

POTENTIAL PROBLEMS IN PAKISTAN'S VALUE ADDED TAX SYSTEM

Muhammad Shahzeb Usman



About the Author

Muhammad Shahzeb Usman completed his Bachelor of Laws (BA-LL.B.) from the Lahore University of Management Sciences (LUMS) in 2021. He graduated with the degree of Master of Laws (LL.M.) in 2022 from the University of Nottingham, United Kingdom where he studied as the Developing Solutions Scholar. In 2019, he completed the International Course on Global Refugee Crisis on Merit Scholarship at *Koc* University, Istanbul, Turkey. In 2018, he also completed an International Course on Politics in South – East Asia at UNMC, Kuala Lumpur, Malaysia. He is currently working as a Legal Researcher in the Department of Lawfare and International Law at the Islamabad Policy Research Institute (IPRI). His areas of interest include analyzing the impact of International Financial Institutions (IFIs) from TWAIL perspective, International Human Rights Laws, Economic Rights, Labour Laws, Tax Laws, Competition Laws, and Refugee Laws.

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Abstract

Tax Collection in Pakistan is a key element of effective governance in the country so that resources are present in the public sector for the creation of a welfare state. However, such a tax system must be fair and progressive in nature. There should be no structural traps within the functionality of the tax laws which creates loopholes from which the tax collection can escape from the coffers of the government. Moreover, tax incidence must also not occur on items which were not meant to be levied as it will decrease purchasing power of the society.

Keywords: Value Added Tax (VAT), Sales Tax 1990, General Sales Tax (GST), Input Tax, Output Tax

- **Introduction**

In Pakistan, Sales Tax Act 1990 introduced the Value Added Tax (“VAT”) and termed it as the General Sales Tax (“GST”). Initially, GST was levied only on goods and at the manufacturing stage of production and imports. However, a major step towards the true implementation was implemented in 1995 - 1996 when GST was converted into a full-fledged VAT. This true implementation was in consideration with all its basic features i.e., self-assessment, functional distribution, input tax credit facility and audit-based procedures.¹ However, many frictions in the system were observed when the system interacted with local conditions of Pakistan. These frictions along with some of the inherent deficiencies in the VAT system caused many problems to emerge in Pakistan in relation to VAT system. Some of the deficiencies in the VAT system in Pakistan are listed below:

- **Addition of Input Taxes in Prices Causing Distortion of VAT**

In Pakistan, the input tax which is paid by businesses in relation to some of their goods such as purchase of cars is not allowed to be adjusted with the output taxes. Similarly, the input tax paid on the provision of any entertainment or leisure services for the employees is also not allowed to be adjusted with the output tax.² As a result, the businesses generally adjust the input taxes paid in relation to the use of their cars and entertainment activities in the price of the services or goods. The price is increased, and the VAT is levied on the value addition which is embedded in it as a small percentage of input tax. This causes double taxation and distortion. Moreover, the input tax paid in relation to the utilities, which has nothing to with the production of goods or provision of services, is also added to the price causing further distortion.³

Pakistan also provides many exemptions from VAT. This is reflected in section 13 of the Sales Tax Act 1990 which allows the goods or imports specified in the Sixth Schedule of the Act to be exempted. Exemptions basically restrict the seller to charge output tax and the tax on the

Note: Input Tax is the amount of tax which a business has already paid in relation to acquiring of supplies for goods or services. Output Tax is the amount of tax which the business shall charge on their final product after they have added value into the raw materials to produce a final product.

¹ Ahmed S, “Implementation of VAT: Pakistan's Experience” [2006] Market Forces

<<http://www.pafkiet.edu.pk/marketforces/index.php/marketforces/article/view/80>> accessed February 28, 2023

²Federal Board of Revenue, SRO 490(I)/2004 dated June 12, 2004

³ Asim Zulfikar Ali, ‘Indirect Taxation in Pakistan’ Class Lecture, Tax Laws, LUMS, Lahore, March 2020

value addition in the product is not levied. This is primarily executed to incentivize certain products or provide relief to a certain class of person like people involved in agriculture.

