax
SRO  Statutory Regulatory Ordinance
IT   Individual Income Tax
TMA  Teshil Municipal Administration
IMP  International Monetary Fund
UN   United Nations
IPO  Internal Revenue Services
VAT  Value Added Tax
IRS  World Bank Research Observer
JIIPT  World Development Report
WDR  World Economic Forum

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The report was prepared by Kaspar Richter (World Bank), and Jorge Martinez-Vazquez (AYSPS). It is based on seven background studies (listed below), drafted by Robina Ather Ahmed, James Alm, Roy Bahl, Musharraf Cyan, Mir Ahmad Khan, Jorge Martinez-Vazquez, Geerten Michelse, Mark Rider, Wayne Thirsk, Umar Wahid and Sally Wallace. The tax revenue simulation results in the report are based on micro-simulation models developed by Mark Rider and Sally Wallace with Harini Kannan. The GST chapter draws extensively on a review of Pakistan’s sales tax by Rebecca Millar and Christophe Waerzeggers from June 2008. The report also benefited from the Pakistan tax administration review by Carlos Silvani, Edmund Biber, William Crandall, Wyatt Grant, Orlando Reos and Geoff Seymour from September 2008. Peer reviewer comments from Kai-Alexander Kaiser, Senior Economist, World Bank; Michael Keen, Advisor, International Monetary Fund; Dr. Ahmad Khan, former Member FBR; Russell Krelow, Senior Economist, International Monetary Fund, and Eduardo Ley, Lead Economist, World Bank greatly enhanced the quality of the report. Dr. Ahmad Khan and Dr. A. R. Kemal reviewed the background studies, and Ehtisham Ahmad commented on the concept paper. Anjum Ahmad, Shamsuddin Admad, Mihaly Kopanyi, Hanid Mukhtar, and Saadia Refaqat from the World Bank provided useful feedback. Mirafe Marcos helped greatly by providing the draft chapter of the provincial background study. The team would like to thank Satu Kahkonen, Lead Economist, Miria Pigato, Sector Manager, Ijaz Nabi, former Sector Manager, Yusupha Crookes, Country Director, and Ernesto May, Sector Director, for continued support and guidance throughout all stages of this report. Muhammad Shafiq, Nimanthi Attapattu, and Irum Touqeer handled with great ease all arrangements for the missions and for the processing of the report.

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Background Papers for the Pakistan Tax Policy Report

7. Wahid, Umar and Wallace, Sally. *Incidence of Taxes in Pakistan: Primer and Estimates*
EXECUTIVE SUMMARY

Preface

One of the toughest questions that the Pakistan government faces is what to do about taxes and how to raise tax revenues. There can be no real progress on education, health care, infrastructure or any major economic issue without dealing with rising budget deficits and mounting debt. To restore the health of the budget, let alone keep pledges for spending more money on social safety nets and development, the government will have to raise tax revenues. As Pakistan’s economy recovers from its present economic crisis, the overall tax effort has to be visibly enhanced. The effort must be fair, efficient and supportive of sustained economic growth.

Tax revenue has continued to be a problem for the Pakistan government. In the past, tax payers have used anything from simple to sometimes complex schemes to keep businesses and households outside the tax authority’s reach. In response, the tax administration has looked for short term solutions and put together makeshift arrangements to save the day. There were new withholding taxes, tax rate increases, revisions of targets and the like. Attempts to remove special treatments and exemptions went against powerful lobby groups and did not usually succeed. Whereas, all this improvisation may not have resulted in buoyant tax revenue collection, it allowed the government to muddle through – until the arrival of the next crisis.

There is broad consensus that Pakistan’s tax system underperforms, as its tax base is very narrow. The government taxes only a limited number of sectors, businesses and people. The low level and large volatility of these tax revenues has greatly constrained the government’s ability to make plans for development and poverty reduction, and respond adequately to sudden economic crises. These weaknesses are so grave that they can undermine the confidence in Pakistan’s economy as a whole.

The appropriate response to these challenges is to embrace a structural reform of the tax system. The goal is to put in place a system that is simple and predictable, encourages investment and rewards people for their hard work. At the same time, it delivers the funds for development spending. Such a comprehensive overhaul of the tax system is a crucial step for securing Pakistan’s sustainable development.

The Pakistan government has now taken on board the challenge of stepping up revenue mobilization. The 2009 Poverty Reduction Strategy Paper (PRSP) lays out the objective of increasing the tax-to-GDP (Gross Domestic Product) ratio by 3.2 percentage points of GDP over the next five years, lifting the tax-to-GDP ratio from 10.4 percent of GDP in 2007-08 to 13.9 percent of GDP in 2012-13. This is encouraging, as in the past, similar targets were far more modest. For example, the 2003 PRSP envisioned an increase in the tax-to-GDP ratio of only 1 percentage point of GDP in five years.

Yet, it is by no means certain that fundamental tax reform will succeed. Previous attempts at setting the system right over the last decades have delivered little in terms of more revenues and a more rational tax system. Comprehensive and fair tax reform will face stiff opposition, as it has done in the past. While the tax system has been bad for the country, it has been good for those who were able to receive high incomes largely shielded from the tax man. These interest groups will not want wider tax nets and more effective enforcement because their narrower interests will supersede the broader ones of a stabilized and growing economy.

This is why, it is feared that when the fiscal pressure will start to ease, the tax reform pushback will be in full swing. Even modest reform proposals to curb tax exemptions and tax evasion will come under fire, and the government will be subjected to pressure to back down and to return to business as usual. This would leave the government with far too little revenue to cover its desired expenses. The result would be unsustainable budget deficits or, alternatively, deep cuts in spending, which in turn would make it impossible to maintain social and infrastructure spending at a level that is required for development. Yet, the special-treatment lobbyists have little to say about how the government should close the budget gap their tax cuts would produce; the talk about fighting government waste and reforming procurement procedures, however important, does not add up to the required sums.

This report highlights design ingredients for a comprehensive reform of tax policy in Pakistan. In the final analysis, the success of tax reform will depend less on the mechanism of taxation and more on the politics of taxation. Beyond adequate administrative resources and an implementation
strategy, this will require a clear political recognition of the importance of the task and the willingness to persist with tax reform over the long haul.

