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Taxation Laws and Policy: Areas of Improvement

MUHAMMAD SHAHZEB USMAN

Executive Summary

Issue

Effective taxation policy is one of the most important tools for running a country. What can be the most effective and innovative solutions to improve tax collection from a policy perspective in Pakistan?

Recommendations

- Unnecessary withholding taxes on banking transactions must be removed.
- To decrease cash in circulation, excessive incentives in terms of low sales taxes on digital payments and a larger increase in literacy and income shall be essential.
- Presumptive taxes which are calculated based on the productivity characteristics of land must be introduced.
- Only a unified tariff code must be relevant rather than various SROs for tariffs on imports.
- Withholding taxes on larger money withdrawals need to be less and saving certificates should be increased in agricultural payments.
- Specific banking laws which protect small companies from high interest rates so that they continue to keep in business.
- NFC awards need to be revised with provinces providing better tax collection on agriculture and property be given encouragement in finances.

Overview

The Pakistani economy is suffering from stagflation. Interest rates are used as a stick to control inflation. If both interest rates are high and inflation is still not controlled, that speaks to the larger issues with the economy which cannot be solved with quick fiscal and monetary solutions. If the economy is growing and unemployment is reduced, inflation increases automatically. In Pakistan, the economy is contracting, and inflation is increasing – a phenomenon disastrous for any country. The root of the issues remains a large consuming-oriented population and fewer fossil fuel resources. The key remains that Pakistan improves tax collection to fund public services. For that purpose, Pakistan targets must remove bottlenecks in the system and target untapped areas of potential.

Analysis

I) Credit Risk and Bank Deposits

Bank deposits in Pakistan soared to a record of 25.6 trillion in June 2023. 98.9% of conventional banking and 98.7% of Islamic banking can be protected under deposit protection in case there is bank failure. The major increase in this is largely due to tighter monetary policy of a higher interest rate and expansion of branch networks. However, the increase in bank deposits in Pakistan is also a symptom of larger economic trends in Pakistan due to higher interest rates which many economic analysts consider as detrimental.¹

An issue that arises with high interest is credit risk. Credit risk diminishes the ability of individual and business borrowers to service their debt. As the debt shall be expensive, it shall result in the collapse of entities and companies that are already in a precarious position due to rising inflation. This inevitably impacts mostly the small and mid-sized firms with less buffer and cushion. As a result, entrepreneurship suffers more and the innovation in the market becomes less. Less economic activity results in less corporate profits and less revenue for the government. The middle classes and working classes suffer more than the elite as even the households who acquire debt in the form of mortgages and auto-loans suffer.² This is especially the case where

¹ News Desk, 'Bank deposits soar to a record high of Rs25.6tr despite YoY deceleration: Report' *Profit* December 2, 2023

² Tobias Adrian, 'Higher for longer' interest rate environment is Squeezing More Borrowers', *IMF* October 10, 2023

there are floating mortgage rates. Purchasing power lowers and less revenue avenue accrues to government due to less consumption.

II Currency in Circulation and Deposits

The rise of currency in circulation and deposit ratio (CC/DD) is also often problematic for tax collection and in case of oil shocks in the market. Inflation does lead to more currency in circulation as savings from deposits are liquidated in favour of spending. Economic activity leads to higher deposits if the savings patterns are to deposit currency. Thus, deposits can be an indicator of a growing economy which can ensure greater tax collection. However, increased incomes shall only ensure greater tax collection if legal measures such as lowering of withholding taxes are provided which increase the documentation of economy for greater tax collection. In the USA, the large bank network was instrumental in increasing deposits as due to these networks, deposits increased from 5.5\$ trillion to 10.1\$ trillion.³ This was especially observed after the financial crisis of 2008 as deposits increased due to higher risk aversion in consumers immediately after a financial crisis. In China, high deposit rates have stimulated a loss of consumption in the market which most people want to spend in terms of education, health and purchasing property.⁴

III Cash in Circulation

In Pakistan Cash in Circulation has primarily increased to Rs.9.2 trillion in June 2023 which is almost an amount equal to 11% of the GDP or 30% of the money supply.⁵ In June 2022, the Cash in Circulation was almost Rs.7.57 trillion which was almost 27.5% of the total monetary value in the system. According to Ammar Habib Khan, only a decade ago, it was 8% but now it is around 20% on average on the money supply.⁶ This explosive growth in Cash in Circulation is concerning as it supports the informal economy, corruption, inflation, *hawala* transactions, and speculative industries like hoarding commodities.⁷

³ 'Deposits grow across Banks following financial Crisis' *Federal Reserve Bank of St. Louis* September 09, 2015

⁴ Editorial, 'High rates of bank deposits may harm the economy' *China Daily* September 17th, 2013

⁵ Syed Salim Raza, Sultan Ali Allana, Zafar Masud 'Comment: Transitioning away from a cash economy' *DAWN* October 5th, 2023

⁶ Salman Siddiqui, 'Rising cash circulation spurs inflation concerns', *Tribune*, August 05, 2023

