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Edited by Nadeem Ul Haque & Faheem Jehangir Khan

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PUBLIC FINANCE MANAGEMENT
(Volume XVI)

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Research for Social Transformation & Advancement
Pakistan Institute of Development Economics, Islamabad

January 2025

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TAMING THE LEVIATHAN FOR PUBLIC SECTOR RESOURCE EFFICIENCY IN PAKISTAN: FISCAL FEDERALISM OR FISCAL DECENTRALISATION?

Muhammad Ahmad Barula

ABSTRACT

Fiscal federalism is the transfer of expenditure responsibility to lower tiers of government with reliance on the central government for resource transfers. Fiscal decentralisation, on the other hand, gives more autonomy to subnational governments for the basic needs of the people as key public sector decision-makers. This is encouraged to target efficiency gains by reducing wasteful expenditures. The current study examined the 'Leviathan hypothesis' of government expenditures under fiscal autonomy and federal resource transfers to provincial governments in Pakistan. The time series analysis with structural breaks was applied to examine the Leviathan hypothesis. The findings support that the Leviathan tendency can be tamed by allocating more resources for development expenditures from fiscal decentralisation in comparison to fiscal federalism. Nevertheless, there is a long way to achieve self-sufficiency under provincial autonomy in taming the Leviathan as currently, the impact of the provincial revenue resources on the overall budget balance is positive but not very significant. For examining the distributional consequences on social sector budgetary allocations and social sector outcomes, the standard pooled OLS regression estimation technique was used after taking into account the time dummies and cross-sectional dummies for the provinces. The impact of expenditures was checked on education sector expenditure (both current and development). The study found that public resource utilisation using provincial tax revenue had positive distributional consequences through the avoidance of wasteful current education expenditures. Furthermore, slope coefficients of provincial tax collection with health infrastructure, both the number of dispensaries and hospitals, were statistically significant and positive and had a large magnitude. This illustrates that the Leviathan is tamed for public sector resource efficiency.

1. INTRODUCTION

With the advent of liberalised policies worldwide during the 1990s, many countries have shown strong advocacy toward fiscal aspects of decentralisation. Fiscal decentralisation can be evaluated by examining the revenue and expenditure shares of the subnational governments (SNG) vis-à-vis the central government. The major motivation behind fiscal decentralisation is to achieve government resource efficiency and improvement in public sector service delivery. However, some mixed results are found in the case of developing countries as against the conventional supporting argument for fiscal decentralisation. In the case of Pakistan, there is asymmetric decentralisation of the fiscal and political institutions (Tunio & Nabi, 2021), i.e., the political structure is completely decentralised but the fiscal system is centralised. In Pakistan, a higher degree of fiscal centralisation is observed due to a greater share of the federal government in tax autonomy and spending as well as heavy reliance of the federating units on federal transfers. The consolidated fiscal operations for 2021 are provided in Figure 1. The greater federal share in tax revenue, non-tax revenue and current expenditure depicts the federal nature of Pakistan's fiscal operations.

Figure 1: Federal and Provincial Fiscal Operations (2020)
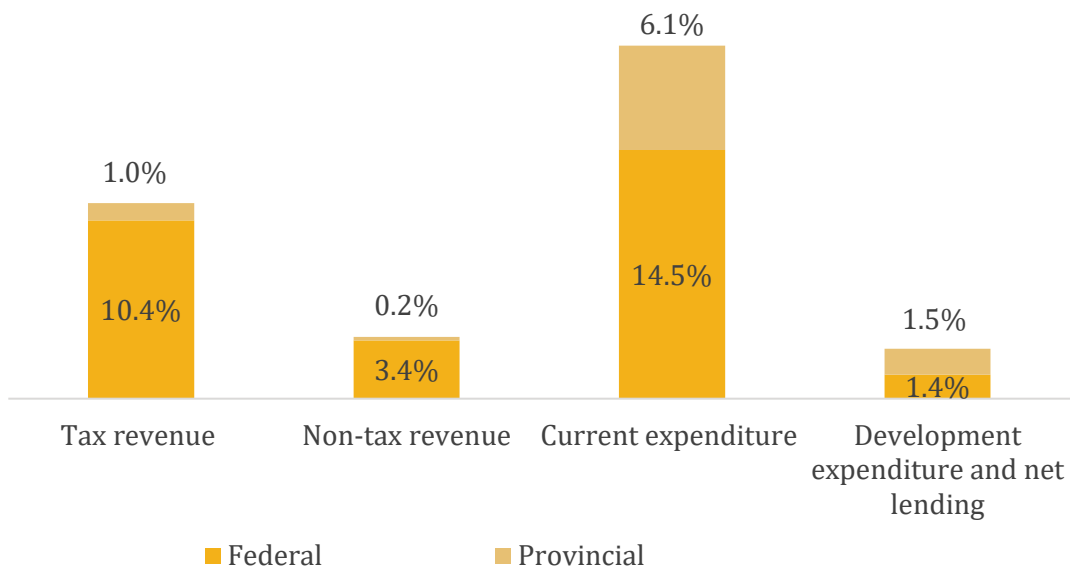
Source: Author's compilation from GOP (2021).
Note: All figures are as percentages of GDP.

Figure 2 shows federal resource transfers to provincial governments (2017 to 2020). There was a slight increase in federal tax transfers in 2018 with a declining trend in 2019 and 2020. On the other hand, federal grants remained stagnant from 2017 to 2019 with a slight increase in 2020. The provincial tax collection as a percentage of GDP is minimal with an average value of 1.1 per cent. Therefore, provincial governments rely heavily on federal resource transfers, especially tax transfers.

Figure 2: Federal Resource Transfers to Provincial Government and Provincial Tax Revenue (2017-2020)
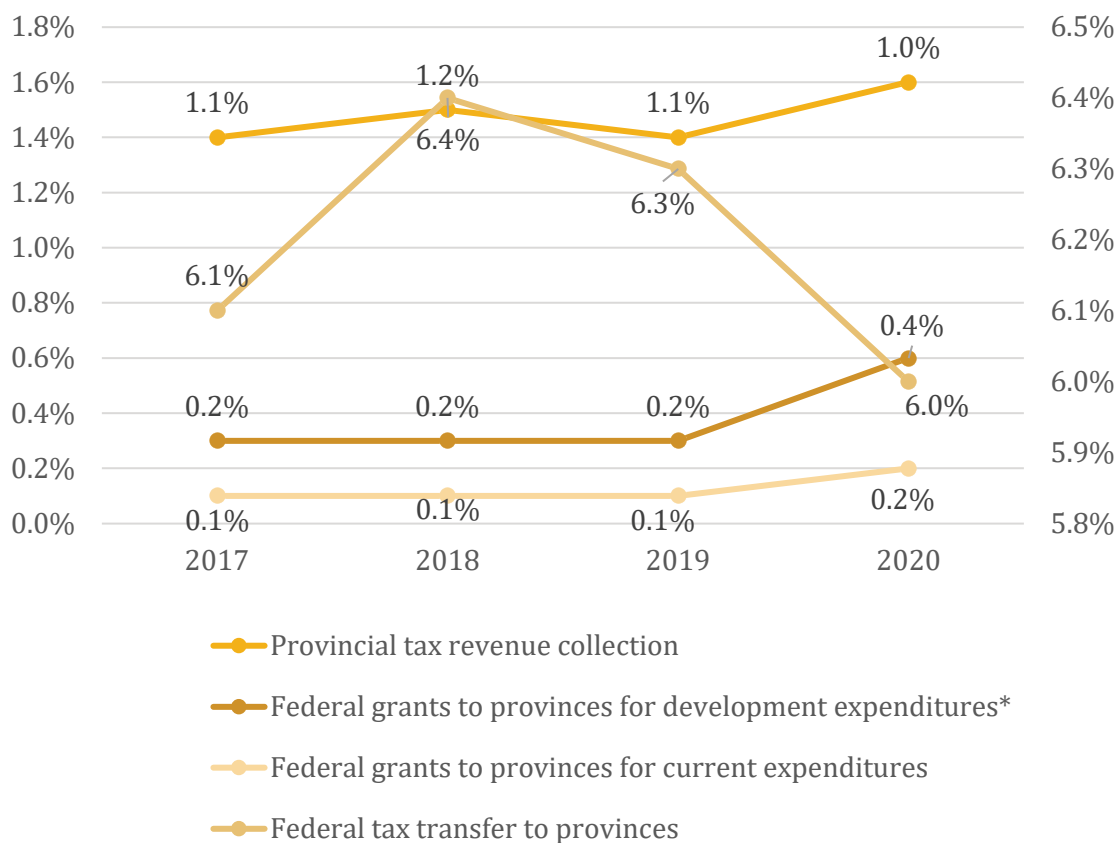
Author's compilation from the GOP (2021).
*Note: *Public Sector Development Program (PSDP). All figures are as percentages of GDP.*

Fiscal federalism is the transfer of expenditure responsibility to lower tiers of government with reliance on the central government for resource transfers. It determines the distributional responsibility of resources to lower tiers of the government. On the other hand, fiscal decentralisation gives more autonomy to subnational governments as key public sector decision-makers to cater to the basic needs of the people. It is a mechanism of devolving fiscal responsibilities to internalise the finances and suitable taxation authority to subnational governments for efficiency gains. Thus, both concepts are distinct in terms of their impact on resource efficiency and effectiveness in public sector service delivery.

The current study examines the 'Leviathan hypothesis' of government expenditures under fiscal autonomy and federal resource transfers to provincial governments in Pakistan. The provincial fiscal balance (as a percentage of total revenue) is given in Figure 3. There was an overall provincial deficit in 2017 with Khyber-Pakhtunkhwa (KP) facing the highest deficit. In 2018, KP had a revenue surplus while the rest of the provinces were deficit provinces with Sindh having the highest deficit. On the other hand, the following year, there was an overall surplus in all provinces with the highest surplus in Sindh. Again, in 2020, Punjab and KP were the deficit provinces, but the volume of deficit was relatively small.

Figure 3: Provincial Fiscal Balance as Percentage of Total Provincial Revenue
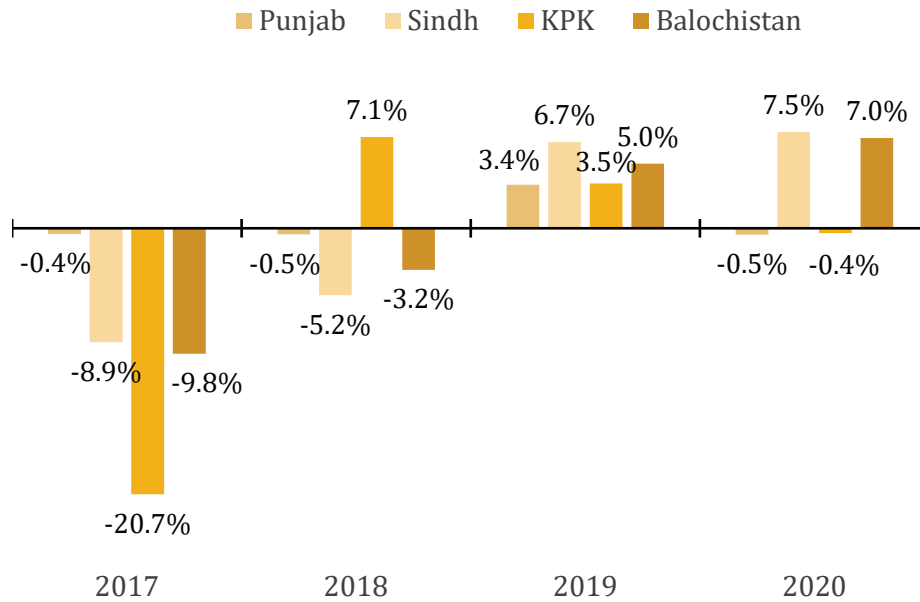
Source: Author's calculations from GOP (2021).