**Tapping Tax Bases for Development**

Pakistan’s tax collection has failed to improve since the late 1990s. Structural problems, such as a narrow tax base, tax evasion, distrust by the taxpayer of public institutions and administrative weaknesses, have all taken a toll on tax collection. The tax-to-GDP ratio increased from 9.6 percent in 1999-2000 to 10.3 percent by 2007-08 (Figure 1). In order to ensure adequate public funding for development priorities while safeguarding macroeconomic stability, the government has endorsed the objective to increase tax collection to 13.9 percent of GDP by 2012-13. This commitment is reflected in Pakistan’s 2009 PRSP. The rise in tax revenues, in addition to a decline in interest payments, will allow the government to reduce the fiscal deficit from 7.4 percent of GDP in 2007-08 to 2.4 percent of GDP in 2012-13.

*Figure 1: Turning Around the Tax-to-GDP Ratio*

International experience shows that tax reform can deliver large increases in the tax-to-GDP ratio. While there are other developing countries at Pakistan’s income level with similarly low tax-to-GDP ratios, countries in the region set a different example (Figure 2). The simple average of the tax-to-GDP ratio in Bangladesh, India, Nepal and Sri Lanka – countries with similar tax policies and administration – is systematically higher than in Pakistan, and the gap increased during the present decade. Furthermore, countries like Egypt, India, Thailand, Turkey, and South Africa experienced rapid growth and rising tax ratios, while Pakistan saw tax collection rising just in line with economic growth. While central government tax collection increased from 13.8 percent in 2000 to 16.5 percent in 2004 in Asian and Pacific countries, it remained roughly constant as a percent of GDP in Pakistan since the early 2000s. However, increasing tax collection is so much more difficult with anemic rather than strong economic growth. Indeed, on the back of the global economic crisis, Pakistan’s tax-to-GDP ratio is set to decline in 2008-09 to 9.2 percent.

Structural weaknesses of Pakistan’s tax system heighten its vulnerability to the economic crisis. The revenue is raised in an inefficient way by favoring certain sectors and economic activities over others. This creates excess burden of taxation and can deter people from investing in the most productive sectors and earning more from the resources available. This ultimately gets in the way of economic growth. Some sectors are more heavily taxed compared to their contribution in terms of GDP than others. Agriculture contributes about one fifth of GDP, yet gives no more than 1 percent in Federal Bureau of Revenue (FBR) tax revenue. Services sector make up almost half of economic value added, but contribute only one quarter of central taxes due to the low tax receipts from wholesale, retail and transport sub-sectors. Given the shortfall in agriculture and services, industry carries the brunt of the tax burden – its tax share is three-times as high as its GDP share. In addition, there are question marks to what extent the tax system, through the way it treats different income classes of people differently, is sufficiently equitable. While some progress has been made, Pakistan’s tax system remains complicated and most taxpayers have little knowledge of their obligations. Finally, provincial taxes yield no more than 0.4 percent of GDP, so that district and provincial governments depend on large fiscal transfers from the centre to meet their expenditure responsibilities.

*Figure 2: Tax Collection in Pakistan and other Developing Countries*
Meeting the Revenue Target

It is important to take a thorough look at options for bringing in reforms in Pakistan’s tax policy. The report shows that Pakistan has the potential to increase the tax-to-GDP ratio by around 3.5 percentage points over the next five years. At the same time, in order to ensure healthy long-run economic development, Pakistan needs to embrace substantial changes in its tax policy. These should be aimed at increasing the buoyancy of the tax system, broadening the tax base, reducing distortions and phasing out exemptions. From the perspective of efficiency, the primary role of taxation is in ensuring a level playing field for economic activities. From the equity side, it is in raising resources fairly to fund equitable public spending. Similarly, from the compliance side, it is in ensuring low costs of compliance (and large costs of non-compliance). For all three, administrative feasibility is vital. It might appear difficult to reform a tax system in a way that it meets the desired multiple objectives. Fortunately, the properties of efficiency, equity and ease of compliance lead, in large measure, to the same basic prescriptions for reforming the tax system for a given tax revenue target:

• make the tax base as broad as possible;
• keep tax rates as low as possible; and
• make compliance simple and non-compliance expensive

Pursuing the twin track reforms of tax policy and tax administration would put the government in good stead to meet its medium-term revenue collection targets. Our simulations show that a fairly simple and comprehensive tax policy reform package could boost tax-to-GDP ratio by 3.5 percentage points of GDP to meet the 2012/13 tax collection target of 13.9 percent of GDP (Figure 3). However, two caveats are important. The simulations relate to the economic situation prior to the current economic crisis. These simulations also assume no changes in enforcement and compliance relative to current levels. Tax compliance could increase with a more simplified and uniform tax system, but it could also fall due to the overall increase in the tax burden. This makes it so important to complement the reforms of tax policy with the reform of the tax administration. Enhancing tax enforcement would contribute to revenue increases through a reduction in the tax gap. After all, our estimates suggest that the revenue potential from eliminating the federal tax gap alone (7.2 percent of GDP) is even larger than from implementing the national tax policy reform package (3.8 percent of GDP) – even allowing for the fact that a full elimination of the tax gap is not desirable, since tax administration is costly.

Figure 3: Raising Tax Revenues: Actual Collection, Additional Collection Target, Tax Policy Reform Impact, and Tax Gap
**Closing the Tax Gap**

The tax gap provides a useful measure of the extent of tax evasion in a country. People and firms fail to comply with tax laws for many reasons, such as illness, distractions, ignorance, sloth and greed. There is a difference between tax avoidance and tax evasion. Tax avoidance refers to the use of the tax law to minimize tax liabilities, which is perfectly legal. Tax evasion, or non-compliance with the tax law, refers to the non-payment of lawful tax liabilities and is illegal. The tax gap does not arise from tax avoidance, but rather from evasion, whatever the underlying motivation. Given this definition, the tax gap becomes zero when everyone fully complies with a country’s tax system. As tax evasion increases, the country’s tax gap increases. Thus, the size of a country’s tax gap is directly related to the extent of tax evasion in the country. A large tax gap suggests that a tax system is likely to underperform in terms of revenues, efficiency, equity and tax administration. As mentioned earlier, the estimated federal tax gap in Pakistan for 2007-08 is about 79 percent of actual tax receipts. This sum amounts to over Rs. 796 billion, or some Rs. 4,800 worth of tax evasion by every man, woman and child in Pakistan.