⁷ Ibid

IV Areas in Agriculture

One of the biggest issues right now is the lack of adequate taxation in Agricultural tax. After the National Finance Commission (NFC) award, the share of provinces reached 57.5% although the power to impose taxes on agriculture, property and services remains with provinces. Provinces increasingly have become addicted to federal money and have less desire to actively tax agriculture. Hence, it is no surprise that the agricultural sector earns less than 0.1 % of the tax revenues for the provincial government even though it accounts for 20 % of the GDP and employs 45% of the workforce.⁸

V Property Tax and Local Governance

One of the most effective ways to tax the property shall be through financially empowered local urban governments. The collection of property taxes is very low. For instance, Punjab collected only 10 billion or 6% of the tax revenue from property. Similarly, Karachi has not had a revaluation since 2001.⁹ The situation demands localization of the powers to tax property with excessive energy of the provinces to direct on this extremely important and lucrative sector which has not within the radar for long.

VI Protectionism and Exports

To deter imports, the government is increasingly imposing tariffs on the imports. However, many of such imports are used as input material for exports and act as a tax on exports. These taxes often act as a higher source of tax revenue than most of the intermediate inputs but are catastrophic for employment in export sectors and competitiveness of Pakistani exports in global sectors which are essential for foreign exchange.¹⁰ Focusing on discouraging imports using tariff rates is simplistic as Pakistan is one of those countries in which even the inputs of exports require excessive amounts of materials which are imported.

⁸ Serhan Cavik, 'Unlocking Pakistan's Revenue Potential' *IMF Working Paper* WP/16/182

⁹ Shahrukh Wani, 'Reforming Pakistan's tax system: Evidence-based suggestions' *JGC* December 3rd, 2018

¹⁰ Mirza Tauseef, 'Untapped export potential', *Riphah Information Portal* January 5th, 2022

VII Recommendations

- Unnecessary withholding taxes on banking transactions must be removed. To add people to the filer category, high charges on banking transactions were imposed which coaxed people into the informal economy. This results in a catch-22 situation since high fees for non-filers were to encourage them to become filers but high fees also deter them from escaping banking channels altogether. ¹¹
- Specific banking laws which protect small companies from high-interest rates so that they continue to keep in business.
- Moreover, a large chunk of our population has no disposable income or literacy to encourage them to make bank accounts. To decrease cash in circulation, excessive incentives in terms of low sales taxes on digital payments and a larger increase in literacy and income shall be essential. ¹²
- Presumptive taxes which are calculated based on the productivity characteristics of land must be introduced. A threshold needs to be introduced which protects low-income farm households.¹³
- For property tax, it is extremely important that an entity is established across provinces with special technology to establish a valuation of the property and is exclusively focused on the collection of property taxes with municipal government possessing enough stakes within that agency. ¹⁴
- The government needs to make a policy on taxation on imports which are the input of exports which ensures that all “all types of duties and taxes i.e. Custom Duty, Regulatory Duty, Sales Tax and Withholding Taxes need to be abolished on the import of input goods and machinery.”¹⁵ For this, only a unified tariff code must be relevant rather than various SROs.
- Saving certificates should be increased in agricultural payments to reduce the liquidity burden on banks in addition to providing saving deposits to small deposit holders. This shall also improve taxation on agriculture. Moreover, NFC

¹¹Ibid (n.5)

¹² Shahid Mehmood, ‘High Percentage Of Currency In Circulation: What Explains It?’ *PIDE* 2023

¹³ Ibid (n.8)

¹⁴ Ibid

¹⁵ Jamil Nasir, ‘The Tariff Tripod of Pakistan: Protection, Export Promotion, and Revenue Generation’ © The Pakistan Development Review 59:3 (2020) pp. 517–551

awards need to be revised with provinces providing better tax collection on agriculture and property being given encouragement in finances.

Recommendations and Action Matrix

Legal Options for Government

Recommendations	Pathways to Solution	Implementation of Solution	Actors Responsible	Implementation Timelines
Taxes on Property, Agriculture, and Imports	Taxes on property are to be based on presumption; unified tariffs for imports acting as input for exports, a provincial share of NFC contingent on better performance in the collection of agricultural and property tax and unnecessary withholding taxes to be removed on banking transactions.	Property tax is to be a collaboration with the local governments with a specialized provincial body for this purpose. All SROs to be removed about those imports leading to exports.	1. Federal and Provincial Ministry of Law 2. Federal and Provincial Ministry of Commerce 3. Federal and Provincial Ministry of Finance	5-6 Months for the Amendments in Law and Regulations
Banking Reforms	Withholding taxes are to be removed on banking transactions while digitalization and filing are promoted through less cash-in circulation measures through only card payments. Liquidity and foreclosure laws are to be made flexible for small companies in cases of high interest rates.	A specific legal amendment for the removal of withholding taxes and legal amendment in banking and foreclosure laws to allow extended deadlines for restructuring of payment for small house owners and small companies.	1. Federal and Provincial Ministry of Law 2. Federal and Provincial Ministry of Commerce 3. Federal and Provincial Ministry of Finance	3 - 6 Months to formulate the Amendments.