It becomes tricky to assess and quantify the impact of fiscal decentralisation on public sector performance due to potential endogeneity issues in econometric modelling. In addition, fiscal decentralisation may lead to efficient resource allocation, but Martinez-Vazquez (2011) states that "decentralization is not an automatic remedy" as it also has repercussions, such as lack of capacity building, macroeconomic instability, political constraints, corruption, and diversion of funds to the local elites. Thus, the question is whether the centralised mechanism can achieve efficient resource allocation through diversification, customisation, and fiscal discipline rules by limiting borrowing.

There is a need to empirically investigate the extent to which fiscal decentralisation in Pakistan can improve the performance of the public sector as well as distributional consequences on economic development and public sector service delivery. The key research questions that the current study aims to address are:

1. What impact does fiscal (de)centralisation or fiscal federalism have on Pakistan's fiscal health?

2. Does fiscal (de)centralisation affect the size and expenditure composition of subnational governments?

3. To what extent does fiscal (de)centralisation affect public service delivery?

The outcome of this study might help the decision-makers to evaluate whether fiscal decentralisation can be beneficial for the country and the extent to which fiscal decentralisation can be put into effect in Pakistan.

2. LITERATURE REVIEW

Qian & Roland (1998) provided a theoretical rationale for fiscal decentralisation and stated that fiscal decentralisation hardens the budget constraints by raising the economic costs of bailing out inefficient projects. De Mello (2000) stated that subnational dependency on vertical transfers worsens the central government's fiscal position in developing countries, but the impact is relatively curtailed in OECD countries. Kwŏn (2002) and

Timofeev (2002) found that revenue decentralisation results in efficient budgetary allocations and also curbs subnational government subsidies. Rodden (2002 & 2003) concluded that borrowing autonomy to subnational governments is associated with a larger fiscal deficit, and a heavy reliance on intergovernmental transfers increases the government size whereas tax autonomy has a positive impact on fiscal discipline. Neyapti (2010) argued that fiscal decentralisation negatively impacts government deficits. Eyraud & Lusinyan (2013) and Presbitero et al. (2014) concluded that a shift from vertical transfers to own revenue resources improves the fiscal balance of subnational governments, whereas fiscal decentralisation, in terms of tax autonomy, strengthens the fiscal balance, such as local property tax. A recent study by Kwabena (2021) explained that the negative effect of fiscal decentralisation on government size diminishes as the democracy level rises except for developing countries.

Fiscal decentralisation is positively associated with developmental expenditures and improves resource allocation for distributional impact (Kwŏn, 2002) as it improves educational outcomes (King & Ozler, 1998; Habibi et al., 2003; Faguet, 2004; Peña, 2007; Faguet & Sánchez, 2014; Barankay & Lockwood, 2007; Simatupang, 2009) and health outcomes (Habibi et al., 2003). Ahmed & Kamal (2014), and Shahab (2018) discussed the evolution of fiscal decentralisation in Pakistan and the critical appraisal of resource distribution and the NFC award. Malik et al. (2006), Faridi (2011), Iqbal et al. (2012), Ahmad (2020), Hanif et al. (2020) examined the relationship of fiscal decentralisation with economic growth and found mixed results.

The literature on fiscal decentralisation shows that revenue decentralisation has a negative effect on economic growth, while expenditure decentralisation has a positive impact. However, the opposite association is also found in empirical findings. Some studies on Pakistan show that fiscal autonomy may stimulate economic growth by making subnational governments more productive and federal transfers positively affect growth only in the short run. There is a need for tax autonomy to have a long-run positive economic impact. Sohail et al. (2021) found that a negative shock to expenditure decentralisation tends to decrease government size, while a positive shock to revenue decentralisation has a direct impact on government size.

3. THEORETICAL FRAMEWORK

The classic viewpoint of federalism is based on the principle of benefit taxation, minimisation of horizontal disparities through vertical transfers, and fiscal discipline through responsible subnational borrowing. Fiscal federalism is the mechanism of revenue sharing of the centre with subnational governments and the distribution of resources as per an approved formula. The central government has all the power and delegates some public responsibility to the lower tiers. Rodden (2003) argues that government size grows faster when reliance on intergovernmental transfers increases for public expenditures. The soft budget constraints give rise to incentive problems due to common pool resources as competing governments tend to overfish.

The Tiebout hypothesis (Tiebout, 1956) of public sector resource allocation justifies the decentralisation mechanism as an effective way of increasing the efficiency of the public sector. Oates (1972) assumes that the government is an 'altruistic agent' and decentralisation leads to increased welfare of society resulting from information advantages and flexibility in adapting to local citizen's needs. Brennan-Buchanan hypothesis, under public choice, assumes the central government to be a monopolist with maximum control over the resources (Brennan & Buchanan, 1980). Thus, the centralised system increases the Leviathan tendency of the government along with more taxation on citizens.

However, the view is undermined by the "race to the bottom" approach under decentralisation resulting from tax competition among subnational governments (Zodrow & Mieszkowski, 1986). Tax competition tames the Leviathan but also leads to inefficient public service delivery. Another viewpoint under the theory of public

choice and political economy debate assumes that the government is composed of self-interested individuals who forcefully do not deviate from good behaviour to preserve the system. Therefore, decentralisation prevents the expansion of the public sector, and this mechanism is known as 'market-preserving federalism' (McKinnon, 1997).

4. METHODOLOGY AND ESTIMATION OF MEASURING THE LEVIATHAN TENDENCY IN GOVERNMENT EXPENDITURES

To determine whether the Leviathan is tamed when the provinces generate their resources, the size of government was measured by government expenditures as a percentage of GDP, which was further categorised into development expenditures and current expenditures. Fiscal decentralisation was measured through the revenue approach, i.e., total provincial revenue collection divided by total consolidated government revenue. The revenue approach has been used by Oates (1985) and Rodden (2003). Fiscal federalism was measured through the transfer approach (Rodden, 2003; Zhu & Krug, 2005), i.e., total transfers from the federal government to a provincial government. Inflation was taken as a control variable, which was measured by the consumer price index (CPI). The data source is the State Bank of Pakistan. The model to be estimated is as follows:

$$\text{Dev.Exp}_t = \beta o + \beta_1 \text{ FiscalDecen }_t + \beta_2 \text{ FiscalFed }_t + \beta_3 \text{Inf }_t + \mu_t \quad (1)$$

$$\text{Curr.Exp}_t = \alpha o + \alpha_1 \text{ FiscalDecen }_t + \alpha_2 \text{ FiscalFed }_t + \alpha_3 \text{Inf }_t + \mu_t \quad (2)$$

In equations 1 and 2 above, Dev.Exp stands for Development Expenditures, Curr.Exp for Current Expenditure, FiscalDecen for Fiscal Decentralisation (Revenue Approach), FiscalFed for Fiscal Federalism (Transfer Approach), and Inf for Inflation, while μ is the error term. The subscript 't' represents the time series from 1980 to 2020.

The study employed the time series analysis by including different orders of integration as well as the possibility of structural breaks in determining the long-run relationship. The Clemente et al.'s (1998) test was applied with one optimal structural break using the additive outlier model that assumes an abrupt change in the time series (Perron, 1989; Vogelsang & Perron, 1998; Clemente et al., Montanez & Reyes, 1998). The econometric specification is provided in Appendix 1. The results are provided in Table 1. The results show that all variables were of a different order of integration when one structural break was assumed with a single mean shift. The optimal breakpoints for each of the time series variables are also provided in the results.

Table 1: Clemente-Montanes-Reyes Unit Root Test with One Structural Break (with Single Mean Shift) Using Additive Outlier Approach

Variable	Optimal Breakpoints (Level)	p-value	Optimal Breakpoints (First/Second Difference)	p-value	Order of Integration
Development Expenditures	1993	0.001	2015	0.907	I(1)
Current Expenditures	1999	0.162	-	-	I(0)
Fiscal Decentralisation (Revenue Approach)	2008	0.000	2009	0.547	I(1)
Fiscal Federalism (Transfer Approach)	2012	0.000	2009	0.914	I(2)
Inflation (CPI)	2006	0.282	-	-	I(0)

Source: Author's calculations.

To determine the long-run relationship, Gregory & Hansen's (1996) structural break cointegration analysis was applied by assuming a single structural break. This approach estimates the relationship with level shifts, regime shifts, level shifts with the trend, and regime shifts with the trend. The econometric specification is given in Appendix 1. The results are provided in Table 2 showing the optimal structural breaks along with the existence of long-run relationship. The results of Gregory-Hansen cointegration help in determining the optimal breakpoints. For further analysis in estimating the long-run coefficients, the breakpoints were selected as the year 2011 for Model 1, and the years 2000 and 2001 for Model 2.

Table 2: Determining the Optimal Structural Breaks Using Gregory-Hansen Cointegration Approach

	Model 1: Development Expenditures				
Fiscal Decentralisation (Revenue Approach)		ADF	Break Date	Zt	Break Date
	Level shift	-6.52***	**2011**	-4.36	1985
	Regime shift	-6.88***	**2011**	-4.36	1988
	Level shift with the trend	-6.10**	1996	-5.81	1994
	Regime shift with trend	-3.28	1985	-4.41	1985
Fiscal Federalism (Transfer Approach)	Level shift	-6.52***	**2011**	-4.36	1985
	Regime shift	-6.88***	**2011**	-4.36	1988
	Level shift with the trend	-3.28	1985	-4.41	1985
	Regime shift with trend	-6.10***	1996	-5.81	1985
	Model 2: Current Expenditures				
Fiscal Decentralisation (Revenue Approach)		ADF	Break Date	Zt	Break Date
	Level shift	-6.23***	**2000**	-3.83	2001
	Regime shift	-5.49*	2001	-3.70	2001
	Level shift with the trend	-4.74	1998	-3.88	1985
	Regime shift with trend	-4.74	2001	-4.71	1992
Fiscal Federalism (Transfer Approach)	Level shift	-5.00**	1998	-3.77	2001
	Regime shift	-4.62	2001	-3.90	1998
	Level shift with the trend	-5.54**	**2001**	-4.16	2001

Source: Author's calculations.
*Note: Inflation is taken as a control variable in all models. ** and *** denote the presence of cointegration at 5% and 1%.*

Since the order of integration was not the same for all the variables, the long-run relationship was further estimated using the autoregressive distributed lag (ARDL) model. Table 3 reports the long-run estimated coefficients of fiscal decentralisation and fiscal federalism with two categories of government expenditures, i.e., development and current expenditures. The models were estimated with the inclusion of optimal structural

break dummies as indicated in Table 2. Table 3 shows that the coefficient value of both fiscal decentralisation and fiscal federalism is negative with development expenditures but positive with current expenditures. These contrasting results are due to lumpy current expenditures which are seldom reduced whereas the size of development expenditures tends to be lower. Thus, the Leviathan tendency seems to exist in Pakistan where government revenue resources are titled more towards financing the current expenditures.