What measures can the government take to reduce the tax gap? International evidence suggests that tax evasion depends crucially on enforcement strategies. It is a fair guess that the FBR is disliked by many Pakistani businessmen, professionals and workers. But many people who dislike the FBR probably do so for the wrong reasons. They may think it is a harsh and cruel agency, but in fact it is not nearly as vigilant as it should be. At least, this is an important lesson from the US Internal Revenue Service’s (IRS) National Research Program. In its three-year study, some 46,000 randomly selected tax returns from 2001 were intensively reviewed, and a tax gap of nearly one-fifth of all taxes (collected by the IRS) was identified. While this tax gap is sizable, most people are compliant, and some people evade far more than others. In the “wages, salaries and tips” category, taxpayers underreport no more than only 1 percent of the actual income. Yet, in the “nonfarm proprietor income” category, 57 percent of the income goes unreported. The reason for such a large difference between the wage earner and the self-employed is that the only person reporting the self-employed’s income to IRS is the self-employed himself, whereas, for the wage earner, his employer is filling in a form to let the IRS know exactly how much he has been paid. The wage earner’s taxes are automatically withheld from his every check, while the self-employed have all year to decide if, and how much, he will pay. It is not that the average self-employed worker is less honest than the average wage earner. Instead, the self-employed knows that the only chance the IRS has of learning his true income and expenditures is to audit him. But since the IRS audit rate is so low — the agency conducts face-to-face audits with no more than 0.20 percent of all individual taxpayers — he can be pretty confident to go ahead and not disclose his actual income. The stark differences in compliance rates across taxable items that line up closely with detection rates suggest strongly that many people pay their taxes not so much because it is the right thing to do, but because they fear getting caught if they do not. A combination of good technology (employer reporting and withholding) and poor logic (most tax-payers overestimate their chances of being audited) makes the system work. So the compliant taxpayer should dislike FBR not because it is too vigilant, but because it is not nearly vigilant enough. FBR requires, among others, a comprehensive risk-based compliance strategy, including reliable data, field audits, and penalties to enforce timely and accurate filing of returns.

Apart from better enforcement of laws, boosting tax morale might be another way to increase tax compliance. In some countries, people appear to be far more compliant than the low audit rates would suggest. One explanation is that tax compliance is voluntary due the intrinsic motivation of citizens to pay taxes. Such tax morale depends on their attitudes toward the state. If the general population feels that the tax system treats them fairly and that they are getting good value for their taxes, their willingness to pay tax increases, and vice versa. Given this view, increasing tax morale should increase voluntary tax compliance. However, increasing the transparency and accountability of the government is likely to work only over the long-term. In the meantime, there is little alternative to an efficient, even-handed and stringent tax administration.

One important issue is how many resources to devote to enforcing the tax laws. Just as it is not optimal to station a police officer at each street corner to eliminate robbery, it is not optimal to completely eliminate tax evasion. The tax gap estimates are not measures of the potential for additional enforcement yields because some would not be cost-effective to collect. Nevertheless, the size of the tax gap suggests that Pakistan’s enforcement measures to date are vastly inadequate.
Raising Revenues from Tax Policy Reform

The structural tax policy reforms outlined in this report could produce substantial revenue increases. In 2007-08, total tax revenue collections stood at Rs. 1.1 trillion or 10.3 percent of GDP. The World Bank (WB) estimates that the proposed tax policy reforms could raise tax revenues by around Rs. 400 billion, equal to 38 percent of 2007-08 national tax collection, or 3.8 percent of GDP (Figure 4). Among the six taxes, there are four revenue gainers and two revenue losers:

- By far the most important revenue impact would come from General Sales Tax (GST) reform. The adoption of a broad-based GST on goods and services in agreement between the federal and provincial governments is, therefore, the central tax policy reform component. This reform would produce an increase in revenues of Rs. 408 billion, assuming exemptions for seven sectors. This is slightly larger than the overall revenue impact of the national tax policy reforms.

- Provincial tax reforms would contribute around Rs. 45 billion, or 11 percent of the overall revenue increase.

- Introducing a two-tier structure for individual income tax and imposing a 10 percent rate on withholding taxes would raise tax collection by Rs. 34 billion, or 9 percent of the overall revenue increase.

- Reforming the federal excise taxation on tobacco would lift tax revenues by Rs. 14 billion, or 4 percent of the overall revenue increase.

- The reduction in the corporate income tax rate to 30 percent would reduce tax revenue by Rs. 38 billion, or 10 percent of the overall revenue increase.

- A three-tier structure of customs duties would lead to a tax revenue loss of Rs. 65 billion, or 16 percent of the overall revenue increase.

These numbers are only indicative and rely on crucial assumptions. For example, the analysis is based on the economic situation of the last few years, where economic growth was robust, inflation kept low, businesses did well and there was increased government spending. Today, Pakistan’s economic situation is different; growth is sluggish, inflation is high, enterprise profits are dropping and government spending is on the decline. In addition, the actual outcomes of tax policy reform would differ because of the changes in the behavior of taxpayers and the economy in response to the changes in tax policy. Finally, some components of the tax policy reform could not be calibrated. In particular, the losses in corporate income tax revenue from the reduction in the rate would be at least in part compensated by a broadening of the tax base.

While the revenue impact of the suggested reforms remains to some degree uncertain, nevertheless, these structural reforms are in line with international principles of good tax policy and provide benefits other than just higher tax collection. First, while the reforms would increase tax burden for all income groups, the proportional increase is the largest for the seventh to the ninth household deciles (Figure 5). Thus, the overall distribution of tax burden in Pakistan would remain progressive. Second, the new tax system would yield a more horizontally equitable distribution of tax burden due to the removal of many exemptions and other preferential tax treatments. This would also improve the overall investment climate in the country, as the equalization and general lowering of the marginal effective tax rates across sectors would reduce the excess burden of taxation on the economy. The reformed tax structure would also be easier to administer, which would lead to improved enforcement and compliance, and therefore more horizontal equity, and in turn more certain revenue flows.