However, as opposed to zero-rated goods, the input tax is not refunded to the seller. Resultantly, a phenomenon called the 'exemption creep' occurs which distorts the whole system. It is noted that each exemption creates direct pressures for more exemptions both upstream and downstream of the product. For instance, if the government creates an exemption for goods sold at an intermediate step in the 'chain of selling', then the firm from which the goods are purchased shall argue to exempt them so that their own value addition escapes tax.⁴ Similarly, the firm to which the goods are sold shall also argue that since the input tax charged by the seller is embedded in the price, it causes double taxation and the final price of the whole item increases which may reduce demand. Thus, exemption at intermediary or initial 'chain of selling' causes significant cascading.⁵

- **VAT Deterring Capital Investment**

Capital goods are tangible assets that an organization uses to produce goods or services. It can be in the form of construction of office buildings, procurement of equipment, and purchase of machinery. In Pakistan, the investment made on these goods involves a considerable amount to be paid in terms of input tax due to their expensive price. However, the return of this input tax requires time as the production unit, for instance, shall take time to produce enough goods and sell them so that the input tax is recovered. The government is also reluctant to pay back the input tax up front to the businesses. Disallowing input taxes on these goods has its own problems that it might prompt the businessmen to put the input tax in prices which shall cause distortion and double taxation in system. As a result, the small or struggling medium sized firms fail to invest in capital goods which restrict their expansion which subsequently deter economic activity and reduce employment.⁶

- **Fraudulent Behaviors in Relation to VAT**

Countries like Pakistan usually use a lower threshold above which they shall charge VAT because of the consideration to increase revenue.⁷ This causes a comparative disadvantage to

⁴ Ebrill L and others, *The Modern VAT* (International Monetary Fund 2001), pp 89.

⁵ *Ibid* (n.3)

⁶ *Ibid* (n.3)

⁷ Ebrill L and others, *The Modern VAT* (International Monetary Fund 2001), pp 114

the compliant taxpayer who earns a higher income and is subjected to VAT but the business which shows less income and is not compliant is granted exemptions. Moreover, a problem in Pakistan was also in relation to the layered system of VAT which prompted taxpayers to register under wrong categories to avoid tax payment. This system envisaged different rates for manufacturers according to their turnovers.⁸

An inefficiency observed in the VAT system of Pakistan is that there is a comparative disadvantage to those taxpayers who could not get refund from the department if their output tax was less than input tax or the goods were zero-rated. This can occur due to fewer linkages in the department. There are also reports of fraud in relation to the refunds. Due to the absence of wide documentation of the intermediary businessmen, they are able to issue fake invoices.⁹ Thus, manufacturers who exports goods can procure fake invoices from these businessmen and make a trail of input taxes which are offset by the output taxes until a huge input tax has to be recovered because of zero rating of exporters.

- **Inter-Provincial and Federal - Provincial Disputes**

Under Sales Tax Act 1990, the provinces shall tax services while the VAT on goods shall be recovered by the Federal Government.¹⁰ There is a considerable confusion in many cases including toll manufacturing that whether the payment paid in relation to the taxable supply is for the provision of goods or services. Similarly, there is an ambiguity that whether the tax on services shall be charged by that province where the service provider is located or where the services are rendered.¹¹ This complication is especially observed¹¹ in relation to services such as TV advertisements. These legal confusions significantly deter smoothness of the tax collection in Pakistan.¹²

- **Administrative Issues**

The weakest component of tax administration in Pakistan is audit which allows VAT to seep in the drains through the malpractices of businesses. Various confusions for the tax department in this process includes the ambit of coverage of audit; the selection of cases for audit; the

⁸ Zaman NU, Ghutai G and Zaidi SRIS, "The Implications of the Value Added Tax in Pakistan: Administration, Experiences and Fears" [2012] SSRN Electronic Journal <https://mpira.ub.uni-muenchen.de/37172/1/MPRA_paper_37172.pdf> accessed February 20, 2023

⁹ Zaman NU, Ghutai G and Zaidi SRIS, "The Implications of the Value Added Tax in Pakistan: Administration, Experiences and Fears" [2012] SSRN Electronic Journal <https://mpira.ub.uni-muenchen.de/37172/1/MPRA_paper_37172.pdf> accessed February 20, 2023

¹⁰ Section 3, Sales Tax Act 1990

¹¹ Huzaima Bukhari & Dr. Ikramul Haq (2016), Towards Flat, Low-rate, Broad and Predictable Taxes, Islamabad: PRIME Institute. pp.64

¹² Ibid (n.3)

method of audit to be used; the selection of management system to monitor the audit program etc. The reason for poor auditing *inter alia* stems from lack of high skills required in officials for this technical task, possibility of collusion of the taxpayer and businesses, weak political commitment and a lack of clear legal framework which defines the rights of taxpayers and the legal powers of the official.¹³