However, considering the optimal break dummy, increasing the provinces' own revenue resources tends to decline the current expenditures more (coefficient value of -0.136) as compared to the impact of fiscal federalism (coefficient value of -0.094). This can be interpreted as the Leviathan tendency of the government towards current expenditures being tamed when the provincial government must generate their revenue resources.

In addition, after considering the break dummy, it is observed that provinces' own revenues and federal resource transfers have a significant positive (0.12) and significant negative (-0.136) relationship with development and current expenditures, respectively, but an insignificant relationship of federal resource transfers with current expenditures. On the other hand, when the magnitude of the relationship is compared, it is observed that fiscal decentralisation through provinces' own revenue generation on development expenditures (coefficient value of 0.12) is slightly higher as compared to the federal resource transfers through fiscal federalism (coefficient value of 0.11). This also supports that the Leviathan tendency is tamed via more resource allocations towards development expenditures from fiscal decentralisation in comparison to fiscal federalism. This provides evidence of public resource efficiency if provinces are allowed to generate their revenue resources rather than being dependent on federal resource transfers.

The coefficients of the error correction model (ECM) are also provided in Table 3, which are statistically significant and depict the speed of adjustment in the long run in case any disequilibrium occurs in the short run.

Table 3: ARDL Estimation with Structural Break Dummies

Variable name	Model 1		Model 2	
	Development Expenditures		**Current Expenditures**	
Fiscal Decentralisation (Revenue Approach)	-0.494** (-2.42)		0.372** (2.55)	
Fiscal Decentralisation (Revenue Approach) with Optimal Break Date	0.12* (2.01) Break Date = 2011		-0.136*** (-3.01) Break Date = 2000	
Fiscal Federalism (Transfer Approach)		-0.297*** (-3.72)		0.083 (0.35)
Fiscal Federalism (Transfer Approach) with Optimal Break Date		0.11*** (2.55) Break Date = 2011		-0.094** (-2.12) Break Date = 2001
Inflation	0.17 (1.20)	0.22 (1.66)	0.05 (0.768)	0.136 (0.403)
ECM (-1)	-0.41*** (-4.71)	-0.45*** (-5.21)	-0.384*** (-4.38)	-0.525*** (-5.19)

Source: Author's calculations.
*Note: The dependent variable is WOSP. ***, ** and * denote that coefficients are significant at 1%, 5%, and 10% respectively. The p-values are given in parentheses.*

After estimating the long-run parameters, the stability of parameters was checked by plotting the CUSUM and CUSUMSQ graphs illustrated in Figure 4. The figures are provided for all estimated models given in Table 3. Although, the CUSUM plot tends to explode out of the upper/lower bounds in some cases, but tends to get back within the range whereas the CUSUMSQ graphs are all within the critical range. This depicts that all the estimated parameters are stable in the long run.

Figure 4: Diagnostics Test for Parameter Stability: Cusum and CusumSq Graphs

Model 1: Development Expenditures
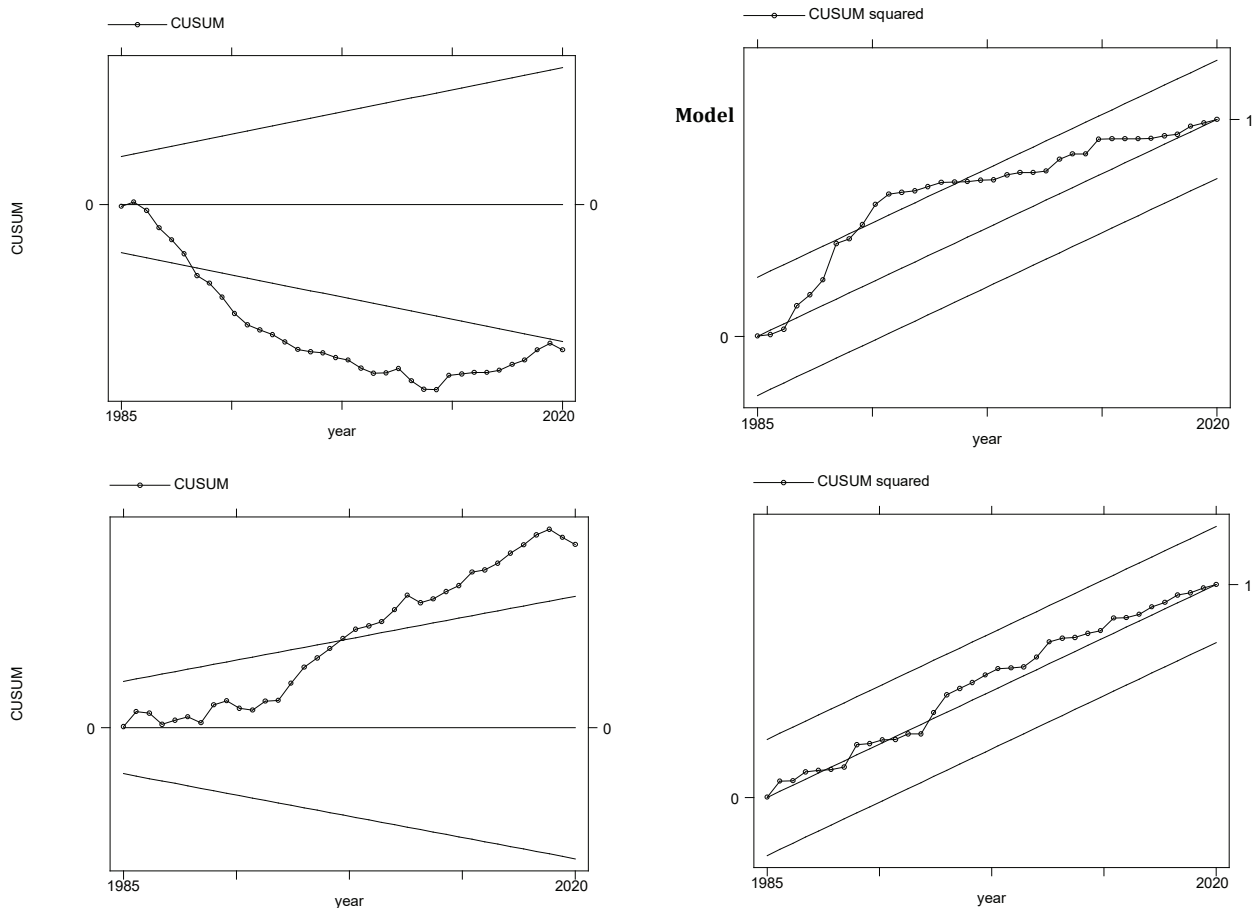
Model 2: Current Expenditures
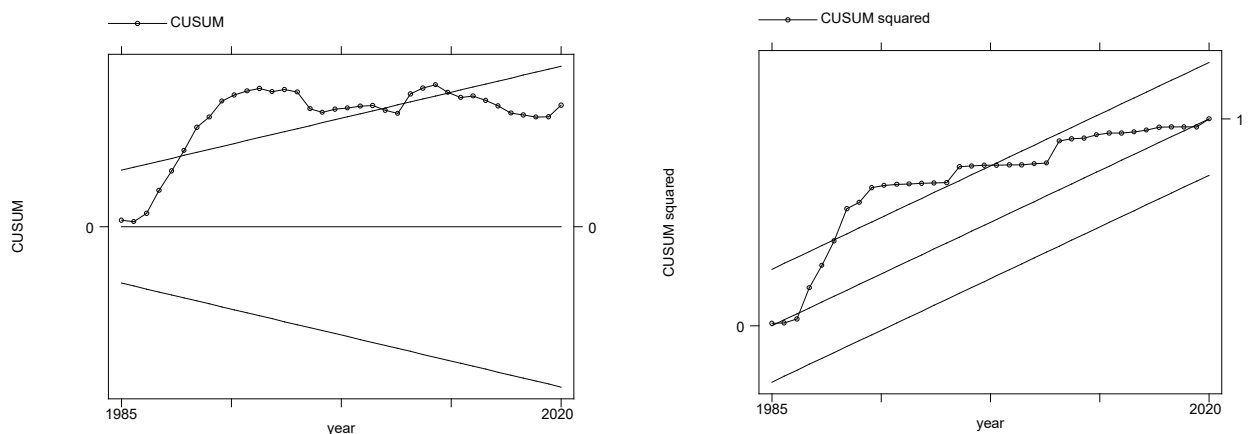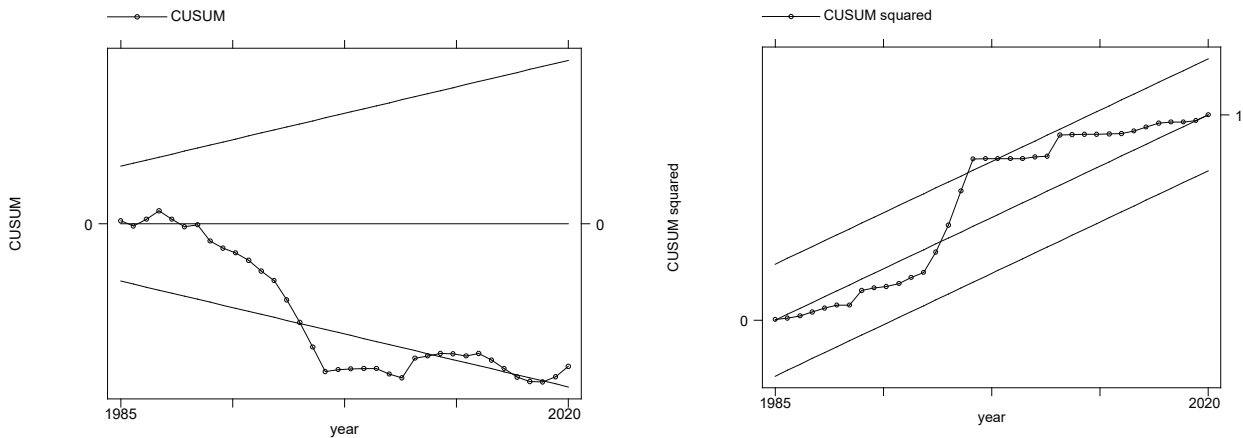
Source: Author's computation using Stata.

Thus, the results show that the Leviathan tendency in government expenditures exists for current expenditures, which can be tamed if provinces are made less dependent on federal resource transfers. Instead, the provinces must be given more autonomy as declared after the 18th Amendment, especially in revenue generation so that resource allocation could be more efficient in terms of less wastage in unnecessary current expenditures rather a shift could be made towards productive development expenditures.