Figure 4: Revenue Impact of National Tax Policy Reform

Figure 5: National Tax Reform and Vertical Equity
Sequencing Tax Policy Reform

Any successful reform has to take along three core stakeholders: the tax administration (FBR), the taxpayer and the policy maker. First, meeting this goal will not only be about bringing changes in tax policy but also about changes in tax administration. In the past, reform initiatives failed because there was inadequate focus on ensuring that tax policy reforms could be well administered. Federal tax administrators have made good progress in a number of areas, but more efforts are needed to complete FBR’s modernization program over the next few years. Similar efforts are needed to strengthen tax administration at the provincial level, such. Second, although overall tax burdens in Pakistan are low, the distribution of those tax burdens among households and among economic sectors is highly unbalanced. The taxpaying members of society who are to compete in an increasingly globalized world are likely to oppose reforms if they see them as further increasing their tax burden while doing little to tax other individuals and businesses that pay little or no taxes. Third, the fiscal position of the government is weak and could deteriorate further in view of the economic slowdown. This will make policy makers reluctant to provide leadership on tax reforms that may be considered uncertain in their revenue impact, especially if they face opposition from interest groups.

Because some of the ills afflicting Pakistan’s tax system have been the outcome of past policy measures, it will be important to spend time and effort to generate broad consensus for the proposed reform package. Many tax incentives and preferential treatments that have been prevalent since long, will be difficult to remove. The political economy of tax reforms in other countries suggests the importance of having a broad package that asks for the sacrifices of many but also offers general advantages including simpler taxes and reduced tax rates. In the case of a gradual implementation of the reforms (Table 2), there is a risk that the reforms which are easier to implement will be picked first and the more controversial reforms requiring a stronger determination, will be delayed, and ultimately derailed. One way to guard against this is to separate the approval of the tax reform package, which could be done upfront for the whole agenda, and the timing of its implementation, which could be done sequentially. This approach could also help in overcoming resistance from particular groups, such as sectors affected by the removal of tax preferences. The overall gains from this whole reform effort should be properly highlighted to increase stakeholder involvement.

The right sequencing of tax policy measures will be important to sustain the reform program. If some of the expected outcomes of the reforms do not fully materialize, a backlash against change could stall its implementation. This highlights the importance of a comprehensive analytical preparation (Table 3) and a road-map for the successful reform of each major tax component (Table 4).

Ensuring early gains should be part of the implementation strategy. The broadening of the tax base should have priority compared to rationalization of taxes, and especially compared to tax rate reduction. Across taxes, GST reform should be the first priority, followed by reforms of provincial taxes, individual income tax and federal excise tax, while the reforms of custom duties and corporate income tax should have the lowest priority (Table 1). For example, trade reform with a reduction and unification of the customs tariffs is desirable, but it should be put on hold until it is certain that the revenue losses from trade liberalization would be offset by larger collections from domestic taxes, especially the GST. When we combine tax by tax the revenue potential from tax policy reform with the potential from tax gap elimination, corporate income tax and GST are the most important areas requiring reforms.

<table>
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<th>Table 1: Sequencing Tax Policy Reform Across Taxes and Issues</th>
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<td>Broadening of Tax Bases</td>
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<td><strong>FIRST PRIORITY</strong></td>
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General Sales Tax

GST is arguably Pakistan’s most important and yet the weakest performing tax, and therefore has the largest reform potential. The performance of Pakistan’s Value Added Tax (VAT), the General Sales Tax (GST), has been disappointing. GST revenue increased from 3.1 percent of GDP during 1999 to 2000 to 4.1 percent of GDP in 2002-03, but then declined to 3.5 percent of GDP in 2007-08 (Figure 6). Since 2006-07, the GST share in FBR taxes has dropped below 40 percent and fallen behind the share of direct taxes. International comparisons confirm that GST collections in Pakistan are weak. For example, India and Sri Lanka collect around 1.5 to 2.5 percent of GDP more through GST than Pakistan. Ironically, the lower collection is not because of lower rates. Until 2007-08, Pakistan charged a standard GST rate of 15 percent on sales price inclusive of any FED and/or customs duty, the same rate as in Sri Lanka and higher than the 12.5 percent rate in India. Pakistan introduced GST rates of 17.5 and 20 percent for some items during 2007-08, and increased the standard rate even to 16 percent during the current fiscal, in an effort to shore up the GST collection.

There is an urgent need to reform GST in order to strengthen the government’s revenue position. The reforms will also help increase economic growth by supporting businesses through a level playing field for GST and simplified compliance. The reform entails the broadening of the GST base via the inclusion of services and the elimination of exemptions and special treatment of sectors. The induction of services sector into the GST net will require revenue sharing with provinces. Other GST reform components include simplification of the tax, modernization of legislation, improvement in the use of administrative resources, and transparent communication between authorities and businesses.

Pakistan needs to overhaul its existing sales tax legislation along the lines of a modern and an international standard VAT system. The new GST law should replace the existing act while incorporating relevant existing provisions, terminologies and concepts, where possible, and should aim to bring the existing GST in line with international best practices. The draft law could be released for public consultation well in advance of its introduction to parliament, so that relevant stakeholders can provide their recommendations. This would require an agreement on a suitable time frame for implementation.

Prior to the implementation of any legislative change, a detailed economic analysis should be conducted to determine the revenue implications of changing from the current sales tax to a modern VAT-style tax. This study should provide recommendations on the following issues:

- extension of the tax base to services;
- the use of exemption and zero-rating, and the treatment of refunds;
- the threshold for registration and whether voluntary registration should be allowed; and
- the extent to which simplified schemes may be used to tax certain sectors or taxpayers more efficiently.

