



Consortium for
Development
Policy Research

Policy Brief PB1202 | State | January 2013

Personal and Corporate Income Tax in Pakistan

About the project

Funded by: International
Growth Center

Impact: This work was
disseminated at various
conferences to an audience of
key policymakers as well as to
the media.

This policy brief was prepared by Dr. Ijaz Nabi (IGC and CDPR) and Dr. Naved Hamid (Lahore School of Economics, IGC and CDPR).

In brief

- A well designed income tax regime, for individuals and businesses, combined with direct transfers can help governments achieve their distributional objectives and leave little rationale for a differential, indirect, commodity tax.
- The income tax base in Pakistan has been eroded because of tax exemptions, tax concessions, and tax evasion, reinforced by weak audit and tax administration. Complicated tax systems add another cost for individuals and businesses to bear, disincentivizing voluntary tax compliance.
- A tax system that tries to achieve multiple objectives will become necessarily complex. It increases the scope for individual discretion and graft and corruption. There is a need for tax systems to be simplified and rationalized.

+924235778180
admin@cdpr.org.pk

www.cdpr.org.pk

IGC
International
Growth Centre

Personal and Corporate Income Tax in Pakistan¹

Taxes on individuals and businesses are termed direct taxes, and those on goods and services are called indirect taxes. This brief will focus on the two most significant direct taxes in Pakistan, the individual income tax and the corporate income tax, which together contribute over 95 percent of direct tax revenue in Pakistan.

Governments can pursue their distributional objectives by combining a well designed income tax with direct transfers. In the presence of such a tax and transfer program, there is usually very little rationale to have a differential commodity tax to meet distributional objectives.

Over the last twenty years there have been major changes in the tax structure in Pakistan. Table 1 compares some major taxes in the years 1989-90 and 2010-11. As a share of GDP, income tax has increased from 1.67 percent to 3.2 percent, customs has declined from 5.9 percent to 1.03 percent and sales tax has increased from 1.8 percent to 3.5 percent. Overall the tax-to-GDP ratio has declined from about 14 percent to about 9.5 percent.

There have been important changes in the share of taxes in GDP but the extent of the changes may be misleading. The major increase in income tax is the result of introduction of withholding taxes in the 1990s. In 2010-2011, of the total income tax collection, 57 percent was collected through withholding taxes (see figure 1). These withholding taxes are levied on salaries and dividends but also on imports, exports, telephone and electricity bills, bank interest and securities and cash withdrawals. Some of the withholding taxes are

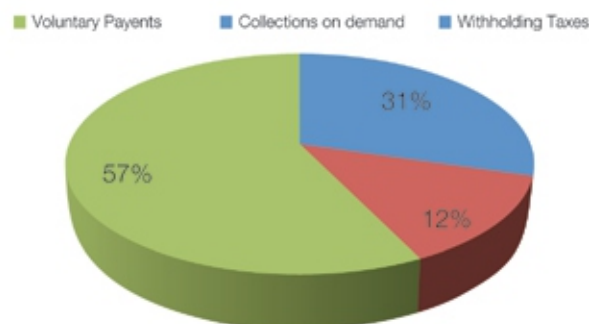
adjustable against total tax liability but others are treated as final discharge of tax liability. Some withholding taxes are in effect customs and excise duties.

Table 1: Comparison of Major Taxes: 1989-90 and 2010-11
(Percentage of GDP)

	1989-90	2010-11
Income Tax	1.67	3.2
Customs	5.9	1.03
Sales Tax	1.8	3.5
Excise Duty	2.7	0.79
Petroleum and Gas Surcharge	1.1	0.63

Source: Pakistan Economic Survey, Economic Advisor's Wing, Finance Division, Government of Pakistan, Various Issues

Figure 1: Income tax distribution by type of collection in 2010-11



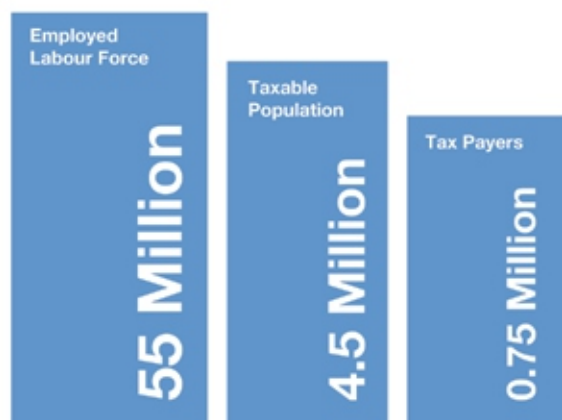
Individual Income Tax:

Non-corporate direct tax, which is mostly individual income tax, presently accounts for about a third of direct revenues – total direct tax revenues in 2011-12 were about Rs740 billion.