5. GROWTH PROPORTION OF TAX COLLECTION AND EXPENDITURE-REVENUE GAPS: A PROVINCIAL COMPARISON

This section presents a brief analysis of provincial fiscal operations supported by a graphical analysis given in Appendix 4. The data source is the State Bank of Pakistan. To standardise the data, all figures were taken as percentages of total provincial revenue. The tax collection was compared with development and current expenditures as percentage shares in total expenditures. Overall balance is the difference between total expenditure and total revenue.

As can be seen in the graphical analysis in Appendix 4, there are sizable differences in the revenue inflow by category which are comparable to the fluctuations in overall balance as surplus or deficit. KP was the most affected in terms of budget deficit in 2012, 2013, 2015, and 2017. Sales tax collection was also the lowest along with negligible amounts collected under property tax, excise duty, stamp duties, and motor vehicle tax. Furthermore, the rise in sales tax revenue collection from 2016 failed to translate into raising the development expenditures.

In the case of Balochistan, the overall balance was in surplus during the years when revenue collection from property tax and excise duty was been higher. However, in later years there was a larger collection of sales tax with a decline in excise and property taxes followed by a budget deficit. For Sindh, from 2018 onwards, the current expenditures increased followed by a cut in development expenditures, but the overall balance also turned positive. In addition, the major share in tax collection was that of sales tax. A similar case is observed for Punjab where an increased share of sales tax in revenue collection underlined a rise and fall in current and development expenditures, respectively, but the overall balance also remained positive.

Following the analysis of the graphical trends in the growth rates of different fiscal operations for each province, regression was also carried out to see if any significant ship existed in containing the Leviathan effect. The following specification was used.

$Balance_{it} = \gamma o + \gamma_1 PTax_{it} + \gamma_2 STax_{it} + \gamma_3 EDuty_{it} + \gamma_4 SDuty_{it} + \gamma_5 MVTax_{it} + \mu_{it}$ (3)

In Equation 3, balance is the overall balance, PTax is property tax, STax is sales tax, EDuty is excise duty, SDuty is stamp duty, MVtax is motor vehicle tax, and μ is the error term. The subscript 't' represents the time from 2011 to 2020 and the subscript 'i' represents the four provinces. The results are presented in Table 5.

The model was estimated using Pooled OLS regression and the diagnostics tests show there is neither heteroskedasticity nor multicollinearity. Although all forms of provincial tax revenue collection have a positive relationship with provincial revenue balance, except motor vehicle tax, the estimates are statistically insignificant. This means that there is a long way to achieve self-sufficiency under provincial autonomy to tame the Leviathan for increasing public sector resource efficiency through the provinces generating their own revenues.

Table 5: Pooled OLS Regression Results

Dependent Variable = Overall Balance (as % of Total Revenue)	
Variable	Coefficient
Property Tax	1.45 [1.44]
Sales Tax	0.001 [0.69]
Excise Duty	0.881 [1.115]
Stamp Duty	0.156 [2.09]
Motor Vehicle Tax	-1.35 [0.825]

- Sample size: N = 4, T = 2011-2020
- The standard errors are given in [ ]
- The Breusch-Pagan test is insignificant indicating no presence of heteroskedasticity.
- VIF = 2.24 (no multicollinearity)

6. METHODOLOGY AND ESTIMATIONS ON MEASURING THE DISTRIBUTIONAL CONSEQUENCES ON SOCIAL SECTOR RESOURCE ALLOCATION: EXAMPLE OF EDUCATION EXPENDITURES

In this section, the relationship between provincial revenue, federal resource transfers and federal grants to provinces with the budgetary allocations in the education sector is examined. The graphical analysis of provincial differences is given in Appendix 2. The analysis shows that current education expenditures are incremental which is translated through a steady rise in the provincial shares from the federal government. On the other hand, the education development expenditures have fluctuated in all provinces except in Balochistan where it has been steady and considerably low. In the case of Punjab, the province's own revenue resources increased from 2015 to 2017 along with a rise in development expenditures in the education sector. Sindh's case is similar from 2013 to 2017. However, not much progress is observed in the case of KP and Balochistan. Taking into consideration federal grants for development expenditures in the provinces, no relationship is observed from the graphical analysis.

To undertake an econometric analysis, the following two models were estimated:

$$DevEDUExp_{it} = \beta o + \beta_1 ProvTax_{it} + \beta_2 FedShare_{it} + \beta_3 FedGrants_{it} + \mu_{it} \quad (4)$$

$$CurrEDUExp_{it} = \sigma o + \sigma_1 ProvTax_{it} + \sigma_2 FedShare_{it} + \sigma_3 FedGrants_{it} + \mu_{it} \quad (5)$$

In the preceding equations, DevEDUExp is Development Education Expenditures, CurrEDUExp is Current Education Expenditure, ProvTax is Provincial Tax Collection, FedShare is Provincial Share from Federal, FedGrants is Federal Grants to Provinces for Development Expenditures, and μ is the error term. The subscript 't' represents the time from 2013 to 2020, while the subscript 'i' represents the four provinces. The model was estimated using Pooled OLS regression (Table 6).

Table 6: Pooled OLS Regression Results for Education Expenditures

Variables	Model 3	Model 4
	Current Education Expenditures	**Developmental Education Expenditures**
Provincial Tax Collection	-0.55*** (0.136)	-0.15*** (0.032)
Provincial Share from Federal	0.36*** (0.024)	0.06*** (0.01)
Federal Grants to Provinces for Development Expenditures	0.76*** (0.196)	0.04 (0.08)
Diagnostic Tests	- The null hypothesis of the Breusch-Pagan test for homoskedasticity is not rejected at a 5% significance level. - VIF = 5.10	- The null hypothesis of the Breusch-Pagan test for homoskedasticity is not rejected at a 5% significance level. - VIF = 3.10

- Sample size: N=4 provinces, t= 2013-2020)
- The standard errors are given in parentheses.
- *** indicates the statistically significant coefficients at a 1% significance level.
- Time and cross-section dummies are included during model estimations

Source: Author's estimations.

The diagnostics tests are also processed which shows that OLS assumptions are not violated. There is no evidence of heteroskedasticity and multicollinearity. The time and cross-section dummies were added during the estimation process to account for any unobserved differences across provinces and time. The results of the estimated models are provided in Table 6.

The results show statistically significant slope coefficients at a 1 per cent level of significance. Interestingly, the coefficients of provincial tax collection are negative but positive with respect to federal revenue transfers to the provinces. Such contrasting results are due to huge differences in the budgetary allocations development and current expenditures on education where current expenditures constitute a greater chunk of the total expenditures. In addition, the graphical analysis given in Appendix 2 also shows that the values of development expenditures are very small along with very minimal growth trends. Therefore, further analysis is needed by comparing the magnitude of the coefficients with respect to the provincial tax collection, provincial share from the federal government and federal grants to provinces.

The fall in current education expenditures is greater (coefficient value of -0.55) as compared to the development education expenditures (coefficient value of -0.15) when the provincial tax collection rises. On the other hand, when provincial share from federal resource transfers increases, the impact is greater for current education expenditures (coefficient value of 0.36) than for education development expenditures (coefficient value of 0.06). This comparison of two categories of education expenditures with respect to provincial tax collection and federal revenue transfers shows that there is the Leviathan tendency to increase the current expenditure. On the other hand, the Leviathan tendency is subdued when provinces are dependent on their revenue generation as the current expenditures fall by a larger value compared to the development expenditures. Thus, the public resource utilisation from the provinces' own tax revenues also has distributional implications by avoiding wasteful current expenditures in the education sector. In conclusion, fiscal decentralisation in Pakistan has positive distributional consequences whereas fiscal federalism increases the public sector resource inefficiency as resource allocation is focused towards increasing the current expenditure more than development expenditures.

7. METHODOLOGY AND ESTIMATIONS OF THE MEASUREMENT OF DISTRIBUTIONAL CONSEQUENCES FOR SOCIAL SECTOR OUTCOME: EXAMPLE OF HEALTH SECTOR SERVICE DELIVERY

This section presents an analysis of the distributional consequences for social sector service delivery. For this purpose, the health sector was selected and the outcome variable was the health sector infrastructure. The data was collected from the Pakistan Bureau of Statistics. The baseline of analysis is presented in the form of graphs (see Appendix 3) illustrating a comparison across four provinces. Only a little small progress is seen in the case of Sindh with a slow but rising trend in health sector infrastructure, i.e., the number of dispensaries and maternity and child welfare centres. On the other hand, Balochistan and KPK have shown no progress and the provincial tax revenues have also been negligible. In the case of Punjab, the downward trend is observed despite a larger provincial share in federal resources and the province's own revenue resources.

The analysis is further extended by estimating the following two models:

$$\text{Dispensaries}_{it} = \rho o + \rho_1 \text{ProvTax}_{it} + \rho_2 \text{FedShare}_{it} + \mu_{it} \qquad (6)$$

$$\text{Hospitals it} = \varphi o + \varphi_1 \text{ProvTax}_{it} + \varphi_2 \text{FedShare}_{it} + \mu_{it} \qquad (7)$$

In equations 6 and 7, Dispensaries is the Total Number of Dispensaries, Hospitals is the Total Number of Hospitals, ProvTax is Provincial Tax Collection, FedShare is the Provincial Share from the federal government, and μ is the error term. The subscript 't' represents the time from 2008 to 2019 and the subscript 'i' represents the four provinces. The model was estimated using Pooled OLS regression with the inclusion of time and cross-sectional dummies to account for any unobserved differences across provinces and time. The diagnostics tests show no evidence of heteroskedasticity and multicollinearity. The results are provided in Table 7.

The slope coefficients of provincial tax collection for health infrastructure, both the number of dispensaries and hospitals, are statistically significant and positive. The coefficients also have a greater magnitude compared to their relationship with the provincial shares from federal resources. This shows that provinces use their revenue resources more efficiently in social sector service delivery than if they were solely relying on federal resources. The regression analysis shows that the coefficient of dispensaries is statistically significant and negative for federal resource transfers. On the other hand, the coefficient is positive, albeit with a very small magnitude, for hospitals. Thus, the Leviathan tendency is curtailed for better social sector outcomes of public service delivery when provinces are given more autonomy to generate revenue resources on their own.

Table 7: Pooled OLS Regression Results of Health Services Provision (Health Infrastructure)

Variables	Model 5	Model 6
	Dispensaries	**Hospitals**
Provincial Tax Collection	8.44*** (1.56)	0.35** (0.15)
Provincial Share from Federal	-1.69*** (0.29)	0.073** (0.029)
Diagnostic Tests	- The null hypothesis of the Breusch-Pagan test of homoskedasticity is not rejected at a 5% significance level. - VIF = 4.57	- The null hypothesis of the Breusch-Pagan test of homoskedasticity is not rejected at a 5% significance level. - VIF = 3.10

- Sample size: N=4 provinces, T= 2008-2019
- The standard errors are given in parentheses.
- *** and ** indicate the statistically significant coefficients at 1% and 5%.
- Time and cross-section dummies are included.