The administration of GST on a self-assessment basis should be an integral part of the new act. In line with FBR’s experience on reforming income tax, this would require:

- A review of all aspects of the administration of sales tax;
- Technical assistance to equip FBR personnel to effectively implement administration of sales tax on a self-assessment basis with all the necessary support for taxpayer education;
- Establishment of an effective audit and enforcement function; and
- Establishment of effective internal and external appeal and review mechanisms.

Strengthening the GST legislation would also require curtailing FBR’s administrative powers. This would include deleting the broad powers to effectively legislate by an administrative order; and limiting rule making powers to deal with subsidiary matters only. Neither the government nor FBR should be empowered to effect substantive changes to the tax rules without parliamentary approval.

Figure 6: Trends in GST Collection
Corporate Income Tax

Following international trends, Pakistan’s corporate income tax rates have come down markedly. In the early 1990s, banking, public and private companies were taxed at the rate of 66 percent, 44 percent and 55 percent, respectively. By 2007, Pakistan adopted a uniform corporate tax rate of 35 percent on taxable profits for both public and private sector companies. In spite of the rate reductions, collections from the corporate income tax improved during this decade on the back of the economic upturn. It increased from 1.2 percent of GDP in 2000-01 to 2.5 percent in 2007-08 (Figure 7). The share of the corporate income tax jumped from one-half to two-thirds in gross direct taxes, and from one-seventh to one-quarter in gross FBR taxes. Revenue collection improved sharply during 2006-07, primarily due to the doubling of nominal tax collection from the financial sector, in addition to a significant performance from public and foreign owned companies from the oil and gas sector. However, the ongoing slowdown in the economy poses a risk for corporate income tax collection during the current fiscal (2008-09).

The corporate income tax system requires change in policy and administration, as well as the strengthening of international tax provisions. The international trend is towards lower income tax rates as a means of increasing economic competitiveness. Pakistan needs to respond to this challenge. Only with a broader tax base is there room to cut income tax rates and to enhance the attractiveness for international capital. Hence, the main priority should be to broaden tax base and lower tax rates. Specifically, the statutory tax rate of the corporate income tax could be reduced. This would bring Pakistan more in line with peer countries and will help to significantly reduce the distorting effects of the corporate tax. At the same time, expanding the base of the corporate income tax, mainly by reducing or rationalizing the use of tax incentives and exemptions, could ensure that the reduction in the statutory rates does not lead to revenue loss, and instead bolsters efficiency and equity. In this regard, it would be important to undertake a complete examination of the costs and benefits of tax incentives and exemptions. In addition, the thresholds for small businesses could be reexamined in order to ensure that only truly small businesses qualify.

The second priority of tax policy reform is to rationalize the withholding tax system. The extensive use of withholding taxes increases the effective tax rate on companies; creates opportunities for tax evasion schemes; masks serious compliance issues; and, through the many special stipulations, complicates the tax system. In many cases, withholding taxes become final liabilities. As a result, many taxpayers are caught in the withholding tax net, even though their incomes would put them in the zero-rate bracket under the regular tax schedule. Some withholding taxes often resemble excise taxes more than income taxes, as in the case of withholding on imports, exports and sales of goods and services. As a general rule, whenever they are imposed on the formal economy, withholding taxes should be considered an advance payment of the final tax liability. Withholding taxes that generate trivial amounts of revenues could well be eliminated. Finally, clarifying FBR’s rules for classifying withholding taxes into the different income tax heads will improve the understanding of their impact of the system of direct taxation, and hence improve FBR’s ability to identify and implement good performance policies.

With regard to international tax provisions, there are three areas requiring reforms. First, there is a need for policy level guidance on new sectors, covering residency, e-commerce, banking and financial activities, turnkey projects, and the establishment of a reliable transfer price, in the 2002 Income Tax Rules. Second, a number of steps could help to limit the use of transfer pricing provisions to exclusively anti-avoidance situations. Third, double taxation agreements should be provided with more detailed implementation rules. For example, the current agreements provide no guidance on the interpretation of terms like “center of vital interests” and “effective place of management” or on the application of reduced withholding tax rates.

Figure 7: Trends in Corporate Income Tax Collection

[Graph showing trends in corporate income tax collection]
**Individual Income Tax**

The individual income tax is typically not popular among taxpayers, yet it needs to be part and parcel of the tax system. As a direct tax on individuals, rather than an indirect tax on transactions, it relies on the tax administration taking a slice of a hard-earned money of workers and the business income of the self-employed. At the same time, the individual income tax is central to a society’s notion of raising revenue in a fair and equitable way. By allowing the assessment of individual economic circumstances, the income tax is naturally better suited for making a tax structure progressive rather than through indirect taxes.

Pakistan’s tax yield from individual income tax is inadequately low and has declined since the early 2000s. Partly due to a reduction in income tax rates, gross revenues from the individual income tax declined from 1.5 percent of GDP in 2000-01 to 1.1 percent during 2007-08 (Figure 8). The individual income tax accounts for around 11 percent of overall FBR tax revenues and 29 percent of direct tax revenues, which also include the corporate income tax, capital value tax and social security taxes. This level of revenue mobilization would seem to put Pakistan somewhere in the middle rank among emerging market economies. However, Pakistan’s standing might actually be worse than what the numbers suggest for three reasons. First, Pakistan’s individual income tax is measured in gross receipts, which include refunds. Second, there are two categories of taxpayers liable to individual income tax in Pakistan: workers and salaried individuals; and small unincorporated businesses and associations of persons, including firms with a profit sharing agreement. This may be in part due to a more expansive definition of individual income tax than the ones used in other developing countries. Indeed, FBR refers to the individual income tax as a non-corporate income tax. Finally and most importantly, the individual income tax collection includes a share of the funds mobilized through withholding taxes. Some of the withholding taxes are presumptive, imposing a fixed charge on certain transactions. This arrangement, in many cases, turns such withholding taxes effectively into indirect taxes. Since the heavy reliance on withholding taxes is unusual, this moves up Pakistan’s rank in country comparisons on individual income tax collections.