In 2010-11 there were only about 0.75 million taxpayers out of a population of 180 million, an employed labour force of 55 million and a taxable population of 4.5 million. The taxpayers were therefore a mere 17 percent of the taxable population.

¹ This brief draws on the following sources: 1. Taxing Pakistan: A Brief Overview by A. Rashid, F. Tirmizi and J. Abbasi, FBR and IGC (2013). 2. Pakistan Tax Policy Report: Tapping Tax Bases for Development, The World Bank, The Government of Pakistan, Federal Board of Revenue and Georgia State University, Report No. 50078-PK, July 2009. 3. Assessing Enterprise Taxation and Investment Climate in Pakistan by J. Alm and M. A. Khan, Andrew Young School of Policy Studies, Georgia State University, International Studies Program, Working Paper 08-10, December 2008.

² Individual income tax consists of taxes on all those non-corporate incomes which are not exempt from taxation and include taxes on wages and salaries, property (rental) income, business income and capital gains.



According to FBR data, nearly 83% of entities registered as “Association of Persons” and about 55% of taxpayers registered with tax offices did not file any tax returns in 2010-11. The percentage of population that files for taxes in Pakistan is 0.5 percent, as compared to India’s nearly 5 percent (see table 2).

Table 2: Percentage of Population that filed for taxes 2010-11

Country	Percentage of Population
Pakistan	0.5
India	4.7
Argentina	16.5
France	58
Canada	89

Source: Rashid et al (2013)

Of the 0.75 million individuals who reported a positive tax liability in 2010-11, about half were individuals whose income tax was withheld at source. In the same year, only about 70,000 individuals paid tax on salary not withheld by their employers, while only about 80,000 salaried workers paying withholding tax (out of about 425,000 or less than 19 percent of the total) filed an income tax return as required by law.

The income tax collection has witnessed a decline since the early 2000s, from 1.5 percent of GDP in 2000/01 to less than 1 percent of GDP in 2010-11. Among the reasons for the decline are the lack of voluntary compliance and reduction in income tax rates in the past decade.

The complexity of income tax structure and the lack of tax literacy among taxpayers are among the many

possible reasons for the poor performance of individual income tax system. The Federal Board of Revenue (FBR) has in 2012 attempted to simplify the income tax code and increase compliance by reducing the income tax slabs from 18 to 5 and introducing a progressive tax of up to 20 percent on marginal increase in income for individuals. A similar progressive tax has been introduced for ‘Association of Persons’ with highest marginal tax rate of 25 percent. A flatter tax system is in general less progressive than more multi-bracketed systems but it remains to be seen if the new system introduced by FBR will net more taxpayers and increase income tax collection.

The Corporate Income Tax:

Corporate income tax in Pakistan is the single largest contributor to the country’s direct tax revenues. In the South Asian region only India collects higher percentage of GDP from corporate income tax than Pakistan does. Table 3 presents a comparison with some countries in the South Asia and South-East Asia region.

The Corporate Income Tax rates have been brought down substantially since the 1990s to attract international business in an increasingly globalized world. A uniform corporate tax rate of 35 percent of taxable profits for all large (public and private) companies was adopted in 2007. This lower tax rate is more in line with corporate tax rates applicable internationally but still higher than in countries such as Malaysia, Turkey and Korea. We also note that while the corporate tax is levied on corporations, the ultimate burden of the tax is borne by shareholders, consumers and workers.

Table 3: Corporate Income tax as percentage of GDP

Country	Corporate Income tax as percentage of GDP
Sri Lanka	1
Nepal	1.5
Pakistan	2.5
India	3.5
Thailand	4.2

Source: Rashid et al (2013)

There are about 51,000 companies regulated by the Securities and Exchange Commission of Pakistan (SECP). From them, about 21,300 corporate income

³ These numbers are reported in a World Bank study.

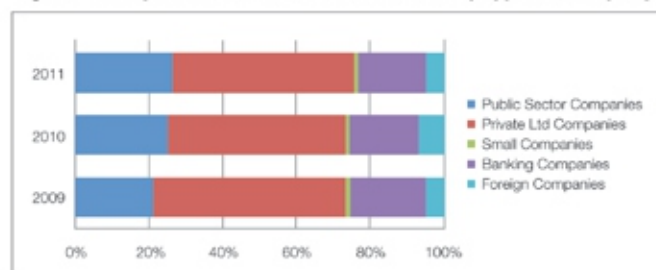
⁴ The collection could be even lower than one percent if we employed a more comparable but restrictive definition of individual income.

tax returns were filed in 2012, and only about 11,600 or 52 percent reported a positive tax liability, implying a compliance rate of less than 42 percent.