Source: Author's estimations.

8. CONCLUSION AND RECOMMENDATIONS

The main objective of this study was to examine the 'Leviathan hypothesis' of government expenditures by taking into consideration the resource differences, i.e., provincial fiscal autonomy in revenue generation or reliance on federal resource transfers. The analysis supports the argument that the Leviathan tendency for higher current expenditures is tamed as after the break date of 2011 (post-18th Amendment), the coefficient value turns positive and becomes greater in magnitude for development expenditures as compared to the current expenditures. However, it can be seen from the analysis that fiscal decentralisation is not an automatic remedy to achieve resource efficiency in government budgetary allocations. This is because of the constraint in existence of the already monstrous nature of the current expenditures in comparison to the development expenditures. This is the reason that the positive coefficient value is attached to current expenditures and the negative sign to development expenditures before the break date of 2011. Furthermore, provincial autonomy can tame the Leviathan but provinces will require a long time to become self-sufficient as the provincial tax collection has a positive but insignificant impact on the budget balance.

In terms of the distributional consequences, the analysis showed that fiscal federalism gives rise to public sector resource inefficiency because resource allocation is focused on increasing current expenditures compared to development expenditures in the social sector, which is shown by the case of education expenditures in this study. Lastly, the analysis of the distributional consequences for social sector service delivery (in the case of the health sector analysed in this study) showed that Leviathan is tamed for a better social sector outcome when provinces are given more autonomy to generate revenues on their own. Thus, the study concludes that fiscal decentralisation could help in taming the Leviathan in favour of higher public sector resource efficiency. However, the importance of fiscal federalism cannot be ignored as it is vital to finance a massive portion of the provincial expenditures in the presence of low capacity of the provinces to generate resources.

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Appendix 1:

1. Econometric specification of Clemente-Montanes-Reyes unit root test

The series is de-trended as below:

$$Y_t = \sigma + \Omega t + \omega DT_t + \tilde{Y}_t$$

Where $\tilde{Y}_t$ is the de-trended series. It is assumed that structural break affects only the slope coefficient and the break date is determined endogenously. The second step uses the residual of the first step to test for change in slope coefficient as presented below:

$$\tilde{Y}_t = \rho\tilde{Y}_{t-1} + \sum_{i=1}^{k} n_i \Delta Y_{t-i} + \mu_t$$

2. Econometric specification of Gregory-Hansen cointegration test

The model is represented as a level shift:

$$Y_t = \alpha_0 + \alpha_1\sigma_t + \beta_1 X1_t + \beta_2 X2_t + \beta_3 X3_t + \mu_t$$

Where, α_0 and α_2 is the intercept before and after shift, respectively, at the time break. σ_t represents the break point affecting only the intercept. The level shift with the trend is represented below where ϕ is the coefficient of the trend, t.

$$Y_t = \alpha_0 + \alpha_1\sigma_t + \phi_1 t + \beta_1 X1_t + \beta_2 X2_t + \beta_3 X3_t + \mu_t$$

The regime shift model affects both the intercept and slope coefficients as represented below:

$$Y_t = \alpha_0 + \alpha_1\sigma_t + \beta_1 X1_t + \beta_{11}\sigma_t X1_t + \beta_2 X2_t + \beta_{22}\sigma_t X2_t + \beta_3 X3_t + \beta_{33}\sigma_t X3_t + \mu_t$$

β_1, β_2 and β_3 represent cointegrating slopes before regime shift. β_{11}, β_{22}, and β_{33} are the coefficients after the structural break. The model of regime shift is written as:

$$Y_t = \alpha_0 + \alpha_1\sigma_t + \phi_1 t + \phi_2 t\,\sigma_t + \beta_1 X1_t + \beta_{11}\sigma_t X1_t + \beta_2 X2_t + \beta_{22}\sigma_t X2_t + \beta_3 X3_t + \beta_{33}\sigma_t X3_t + \mu_t$$

The coefficients α_0, β_1, β_2, β_3 and ϕ_1 are before the regime shift whereas α_1, β_{11}, β_{22}, β_{33} and ϕ_2 are the corresponding changes after the break.

Appendix 2: Graphs as Baseline for Model Estimations of Distributional Consequences on Social Sector Resource Allocation i.e., Education Expenditures
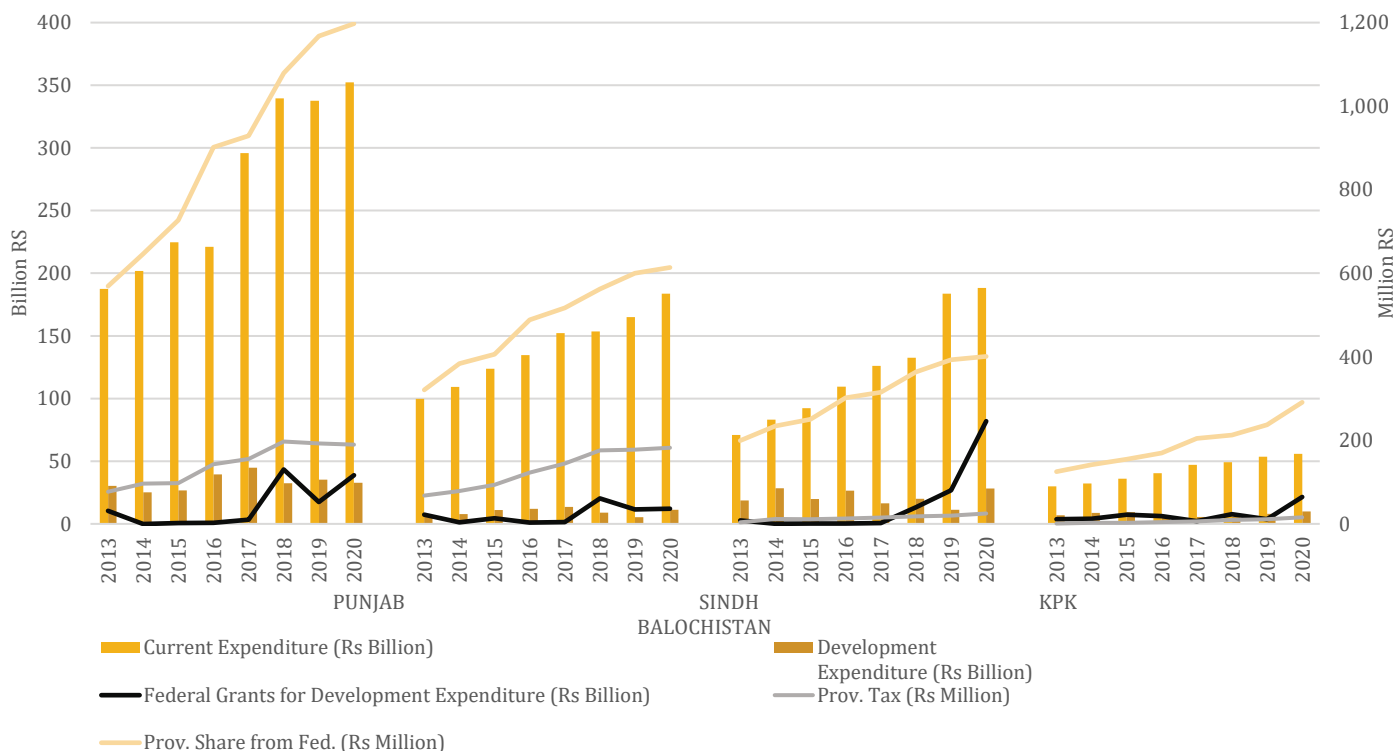
Source: Author's compilation from GOP (2021).

Appendix 3: Graphs as Baseline for Model Estimations of Distributional Consequences on Health Sector Service Delivery
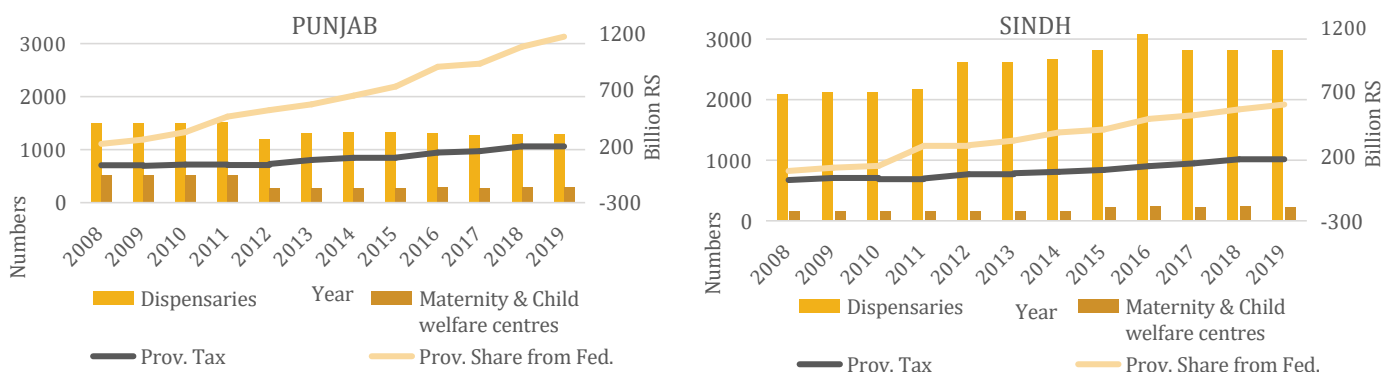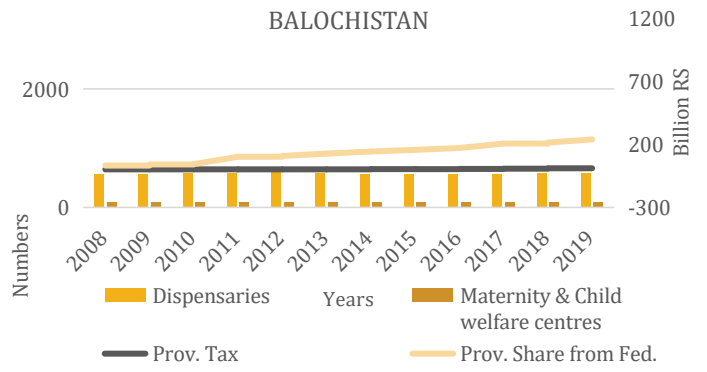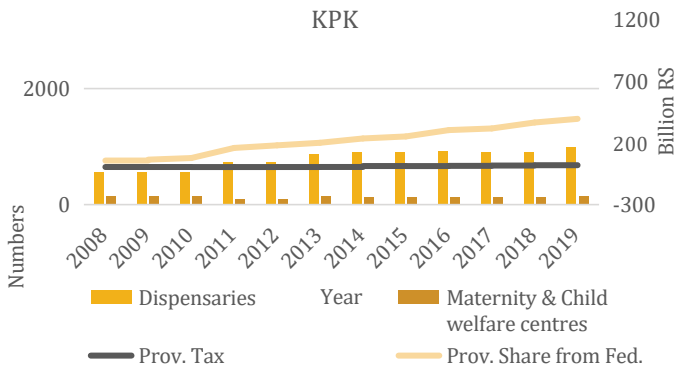
Source: Author's compilation from GOP (2021).