There are two priorities in the reform of the individual income tax. First, streamlining credits and phasing out many exemptions would move it closer to a fully-fledged broad-based income tax. The tax credits could be reshaped so that the amount of targeted allowances remains unchanged, irrespective of the income level of the beneficiary taxpayer. While most exemptions and credits are relatively minor, there is one noticeable exception. Imposing a modest tax on short-term stock market related capital gains would seem attractive from multiple perspectives: it benefits the national exchequer by generating revenues over the medium term; it improves efficiency by making companies more indifferent between retained earnings and paying out dividends; and it improves equity by making the tax system more progressive. Arguably, it would also be good politics, as it would be a symbol for a government ready to tackle powerful lobbies for the national interest. Whatever is done with the capital gains tax, there is every reason to tax the incomes of stockbrokers according to the regular schedule for non-salaried taxpayers.

Second, the tax design can be simplified. The individual income tax operates with two basic schedules for recipients of wage and non-wage or business income. There are anywhere from fourteen to twenty different tax brackets, each having large but different zero rate brackets for men and women. The high threshold level could be addressed over time by keeping the zero-band constant in nominal terms in spite of inflation. The individual income tax applies higher marginal tax rates to the total amount of a non-salaried taxpayer’s income. This problem can result in punitively high effective rates of marginal taxation and create perverse incentives to accurately report additional amounts of taxable income. The marginal tax relief introduced in 2008-09, mitigates this problem to some extent, but it further complicates the tax system and applies only for salaried taxpayers.
Federal Excise Duties and Custom Duties

Excise duties are taxes on the sale or use of specific goods and services, such as tobacco and petrol. Their design does not follow the standard prescription of a broad base and low rates. Instead, a good excise system is invariably one that generates revenue from a narrow base with relatively low administrative costs. Federal excise taxes play an integral role in Pakistan’s tax system (Figure 9). Among the major taxes, they contribute least in terms of revenue collection, and it is crucial to bolster the role of excise taxes. They could serve well the traditional excise tax goals of raising revenue, discouraging undesirable types of consumption, pricing some public services such as roads, and improving the overall progressiveness of taxation. Maintaining sizable excise taxes on petroleum products is justified on efficiency grounds, as the use of petroleum is harmful for the environment. Expanding the coverage of excise by including services – and possibly selected luxury goods – that have so far escaped effective taxation could help to fix a major hole in the tax system and boost revenues along the way. This arrangement should be confined only in the interim until a fully fledged value added tax, covering both goods and services, is put in place.

Figure 9: Trends in Federal Excise Duties’ Collection

Additional areas of reform include modernizing the legislative framework and bringing it in line with any changes in the sales tax law; converting ad valorem rates to in rem rates for tobacco products; and simplifying the rate structure for petroleum products. Like for the other taxes, ensuring compliance with the federal excise taxes is crucial.

Customs duties are levied on the dutiable value of goods imported into Pakistan. They raise revenue and provide some protection to domestic producers against foreign producers (Figure 10). In the short term, proceeding prudently with any further reduction of customs tariffs is desirable. Tariff reduction leads to revenue losses as long as the government is not able to compensate these revenues from domestic tax sources. While continuing with carefully paced tariff reductions, Pakistan could consider a sequence of separate measures to avoid overall revenue losses. It could initially eliminate existing tariff exemptions in the system; then increase excise rates on excisable imports to balance out tariff reductions; and finally adjust the scope and rate of the GST to meet remaining revenue needs.

Figure 10: Trends in Custom Duties’ Collection

In the long-term, FBR is set to focus on trade facilitation rather than on revenue generation, with the expectation that lower tariffs will spur economic growth and revenue gains elsewhere in the economy. This policy will help reduce the differences in the effective rates of protection of different sectors of the economy, reduce distortions in the allocation of economic resources, and lead to increases in economic welfare. A progressive substitution of customs tariff collection with revenues from domestic taxes could also make the tax system more progressive. One reform priority lies in further reducing tariff dispersion, by reducing the number of rates outside the regular tariff bands and eliminating special exemptions. For example, in 2007-08, some 471 tariff lines out of the overall 6,774 tariff lines were above 25 percent. Pakistan might also want to make the tariff schedule more uniform. At present, lower rates apply to raw materials in general and higher rates on finished goods. Such an escalated tariff structure leads to effective rates of tariff protection that are much higher for finished goods than the nominal tariff rates indicate.
Provincial Taxation

Weak mobilization of provincial taxes contributes to the overall poor tax effort. At a time when federal government taxes are less than 10 percent of GDP, there is a natural question whether the revenue collection of provincial governments is adequate. Two considerations might suggest they are not. First, while the federal government carries out the bulk of the revenue collection, provincial governments deliver a large chunk of the public services. Provincial expenditures represent close to 30 percent of national government expenditures, yet provincial tax revenues contribute just 4 percent of national tax revenues (Figure 11). The gap is filled primarily by federal transfers to the provinces based on the ratio agreed in the National Finance Commission (NFC) Award. The large vertical imbalances between federal and provincial government weaken financial management and fiscal accountability to the public. The provincial expenditure-revenue imbalance means that the tax system violates the benefit principle, which is one of two fundamental tax principles. According to this principle, people should be taxed according to the benefit they receive from the government services financed by the tax revenue raised. Second, all provinces carry structural fiscal deficits which they finance, among others, by drawing from balances created by unfilled positions and by slow disbursements of project funds. These deficits are not sustainable in the long run and call for greater own-source revenue efforts.

The barriers to increasing revenue mobilization by provincial governments are formidable. They range from structural problems with the present tax system, to administrative shortcomings and the absence of incentives for provincial governments to increase their tax effort. There are also important constitutional limitations for revenue assignments amongst various levels of government. Revenues are assigned between the federal government and the provinces by specific constitutional provisions. The federal-provincial assignment is in general determined through the federal and concurrent lists. Revenue sources that are mentioned in the federal list belong to the federation only; those in the concurrent list are a shared base for which both the federation and the provinces can develop legal instruments to tax the base; and those neither mentioned in the federal or concurrent lists belong to the province only. While the constitution assigns the federal government the more buoyant and easy-to-reach taxes, provincial taxes are sufficiently broad based to form a substantially more revenue productive tax system than currently the case. The provincial taxes include property and property transfer taxes, motor vehicle taxes, sales tax on services and the agriculture income tax. However, tax exemptions and preferences have narrowed existing tax bases, and many taxes are subject to specific rates.