In spite of the rate reductions and the compliance issues, the share of corporate income tax in GDP increased from 1.2 percent of GDP in 2000-01 to over 2.5 percent of GDP in 2010-11. Further, at Rs. 392 billion, its share in federal direct taxes increased to over two-thirds while it accounted for over one quarter of total FBR revenue by 2010-11.

The single largest contributors to corporate income tax remain local private sector corporations, followed by the public sector and banking companies. Contrary to popular belief the foreign owned multinational companies pay less than 10% of the taxes collected in this category. See figure 2 for annual breakdown of corporate income taxes by type of company.

Figure 2: Corporate Income tax distribution by type of company



Small companies pay a much lower tax of 25 percent. The difference in tax rates applicable to small companies and to large corporations creates incentives for small companies to stay small or at least legally small.

The tax rate is only one part of the overall tax and incentive structure for investments in Pakistan. The incentive structure also includes various forms of tax concessions and tax holidays. Effective tax rates, which take into account these other incentives, differ by sectors and by type of assets (see Alm and Khan (2008)). Good tax policy would suggest that policy makers should not discriminate between sectors and assets for investment purposes unless there are very good reasons for encouraging investment in particular sectors, e.g., for reasons of export growth or greater employment. The emerging consensus is that more

important than tax incentives (lower tax rates or tax holidays) are other elements of investment climate, such as macroeconomic stability, quality of infrastructure, skill level of the workforce, location, size of the domestic market, regulatory environment and the rule of law (World Bank et al (2009)).

Concluding Remarks

The income tax base in Pakistan has been eroded because of tax exemptions (see box 1), tax concessions and tax evasion. Weak audit and tax administration reinforce tax evasion. The revenue loss from non-compliance was estimated to be Rs450 billion for corporate income tax and Rs31 billion for individual income tax in 2008 (World Bank et al 2009). Interest groups and lobbies have won tax concessions and tax exemptions and these interest groups have become strong and entrenched over time. The revenue loss from tax exemption was estimated to be Rs230 billion in 2011.⁵ The system of SROs also undermines any tax policy and renders the tax structure ad hoc.

The administration of income tax is one of the major bottlenecks in effective implementation of taxes. The limitation of the tax administration must be kept in mind when designing a tax system. Tax compliance involves its own cost. A complicated tax system can add enormously to the cost of tax compliance. Estimates by Pricewaterhouse-Coopers reported in Alm and Khan (2008) suggest that cost of tax compliance for a prototype corporation in Pakistan is 40 hours per year for corporate income tax, 40 hours for labor tax payments and 480 hours for consumption tax payment. The total number of days taken up by tax compliance is 560 hours. This ranks Pakistan 156th out of 178 countries (with the best performer ranked 1st and worst performer ranked 178th). This compares with rank of 90 for Sri Lanka, 105 for India and 140 for Bangladesh.

A tax system which tries to meet multiple objectives, including progressivity, promotion of FDI and domestic investment, small business enterprises, export industries, employment and so forth will become necessarily complex. It adds greater administrative discretion, greater contacts with tax payers and scope

⁵ This estimate is reported in World Bank study.

for graft and corruption, an uneven playing field with more informed and clever players taking advantage over the less informed, distorted incentives and scope for tax evasion. Such evasion reduces tax revenues, distorts resource allocation and compromises the distributional objectives of the tax system (Alm and Khan (2008)).

Tax reform would have to ensure that withholding taxes are not disguised forms of trade and excise taxes, that the difference in tax rates for small companies and large corporations, which creates incentives for small companies to stay small, are rationalized, that all manner of tax concessions, which have eroded the tax base, are withdrawn, and that the present system of universal self assessment is accompanied by a strong system of tax audit to reduce tax evasion and improve tax compliance.

Box 1: Key Sectors Exempted from Income Tax

- Capital gains arising from sale of real estate
- Income from mutual funds, investment companies or education institutes
- Income from trusts, welfare, religious and charitable organizations
- Income from federal securities
- Military and non-military pensions
- Annuity payments and other payments from workers participation fund
- Export of IT
- Agriculture income (unless tax payer earns more than Rs. 80,000 of non-agriculture income)