Appendix 4: Growth Proportion of Provincial Taxes and Expenditure-revenue Gaps

- Property Taxes (% of total prov. revenue)
- Sales Tax on Services GST (% of total prov. revenue)
- Excise Duties (% of total prov. revenue)
- Stamp Duties (% of total prov. revenue)
- Motor Vehicles Tax (% of total prov. revenue)
- Overall Balance (% of Total Revenue)
- Dev. Exp. (% of total expenditure)
- Curr. Exp. (% of total expenditure)

Source: Author's compilation from GOP (2021).

WITHHOLDINGISATION OF THE TAXATION SYSTEM: BENEFICIAL OR NOT?

Amer Shakeel

ABSTRACT

Tax collection has always been a challenge for governments all over the world. Pakistan has a relatively low tax-to-GDP ratio which creates budgetary pressure and affects the development of the country. The withholding taxation system is considered an easy and convenient way for the collection of income tax. The tax collected through this system comprises a major portion of the income tax in Pakistan but the problems in the withholding taxation system have adverse effects on the economy and federal tax collections.

In this research report, we present the current state of the withholding taxation system and identify the problems in this system. Suggestions are also given to overcome these problems and to make improvements. The results are based on data collected from different reports published by the Federal Board of Revenue, Finance Division, research institutions, and other departments regarding the withholding taxation system. Besides this, discussions were had with tax professionals, taxpayers, and businessmen to identify the effects of this system.

One of the major findings of this report shows that 65%-70 per cent of the total income tax is collected through the withholding taxation system and if we include other voluntary payments this reaches 96 per cent. Only 3%-4 per cent of the tax is collected through the direct efforts of the FBR. This shows Pakistan's overreliance on withholding taxes. This research also finds that comparatively low-income tax has been collected from the services and trade sector. Data analysis at the individual level shows that salaried persons pay almost half of the amount of the withholding income tax collected from individuals, which indicates that the current withholding taxation system does not cover a significant number of non-salaried individuals.

This report draws some important implications for different stakeholders. First, reliance on the withholding income taxes should be reduced because income tax is a direct tax and it should be collected in a direct tax mode. Second, if over-reliance seems unavoidable, there is a need to introduce new withholding income tax provisions for under-paying sectors, such as services and trade. Last, there is a need to transform the cash economy into a documented economy to bring more individuals and businesses under the tax net.

1. INTRODUCTION

Tax is a compulsory payment by the people to the government which is ultimately used for the common interest and welfare of the public of the country and running the expenses to carry out the government functions (Ahmed, 2016). It is imposed on a taxpayer, either an individual or a legal entity, by the government to fund various public expenditures, government spending, and development work.

The first known taxation took place in Ancient Egypt around 3000–2800 BC. Tax is considered the largest financial source for development work, like public services, poverty relief, and the establishment of physical and social infrastructure that leads to the long-term growth of a country. However, for a long time, many developing countries, like Pakistan, have been facing a great challenge in generating revenues from taxes (Khan & Ahmad, 2014). A failure to pay the taxes on time is punishable by the law.

A tax system is a set of policies for individuals and organisations to pay taxes on their taxable incomes (Górecki & Letki, 2021). The structure of taxation affects the pattern of economic development in developing countries. They use their taxation system as a principal policy instrument to provide incentives for the development of the different sectors.

Withholding tax (WHT), also called a retention tax, is the act of deduction or collection of tax at source, which has generally been an advance tax payment. Withholding tax is a tax system in which the payer withholds a portion of a payment and remits it directly to the government. Its common example is tax deducted from the salary of an employee by the employer. After the deduction, the employer deposits this tax into the national treasury in the name of the employee. This tax system is used by many countries around the world, including developing countries, to ensure that individuals, companies, and other legal entities who derive income should pay their due share of taxes (Mella, 2023). It is an important and timely source of revenue for the government.

The WHT has several advantages and disadvantages for governments and taxpayers (Shi et al., 2023). The WHT system allows governments to reduce tax collection costs by using the administrative powers of the withholding agents. Another advantage of the WHT is that the remitter, also called the withholding agent, is not the statutory bearer of the tax. This decreases the incentive of tax avoidance since the remitter does not directly benefit from evasion. The WHT shifts the risk of non-compliance to the remitter, and taxes may be not withheld or not remitted to the tax authorities (Buettner et al., 2020). Overall, the WHT system has the benefit of reducing the cost of tax collection and enhancing the government's cash flow and budgetary management because of the advance collection of taxes.

Scope of the Study

Low tax-to-GDP ratios are one of the reasons for poor economic development in developing countries. These countries use different instruments for the collection of taxes (Dahal, 2020). Like other developing countries, Pakistan is also facing tax evasion and noncompliance behaviour of the taxpayers (Akitoby et al., 2020).

Governments always try to find ways and methods to minimise the time lag between the point when the amount of tax becomes due and the point when the government receives this amount from the taxpayer. The most famous and effective way to achieve this objective is the WHT system. The origins of the WHT can be found in the 15th century, and it became the most famous form of direct tax collection during the 16th, 17th, and 18th centuries. In the modern world, its use is increasing (Ahmed, 2020).

The government often collects this tax to ensure that taxpayers comply with their tax obligations (Dalziel et al., 2018). Withholding tax has become increasingly common in recent years, and many countries have adopted it to collect revenue (Pavlovich, 2022). There are many problems in the implementation of the WHT regime in

Pakistan. In the current study, the scope of the WHT regime is discussed. Through data analysis, the problems and difficulties of different stakeholders are identified and solutions recommended.

Literature Review on Withholding Taxation

The WHT system helps to ensure tax compliance and perform tax obligations. Through this system, a government receives its revenue on a timely basis and throughout the year (Wang et al., 2023). Persons earning income from any source need to maintain all records of the tax withheld by other parties on the payments made to them. This creates an administrative burden for them, which also inflicts more expenses on the administration, and it becomes a burden on low-income taxpayers (Thomas, 2019; Khan & Siddiqui, 2023).

The WHT system is used in many developing and developed countries all over the world (Mella, 2023). The rates of the WHT are different as per the taxation laws of different countries (Altawyan, 2023). Withholding tax has several advantages. First, it helps to ensure that taxpayers comply with their tax obligations. By withholding a portion of income before it is paid out, the government can ensure taxpayers pay their taxes on time. Second, withholding tax is an efficient way of collecting revenue. It eliminates the need for taxpayers to keep track of their tax obligations and it ensures that the government receives its revenue promptly (Wang et al., 2023). Third, withholding tax is easy to administer. For example, employers are responsible for withholding tax from their employees' wages and remitting it to the government, making it a relatively simple process.

Previous studies also identified some disadvantages of the WHT system. First, it can be a burden on taxpayers, particularly those with low income. When a portion of income is withheld, it can reduce the amount of money taxpayers have available. Second, withholding tax can be complex and confusing, particularly for taxpayers unfamiliar with the tax system. Third, withholding tax can create cash flow problems for businesses, particularly those that operate on a tight budget. If a large amount of tax is withheld, it can impact a business's ability to pay its bills and meet its financial obligations (Martin, 2010; Khan & Siddiqui, 2023).

There are few studies on the costs and benefits of the WHT system and this area should be explored by researchers and professionals (Mpofu, 2022). The major motive for implementing more WHT on transactions is to increase the collection of income tax easily. It is considered the most convenient way to collect income tax but there are also its demerits (Dusek & Bagchi, 2018). In the presence of the WHT, the compliance rate of tax is higher and it also reduces the administration and compliance costs when implemented because its collection is assigned to third parties called withholding agents (Thomas, 2019). On the other hand, it increases the risk of noncompliance by third parties involved in the collection of withholding tax (Advani, 2022). There are several gaps in the literature on withholding tax's cost and benefit analysis. One of the gaps in the literature on withholding tax is the lack of empirical studies that examine the costs and benefits of withholding tax (Mpofu, 2022). While some studies examine the influence of withholding tax on trade and investment, there is a lack of studies that analyse the administrative problems of implementing the WHT system (Deng et al., 2022).

There is a need to study the WHT system and its effects, problems in its administration, criticism of this system and suggested solutions in developing countries like Pakistan because in Pakistan it consists of, on average, 70 per cent of the total income tax collected. There are almost eighty-plus types of different transactions covered under this WHT system, and it is one of the highest numbers of transactions in developed and developing countries.

Research Problem

The WHT is the most effective way of income tax collection in Pakistan. The contribution of the WHT to the total income tax collected is almost 69 per cent (FBR Year 2021). It is operated through withholding agents (WHAs) who collect these taxes and deposit them in the national treasury. There are detailed provisions regarding the

WHT in the Income Tax Ordinance 2001. These legal provisions are related to the scope, rates, and taxability of the WHT. They also elaborate on the scope and responsibility of WHAs. Increasing the tax-to-GDP ratio is a bigger challenge in developing countries. In Pakistan, the FBR and government are striving to make it better. The WHT system has costs and benefits as well as many limitations. These things need to be identified and discussed, and solutions should be recommended.

Research Questions

This study tries to find the answers to the following research questions:

- Are withholding taxes helping in the collection of income tax?

- What is the main criticism of the WHT system?

- What is the role of WHAs, and are they performing their role in a better way?

- What is the solution for irregularities that exist in the tax collection/deduction by WHAs and onward timely transfer to FBR?

- What are the suggestions to make the WHT system simpler and easier to handle?

- Are current human and other resources of FBR enough for the administration of the withholding taxation system?

- Is there any form of irregularities that exist in the WHT system?

- How can we control irregularities in the WHT system?

- How can we make tax audits more transparent and effective?

- Are withholding taxes affecting the business environment?

- Is there any substitute for withholding taxes?

Objectives of the Study

The following are the main objectives and sub-objectives of this research project:

- Regarding the economy, business environment, and different groups of taxpayers:

  i.   To identify the effects of withholding taxes on the business environment.

  ii. To explore the related benefits and costs of withholding taxes in Pakistan.

  iii. To identify the problems being faced by taxpayers due to the withholding taxation system and their solution.

- Regarding the withholding tax laws:

  i.   To outline the withholding tax system in Pakistan.

  ii. To compare withholding taxes with the regional and other countries.

   iii.   To analyze the reasonableness of WHTs and to recommend changes in them.

   iv.   To identify the substitute for withholding taxes.

- Concerning the WHAs:

   i.   To identify the irregularities that exist in the tax collection/deduction by WHAs and onward timely transfer to the FBR, and recommend solutions for them.

   ii.   To analyse the current nature and size of the WHAs and the FBR control over them.

   iii.   To identify the different problems being faced by WHAs in tax deduction/collection and compliance with related provisions of Income Tax Ordinance 2001.

- Concerning FBR:

   i.   To identify the administrative problems being faced by FBR in the administration of withholding taxes and their solution.

   ii.   To identify problems in tax audits and recommend solutions.