An area of great concern in relation to the VAT administration in Pakistan is related to compliance and collection costs. Tax compliance is very low in Pakistan as very few people are registered persons and less businesses file monthly tax returns.¹⁴ The collection costs need a huge infrastructure with necessary departmental officials at the local level. Moreover, collection and compliance require state-of-the-art training of the officials; an easy system of filing with minimum reliance on lawyers and mass-education of taxation. Adequate investments in digitalization of the records in the tax department and connecting it with other databases of government are not present which further deter compliance and collection. Digital cash registers and mass training of businessmen is absent so that a tax culture can be groomed in the country. These supporting processes are very important for stabilizing the system and require capital investment. Moreover, the problems especially emerge for the small and medium sized enterprises which result in unbearable compliance costs on them due to extensive documentation for federal and provincial sales taxes.¹⁵

- **Suggestions**

- 1) There needs to be an establishment of National Tax Authority (“NTA”) which is the sole collector of taxes in the country on the level of provinces as well as federation. Creation of NTA will reduce the problem of lack of harmonization between federation, provinces and local governments as well as possess the technical expertise in relation to taxation. NTA should be only responsible for collecting taxes with no role in legislation. It shall be accountable to Parliament through the Minister of Finance and Revenue and will be overseen through an independent Board of Management. The Board of Management shall appoint a Chief Executive Officer and Board will have representation from all provinces.¹⁶ This integration between the Federation and

¹³ Ibid (n.3)

¹⁴ Ahmed S, “Implementation of VAT: Pakistan's Experience” [2006] Market Forces <<http://www.pafkiet.edu.pk/marketforces/index.php/marketforces/article/view/80>> accessed February 23, 2023

¹⁵ Ibid (n.8) pp 45

¹⁶ Ibid (n.8) pp 37.

Provinces shall be inspired through the Canadian concept of 'participating provinces' under the Canadian system of Harmonized Sales Tax ("HST") where the provinces and federation will collect taxes of all types through same entity. This shall ensure better synchronization in terms of keeping records for payment of different species of taxes at all levels which will help NTA to spot any irregularities. Moreover, there shall be no need to file different tax returns for sales tax to provinces and federation while both shall not tax the same source of revenue if there is any confusion as to the nature of particular sale to be classified as goods or services.¹⁷ For the establishment of NTA, Council of Common Interest under Article 153 of the Constitution of Pakistan must discuss the requisite legislations at all tiers of government and its control shall be under National Economic Council under the Article 156.¹⁸

- 2) NTA shall be backed through Tax Intelligence System ("TIS"). TIS will be responsible for sending notices to potential taxpayers through a system in which it provides an estimate to the taxpayer of the department's expectation in relation to their returns. For this purpose, an integration between sales tax collections on goods and services with income tax returns and property taxes must be executed.¹⁹
- 3) In relation to the problem of exemption creep in Pakistan, it is suggested that if exemptions are applied only at the last stage of the consumption, there shall no cascading. Moreover, this shall ensure that the benefit is borne by the ultimate consumer.
- 4) The removal of double taxation which is caused due to the purchases of items such as cars for businesses requires a specific mechanism with the consultation of businessmen. This mechanism should formulate a policy to pro-rate the input taxes to be charged on items which are difficult to directly link with activities of businesses.
- 5) The expediting of business activity requires that capital goods must be exempted or zero rated so that there is less time lag of recovering input tax and investment is increased.
- 6) The solution to prevent frauds of input tax requires a narrow curtailing of refunds for input tax. This can be achieved by limiting it to only exporters and ending of zero-rating on domestic supplies, especially on high fraud sectors such as textiles.

¹⁷ Ibid (n.8) pp 55

¹⁸ Ibid (n.8) pp 30

¹⁹ Ibid (n.8), pp.30

- 7) The efficiency of the audit system is the key to ensuring an efficient VAT system because it ensures that there shall be an oversight of the department in relation to any fraud or non-compliance with the tax provisions. However, this shall require comprehensive and institutional methods. These methods include a simultaneous review of income tax, wealth statement and VAT returns as an exorbitant increase in income tax or assets but no increase in VAT raises a suspicion of non-compliance. Similarly unannounced visits to a taxpayer's premises, perusal of appropriate records and proper invoices are important to catch frauds such as observed in textile sector. There must also be 'comprehensive audits' in all those cases where serious misreporting has been detected during any of the probes. An effective audit system also requires that a post refund audit of compliant taxpayers and pre-refund audit of high-risk claimants must be made a norm so that a 'looming deterrent' is accorded to all tentative fraudsters.
- 8) In order to remove the inefficiency in markets, there is a need to place a higher threshold for exemption in Pakistan.