There are good opportunities for reforming the system of provincial level taxation and fiscal decentralization in Pakistan. This report proposes structural reforms of provincial taxation that could deliver increases of 115 percent and 143 percent in provincial tax collection in Punjab and NWFP, respectively. In view of the similarities of the economies, tax systems and tax policies, increases of the same order would be achievable through similar reforms in Balochistan and Sindh. Moreover, the reforms outlined here have other beneficial properties in terms of improving the equity of the system, reducing the administrative cost and rationalizing tax instruments. These policy changes cannot be realized without a significant upgrading of the tax assessment and collection efforts of the provincial governments. A comprehensive reform will require involvement from both federal and provincial governments. In the past, provincial governments in particular, have not shown much interest in revenue mobilization. There are three ways in which this reluctance might be overcome to reform the tax system. First, convince taxpayers that an outcome of the reform will be improved public services. Second, they should believe that a comprehensive reform will bring about a fairer tax system. It also can be argued that such a tax system will be friendly to economic development because of its fairness and because the higher rate of revenue mobilization could lead to infrastructure improvements. Lastly, offer financial incentives as part of the NFC Award to help provincial governments overcome their reluctance to increase taxes.

Figure 11: Trends in Provincial Tax Collection
Scope and Process

The Pakistan Tax Policy Report provides a comprehensive assessment of Pakistan’s tax policies and lays out options for its reform. It is based on work commissioned for this report and on contributions of other researchers in Pakistan and elsewhere. The report has four parts (Figure 12). The first part, this chapter, argues from a macroeconomic perspective that there are no viable alternatives to mobilizing tax revenues for financing government expenditures. The second part, Chapter 2, pulls together the main findings to lay out a roadmap for tax reform. It presents a comprehensive medium-term reform agenda for tapping tax bases aimed at Pakistan’s development. The third part, Chapter 3, subjects Pakistan’s tax system to a basic health check and assesses with regard to the four properties of adequacy, efficiency, equity and compliance. The final part, covered in Chapter 4 to Chapter 9, takes each major tax and discusses how it squares up with regard to the properties spelled out in Chapter 3.

This report is the outcome of a partnership among three parties: the FBR; the Andrew Young School of Policy Studies (AYSPS) at Georgia State University, and the World Bank (WB). The Government of Pakistan (GoP) attaches high priority to broadening the tax base in an efficient and equitable manner, and is aware of the need for further improvements in the existing tax system. Following the launch of a project of FBR and the WB on tax administration reform in 2005, the government wanted to start a parallel initiative on tax policy. In response to the government’s request, a partnership among the three parties was formed in January 2007. Additional government counterparts included the Ministry of Finance (MoF) and finance departments of Punjab and Balochistan. The services of AYSPS were generously supported through the UK Department for International Development (DFID).

This collaboration extended beyond the delivery of a report. Pakistan’s capacity to undertake fiscal policy analysis is limited, despite some positives at FBR and elsewhere. As part of a long-term remedy, initiatives such as postgraduate training of FBR and MoF personnel in fiscal policy, similarly expanding the number of positions dedicated to tax policy analysis in those institutions, and offering more attractive salary and working conditions to draw and retain the right people are much needed. Such measures were beyond the scope of this project. Nevertheless, other forms of capacity building took place by the joint work of the AYSPS experts and government tax policy analysis experts, ensuring that the process of preparing the report served as a “teaching tool” for capacity building and a “collaborative tool” to build ownership. Many of these mechanisms also served as dissemination tools to stimulate dialogue. The report’s primary audience is the federal and provincial governments. The report is also written for policymakers and development practitioners in Pakistan, as well as for governments and international donors that support tax policy reform in other South Asian countries. The report is expected to generate debate and discussions among the civil society and research communities.

The background studies for this report were structured as a series of seven tax policy papers. The AYSPS teams visited Pakistan two times in the course of the preparation of each policy paper. The first mission gathered the basic information, held detailed discussions with government staff and other stakeholders, and came to an agreement with the Pakistan authorities on the coverage of each tax policy study. The second mission presented the draft policy paper and collected comments and feedback for the final report of the study.
## Table 2: Piecemeal and Comprehensive Tax Policy Matrix

<table>
<thead>
<tr>
<th>Reform Type</th>
<th>Proposal</th>
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<tbody>
<tr>
<td><strong>Individual Income Tax</strong></td>
<td></td>
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</table>
| Piecemeal            | • Introduce taxation of short-term stock market related capital gains  
|                      | • Tax stockbrokers’ income according to the non-salaried income tax schedule  
|                      | • Broaden the tax base by reducing the zero-rate income thresholds in real terms  
|                      | • Replace the two basic schedules with single schedule accompanied by tax credits for earning labor income or for female labor force participation  
|                      | • Remove notch problem by reverting to conventional method of taxing personal incomes progressively  
|                      | • Reduce significantly the number of tax brackets  
| Comprehensive        | • Introduce broad-based two-tier individual income tax  
| **Corporate Income Tax** |          |
| Piecemeal            | • Limit the use of tax exemptions and tax incentives for industrial policy  
|                      | • Make withholding taxes adjustable for formal economy  
|                      | • Limit favorable withholding tax rates for informal economy  
|                      | • Eliminate withholding taxes that generate only small revenues  
|                      | • Narrow definition for small businesses by reducing turnover threshold in real terms  
|                      | • Make small businesses withholding agents  
|                      | • Strengthen rules for international tax provisions  
| Comprehensive        | • Introduce corporate income tax with lower rate and wider tax base  
| **General Sales Tax** |          |
| Piecemeal and Comprehensive | • Redraft the sales tax act to convert general sales tax into modern VAT, designed as shared federal-provincial tax covering both goods and services and under federal administration  
|                      | • Expand successively the base of the sales tax  
| **Federal Excise Duties** |          |
| Piecemeal and Comprehensive | • Bring federal excise legislation in line with the sales tax law  
|                      | • Convert the existing ad valorem rates into in rem rates for tobacco products  
|                      | • Index in rem rates for inflation  
|                      | • Employ excise duties as green tax and simplify the rates structure for petroleum products  
|                      | • Bring additional luxury goods and services under excise taxation  
| **Customs Duties**    |          |
| Piecemeal            | • Combine tariff reductions with a sequence of separate measures to avoid overall revenue losses, including elimination of existing tariff exemptions (especially at the 6-8 digit level), increases in excisable imports; and expansion of the yield from general sales tax  
|                      | • Reduce tariff dispersion, especially at disaggregated level  
| Comprehensive        | • Introduce customs duties with three tariff rates for unprocessed, intermediate and processed goods  
| **Provincial Taxes**  |          |
| Piecemeal            | • Strengthen major provincial taxes selectively  
| Comprehensive        | • Strengthen consolidated system of provincial taxes and provide incentives for revenue effort  