Relevance and Significance of the Study

This study is aimed at adding value by making relevant recommendations and conclusions with the intent to make the withholding tax system more effective and useful.

The findings of this research project are helpful for:

- Designing new rules and making current rules more effective for better tax collection.

- Making new regulations that protect taxpayers.

- Broadening tax net and adding new people to active taxpayer's list.

- Minimizing the time delay in tax receipts by WHAs, onward transfer to the FBR and stuck-up funds.

- Making better administration of withholding taxation system.

- Making rules for timely receipts of WHT from WHAs, which will help to manage the cash flow of the Government.

- Making the business environment friendlier and more favourable.

- Making tax audits more effective.

2. RESEARCH METHODOLOGY

In the first phase of this research project, we collected the required data from different reports published by FBR, the Finance Division, research institutions, and other departments regarding the WHT system. For the collection of additional data, which is not publicly available, a direct request was made to the FBR and in response to that the FBR provided us with some of the requested data officially. The credibility of the data was ensured and all the

required data were taken from the official reports of FBR. Discussions were also held with tax professionals, taxpayers, and businessmen to identify the effects of the WHT system. Then this data was analysed and interpreted to answer the questions of the study.

3. TAXATION IN PAKISTAN

The Federal Government of Pakistan collects three types of major direct taxes, which include income tax, workers' welfare fund, and workers' profit participation fund. Indirect taxes include sales tax on goods, federal excise duty, and customs duty. Major provincial taxes include sales tax on services and property tax. The biggest source of federal taxes is sales tax on goods. Income tax is the second biggest source of tax income of the federal government. Both income tax and sales tax consist of almost 80 per cent of the total tax revenue of the federal government (FBR Year Book, 2022). Income tax consists of more than 97 per cent of the direct taxes collected by the federal government (FBR Year Book, 2022). Direct taxes consist of 38-40 per cent of the total tax collected by the federal government and the remaining portion is collected through indirect taxes (FBR Year Book, 2022). In Table 1, we can see the amount of tax collected through these taxes from 2008 to 2022.

Table 1: Tax Collection of the FBR (PKR Million)

Tax Year	Sales Tax	FED	Custom Duty	Total Indirect Taxes	Income Tax	Other Direct Taxes	Total Direct Taxes	Total Taxes	Indirect Taxes %	Direct Taxes %
2008	377	92	151	620	368	20	388	1,008	62%	38%
2009	452	118	148	718	422	22	444	1,162	62%	38%
2010	517	121	162	800	505	24	529	1,329	60%	40%
2011	634	137	185	956	582	20	602	1,558	61%	39%
2012	805	122	217	1,144	720	18	738	1,882	61%	39%
2013	843	121	239	1,203	723	20	743	1,946	62%	38%
2014	1,002	139	241	1,382	855	29	884	2,266	61%	39%
2015	1,088	162	306	1,556	1,007	27	1,034	2,590	60%	40%
2016	1,302	188	405	1,895	1,192	25	1,217	3,112	61%	39%
2017	1,329	198	497	2,024	1,324	20	1,344	3,368	60%	40%
2018	1485	214	608	2,307	1,515	22	1,537	3,844	60%	40%
2019	1,459	238	686	2,383	1,426	19	1,445	3,828	62%	38%
2020	1597	250	627	2,474	1,502	21	1523	3,997	62%	38%
2021	1,988	277	748	3,013	1,711	20	1,731	4,744	64%	36%
2022	2,532	320	1011	3,863	2,216	69	2,285	6,148	63%	37%

Source: FBR Year Books (2008-2022).

There is a 6 times increase in the total tax collected from 2008 to 2022. Ratios of direct to indirect taxes were almost consistent during this period.

Income Tax in Pakistan

The first income tax law in the Indo-Pak region was the Income Tax Act of 1860, which was subsequently repealed by the Income Tax Act of 1886. Later on, the Income Tax Act of 1918 and then the Income Tax Act of 1922 were introduced. This law remained in force after the independence and was replaced by the Income Tax Ordinance of 1979 (Ahmed, 2020). The current Income Tax Ordinance 2001 (ITO 2001) was promulgated on September 13, 2001. This law specifically deals with income tax, while there are other relevant laws for other types of taxes. For the administration of federal taxes, an institution called the Federal Board of Revenue (FBR) was established. The FBR is responsible for implementing these taxation laws in Pakistan. The FBR, being a regulatory body, manages the affairs of federal taxes in Pakistan. To explain the procedural matters of the implementation of income tax law, the FBR under the authority of section 237 of ITO 2001, developed the Income Tax Rules 2002. Both of these laws, Income Tax Ordinance 2001, and Income Tax Rules 2002 deal with the affairs of income tax in Pakistan.

Income tax law classifies the income under following five heads as per ITO 2001:

- Income from salary

- Income from property

- Income from business

- Capital gain

- Income from other sources

All types of income must fall under any one of the above-mentioned heads, and income tax law describes the rules and regulations for the calculation of taxable income under each head. Income tax will be calculated as per the specified rates on the total taxable income from all heads.

Modes of Payment of Income Tax

Income tax is calculated as per rules and regulations given by the ITO 2001. The ways of the payment of income tax to the government are also explained in ITO 2001. The following are modes of payment of income tax.

Deduction/Collection of Income Tax at Source/Withholding Tax: It is the first and the biggest mode of the collection of income tax from taxpayers. Income tax law has specified some transactions and when these transactions are generated, the person making/receiving the payments is required to deduct/collect income tax at source from these transactions with specified rates. Generally, it is called withholding tax and it was 69 per cent of the total income tax collected during the year 2022 (FBR Year Book, 2022).

Quarterly Advance Payment of Tax: The income tax law has specified some persons who are required to calculate their income tax as per the rules and pay that amount at the end of each quarter of the financial year. This tax is adjusted from the tax liability of these persons at the end of the financial year. It was 26 per cent of the total income tax collected during the year 2022 (FBR Year Book, 2022).

Payment of Tax with Annual Income Tax Return: At the end of the financial year, the persons who are required to file income tax returns under section 114(1) of ITO 2001 pay their income tax liability at the time of the filing of returns. An income tax return cannot be filed until a tax payer pays the admitted income tax liability. It consisted of 3 per cent of the total income tax collected during the year 2022 (FBR Year Book, 2022).

Income tax paid under the above three heads is collectively called income tax paid voluntarily by the taxpayers.

They are collected without the involvement of direct efforts of the FBR.

Payment of Tax on Demand by Tax Authorities: Upon the detection of undeclared expenses or assets or after the audit of the taxpayers by the FBR, a tax demand is generated and the taxpayer pays this amount in the national treasury. This is the only income tax collection that involves the direct efforts of the FBR. It was 4 per cent of the total income tax collected during the year 2022 (FBR Year Book, 2022).

4. WHY WITHHOLDINGIZATION?

The WHT is an easy and convenient way to collect tax from taxpayers. It involves zero cost and minimum time required for the collection of tax. Tax is withheld by WHAs and deposited within a few days after the collection/deduction (Mpofu, 2022). The following are some major reasons behind the adoption of the WHT system.

Convenience in Tax Collection: It is easy to collect income tax through this system because it is collected and deposited in the treasury when transactions are generated (Alm, 2021). In a country like Pakistan, which has limited resources, it is difficult to cover every type of income and impose the required income tax on it after the assessment. Through this system, a payer/receiver called a withholding agent simultaneously becomes the agent of the revenue authorities and collects income tax on their behalf.

Ease for Tax Payers: For taxpayers, it is easy to pay the required tax conveniently. For example, salaried persons pay the total tax due on their salary through a deduction at source from the monthly salary payment. Through this system income tax burden of taxpayers spreads over the whole year in easy small instalments. This results in saving them from the burden of income tax accumulated at the end of the year (Ahmed, 2020).

Low Cost of Collection: The WHT system reduces the cost of collection of income tax because its collection depends completely on the WHAs. They collect the tax while doing specified transactions and deposit it in the national treasury. Thus, there is no direct collection cost of FBR involved in this procedure.

Better Cash Flow Management for the Government: The government gets the money promptly and throughout the year through this system. Because the major portion of the income tax is collected through this system, the government does not need to wait for the payment of the income tax by the taxpayers at the time of filing annual income tax returns. In this way, the WHT system improves the cash flow management of the government (Ahmed, 2020).

Reduction in Tax Avoidance and Evasion: Tax avoidance and evasion are not possible for those transactions that are covered under the WHT system (Alm, 2021). WHAs are responsible for the collection/deduction of this tax and they cannot avoid it because of the penalties imposed by the ITO 2001.

5. WITHHOLDING INCOEM TAX-A DIRECT OR INDIRECT TAX?

There is a strong debate between researchers and professionals about whether the WHT is a direct or indirect tax. The collection mechanism of the WHT is similar to the collection of indirect taxes like sales tax or excise duty. The whole system of the WHT depends on the role of withholding agents. The effect of the WHT as a direct or indirect tax depends on the items included in the WHT list. If the WHT is levied on expenses rather than on revenue or income, it affects the consumer like indirect taxes (Akram, 2016). In Table 2, we can see the types of WHTs on incomes or expenses being paid by consumers. Most of the items included on the list of WHT are expenses by

nature and consumers of goods and services bear these taxes. This is against the basic philosophy of the income tax, which is a direct tax. Its most understandable example is withholding income tax collected at the import stage. Importers include this income tax in the cost of imported products and transfer its financial burden to the consumer of goods as sales tax and customs duty.

To eliminate the effect of the WHT as an indirect tax, there is a need to rationalise the list of WHTs. We propose that only incomes or revenues should be included on the WHT list, while all items that are expenses in nature should be eliminated from the list of the WHT.

6. WITHHOLDING TAX REGIME IN PAKISTAN

Because WHTs are collected/deducted at the source, it is considered the quickest and the most convenient way of collecting income tax. This method is widely used in most economies for tax collection (Pavlovich, 2022). It provides a reliable stream of income for the government throughout the year. In Pakistan, it increased from PKR 5 billion in 1991 to PKR 1,534 billion in 2022 (FBR Year Book, 2022), indicating exponential growth and Pakistan's strong reliance on WHTs. It contributed 69 per cent of the total income tax collected and 25 per cent of the total tax collected in the year 2022 (FBR Year Book, 2022). Due to its significant contribution to the total tax collected, it is extremely important to study the relevant problems and challenges related to the WHT regime.

Tax Collected or Deducted at Stource

There are certain transactions prescribed by ITO 2001, covered under the withholding tax regime. When these transactions are generated, then prescribed persons who are called withholding agents collect or deduct income tax at source according to the specified rates. There is a small difference between withholding income tax deducted and collected at source. If a withholding agent is making a payment to a taxpayer and deducts the tax from that amount and pays the remaining balance to the taxpayer, it is called tax deducted at the source. Its common examples are payment of salary, dividends, and profit on debt.

But if a withholding agent receives payment from a taxpayer and collects the income tax from that amount, it is called tax collected at the source. Its common examples are the payment of withholding income tax on the purchases of motor vehicles and the payment of electricity bills.