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Table 3: Analytical 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</td>
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<tr>
<td>taxes and modernize the delegation framework for the revenue</td>
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<tr>
<td>laws</td>
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<tr>
<td>• Conduct economic analysis of specific proposals for tax policy</td>
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<tr>
<td>changes, including expansion of the tax bases and adjustment</td>
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<tr>
<td>in rates. This work includes the following:</td>
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<tr>
<td>• Develop reformed system of tax credits</td>
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<tr>
<td>• Develop transition plan from current system of multiple tax</td>
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<tr>
<td>brackets to two-tier tax rates</td>
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<tr>
<td>Individual Income Tax</td>
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<tr>
<td>• Develop reformed system of tax credits</td>
</tr>
<tr>
<td>• Develop transition plan from current system of multiple tax</td>
</tr>
<tr>
<td>brackets to two-tier tax rates</td>
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<tr>
<td>Corporate Income Tax</td>
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<tr>
<td>• Establish clear attribution of withholding tax collection to</td>
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<tr>
<td>salaried taxpayers, non-salaried taxpayers and corporations</td>
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<tr>
<td>• Review each withholding tax with regard to its revenue impact,</td>
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<tr>
<td>base, rate and adjustability</td>
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<tr>
<td>• Evaluate treatment of debt and equity</td>
</tr>
<tr>
<td>• Assess potential to widen corporate income tax base through</td>
</tr>
<tr>
<td>the elimination of exemptions, investment incentives and</td>
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<tr>
<td>special treatments</td>
</tr>
<tr>
<td>General Sales Tax</td>
</tr>
<tr>
<td>• Develop plan for widening successively the tax base</td>
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<tr>
<td>• Develop revenue sharing formula between federal government and</td>
</tr>
<tr>
<td>provincial governments</td>
</tr>
<tr>
<td>Federal Excise Duties</td>
</tr>
<tr>
<td>• Assess scope for increasing taxation of luxury goods and</td>
</tr>
<tr>
<td>services</td>
</tr>
<tr>
<td>• Develop reformed system of petroleum products</td>
</tr>
<tr>
<td>Custom Duties</td>
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<tr>
<td>• Assess scope for expanding the base of dutiable imports</td>
</tr>
<tr>
<td>• Develop transition plan from current multiple duties rates</td>
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<tr>
<td>structure to three-tier duty rate structure</td>
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<tr>
<td>Provincial Taxes</td>
</tr>
<tr>
<td>• Conduct provincial tax policy analyses for Balochistan and</td>
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<tr>
<td>Sindh</td>
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<tr>
<td>• Develop reform proposals for revised National Finance</td>
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<tr>
<td>Commission Award that include incentives for provincial</td>
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<tr>
<td>revenue effort</td>
</tr>
<tr>
<td>Time-Period</td>
</tr>
<tr>
<td>------------</td>
</tr>
<tr>
<td><strong>Individual Income Tax</strong></td>
</tr>
</tbody>
</table>
| Short-Term | • Tax stockbrokers’ income according to the non-salaried income tax schedule  
• Broaden the tax base by reducing the zero-rate income thresholds in real terms  
• Remove notch problem by reverting to conventional method of taxing personal incomes progressively |
| Medium-Term | • Introduce taxation of short-term stock market related capital gains  
• Replace the two basic schedules with single schedule accompanied by tax credits for earning labor income or for female labor force participation  
• Streamline system of personal tax credits  
• Ensure that tax credits deliver the same amount of tax relief regardless of the taxpayer’s taxable income  
• Introduce broad-based two-tier individual income tax |
| **Corporate Income Tax** | |
| Short-Term | • Limit the use of tax exemptions and tax incentives for industrial policy  
• Narrow definition for small businesses by reducing turnover threshold in real terms  
• Make small businesses withholding agents  
• Eliminate withholding taxes that generate only small revenues |
| Medium-Term | • Make withholding taxes adjustable, especially for formal economy  
• Limit favorable withholding tax rates for informal economy  
• Strengthen rules for international tax provisions  
• Lower tax rate when tax base wide enough to ensure adequate revenues |
| **General Sales Tax** | |
| Short-Term | • Redraft the sales tax act to convert general sales tax into modern VAT, designed as shared federal-provincial tax covering both goods and services and under federal administration |
| Medium-Term | • Expand successively the base of the sales tax |
| **Federal Excise Duties** | |
| Short-Term | • Convert the existing ad valorem rates into in rem rates for tobacco products  
• Index in rem rates for inflation  
• Employ excise duties as green tax  
• Bring additional luxury goods and services under excise taxation |
| Medium-Term | • Simplify the rates structure for petroleum products  
• Bring federal excise legislation in line with the sales tax law |
| **Customs Duties** | |
| Short-Term | • Eliminate tariff exemptions, especially at the 6-8 digit level  
• Reduce tariff dispersion, especially at disaggregated level |
| Medium-Term | • Introduce customs duties with three tariff rates for unprocessed, intermediate and processed goods once tax base wide enough to ensure adequate revenues |
| **Provincial Taxes** | |
| Short-Term | • Strengthen major provincial taxes selectively |
| Medium-Term | • Strengthen consolidated system of provincial taxes and provide incentives for revenue effort |