Figure 1 helps to understand the concept of withholding tax deducted or collected at the source by withholding agents.

Figure 1: Concept of Tax Collection and Deduction at Source
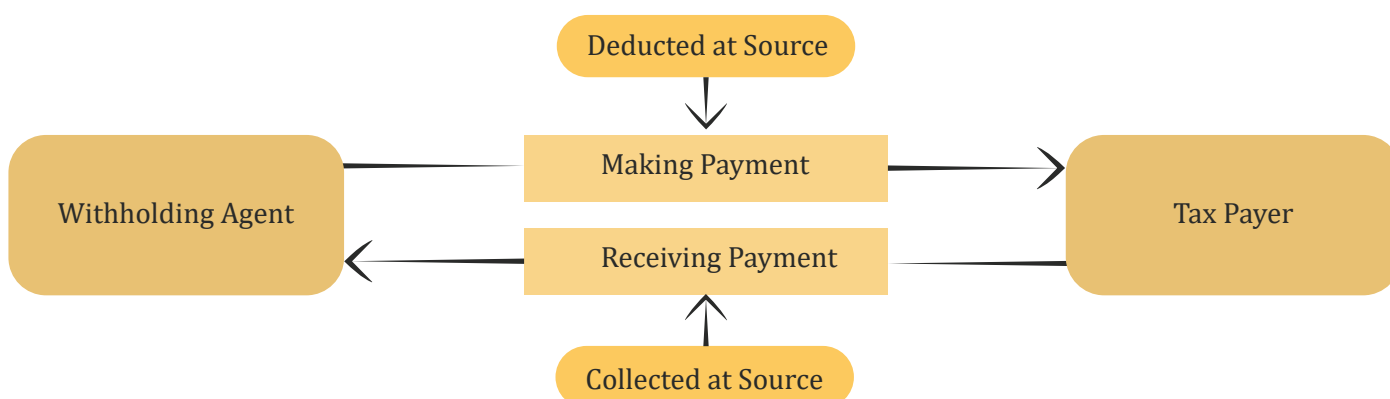
Variations in the WHT rates depend on the country's tax laws and regulations (Mahpudin et al., 2022). In Pakistan, these rates are prescribed in the first schedule of the ITO 2001. At the time of the final computation of income tax, the WHTs are treated either adjustable against the tax liability of that year or considered as a full and final discharge of income tax liability on those relevant transactions. These tax treatments are given in income tax law and they are changed from time to time in budgets through the Finance Act. Transactions covered under the WHT regime started with salary, interest on securities, and dividend under the Income Tax Act of 1922. Under ITO 2001, there are 24 sections/sub-sections mentioning more than eighty types of different transactions on which tax is collected or deducted at the source. There has been a drastic increase in WHT provisions during the previous twenty years (Ahmed, 2020).

In Table 2, the average rates of the transactions of the WHT and the nature of these transactions (income or expense) are explained. These rates are 100 per cent more in the case of a non-filer taxpayer except for in a few cases.

Table 2: Summary of Withholding Tax Rates (Updated as per tax year 2024)

Sr.#	Transactions/Items	Nature: Expense or Income	Collected/ Deducted at source	Rates
1-	Imports	Expense	Collected	1%- 5.5 %
2-	Salaries	Income	Deducted	Slab rates 2.5%-35%
3-	BoD Meeting Fee	Income	Deducted	20%
4-	Cash dividends, specie dividends, mutual funds	Income	Deducted	15%
5-	Interest, interest on the National Saving Scheme (NSS), interest on bank accounts, interest on government bonds, interest on company loans.	Income	Deducted	15%
6-	Payment to non-residents	Income	Deducted	3% - 20%
7-	Payment for service	Income	Deducted	4%-11%
8-	Payment for goods	Income	Deducted	1.5% - 4.5%
9-	Payment for contracts	Income	Deducted	7.5%-8%
10-	Exports of goods	Income	Deducted	1%
11-	Exports of services	Income	Deducted	0.25%-1%
12-	Rent of immovable property	Income	Deducted	Slab rates 5%-25%
13-	Prize on prize bonds	Income	Deducted	15%-20%
14-	Winnings from a raffle, lottery, prize on winning a quiz, prize offered by companies for promotion of sale or cross-word puzzle	Income	Deducted	20%
15-	Sale of petroleum products	Income	Deducted	12%
16-	On purchase and registration of motor vehicles	Expense	Collected	Based on engine capacity

17-	Cash withdrawal from banks	Expense	Deducted	0.6%
18-	Brokerage and commission	Income	Deducted	8%-12%
19-	Tax on motor vehicles	Expense	Collected	Based on engine capacity
20-	Electricity consumption	Expense	Collected	5%-12%
21-	Telephone and Internet	Expense	Collected	10%-15%
22-	Sale by public auction	Expense	Collected	5%-10%
23-	Sale of immovable property	Income	Collected	3%
24-	Advance tax on foreign TV serials	Expense	Collected	Different rates
25-	Advance tax on sales to distributor, wholesaler	Expense	Collected	0.1% - 0.25%
26-	Advance tax on sales to retailers	Expense	Collected	0.5%
27-	Advance tax on the purchase of immovable property	Expense	Collected	3%
28-	Advance tax on the amount remitted abroad credit, debit or prepaid cards	Expense	Collected	1%

Source: FBR (2001).

Contribution of WHTs and Other Voluntary Payments in Total Income Tax Collected

It was mentioned in the previous section that four modes of collection of income tax exist in Pakistan's taxation system. Table 3 shows the total income tax collected, income tax collected through the WHT system, income tax paid by the taxpayers with the income tax return, quarterly advance tax (collectively called voluntary payments), and income tax paid on demands generated by the FBR officials through assessments and audits.

Table 3: Voluntary Tax Payments and Payment on Demand (PKR Million)

Years	Gross Income Tax Collected (A)	Withholding Income Tax (B)	Income Tax Paid with Annual Return (C)	Quarterly Advance Income Tax (D)	Total Voluntary Payments (B+C+D)	Income Tax Paid on Demand by FBR
2006	243,736	139,274	24,011	63,349	226,634	16,799
2007	346,900	169,191	48,553	117,182	334,926	11,173
2008	393,782	205,144	9,199	136,417	350,760	42,779
2009	461,239	242,137	14,484	127,196	383,817	77,167
2010	559,698	295,249	9,500	156,301	461,050	98,529
2011	629,102	357,836	11,852	184,213	553,902	72,182
2012	811,893	420,457	14,968	222,398	657,823	130,054
2013	776,009	436,088	14,770	230,150	681,008	89,427
2014	918,863	571,667	13,761	248,837	834,265	80,582
2015	1,084,472	691,181	17,915	269,693	978,789	115,495
2016	1,242,195	803,116	38,462	302,358	1,143,936	87,884
2017	1,373,697	944,068	45,394	325,112	1,314,574	92,819

2017	1,373,697	944,068	45,394	325,112	1,314,574	92,819
2018	1,577,441	1,046,917	131,216	335,791	1,513,924	102,905
2019	1,509,788	960,239	117,830	344,334	1,422,403	102,648
2020	1,570,820	1,091,737	60,674	350,664	1,503,135	60,807
2021	1,802,417	1,237,338	54,091	413,664	1,705,092	80,143
2022	2,269,800	1,534,400	78,534	586,880	2,199,814	101,095

Source: FBR Year books (2006-2022).

Income tax collected through the WHT system represents the major portion of total income tax. The WHT is the most effective and convenient way to collect income tax in Pakistan. A comparison of the contribution of the WHT to the total income tax collected is given in Figure 2.

Figure 2: Comparison of WHTs Collection with Total Taxes, Direct Taxes and Income Tax Collection
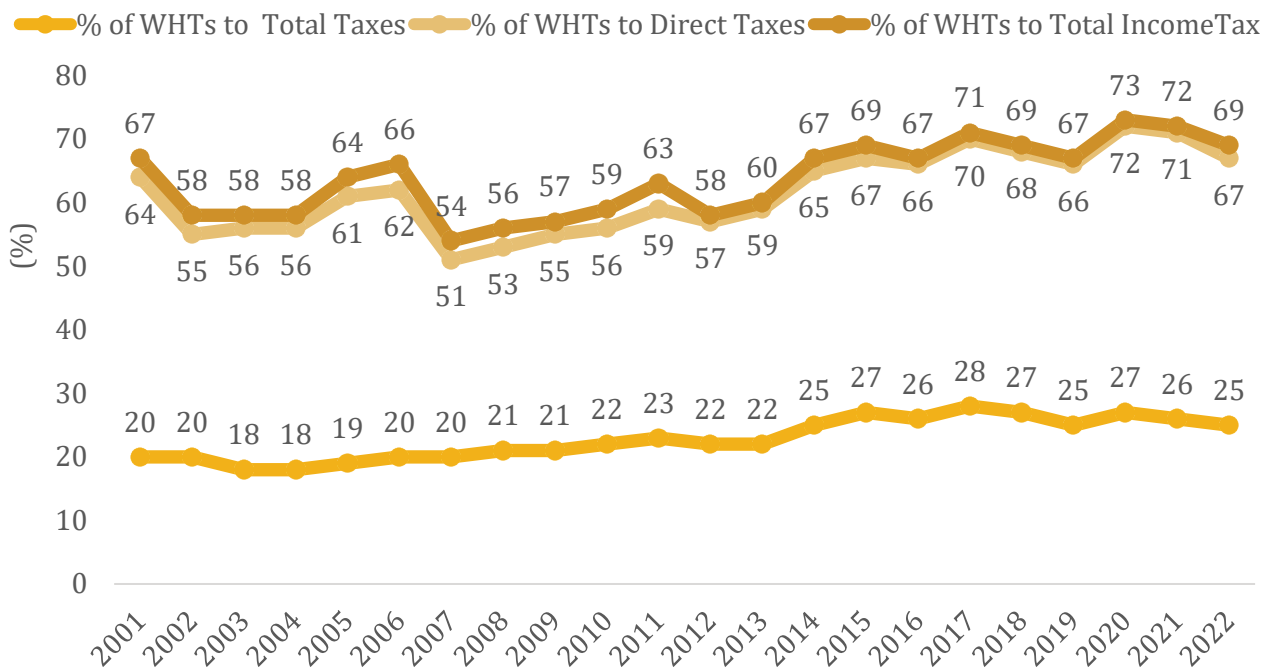
Source: FBR Year Books (2001-2022).

In addition to the WHTs, other voluntary payments (VP) include income tax paid at the time of filing of return and quarterly advance tax. Table 4 and Figure 3 show the percentage contribution of these three voluntary payments (withholding tax, income tax with return and quarterly advance tax). They also highlight the lowest contribution of the income tax collected on demands generated by the tax officials after the assessment procedures or audit. We can compare the contribution in total income tax collected from these modes of tax collection.

Table 4: Ratio of Voluntary Tax Payments and Payment on Demand

| Years	Total Income Tax Collected (PKR Million)	Per Cent of WHTs to Income Tax Collected	Per Cent of Tax paid with Annual Return to Total income Tax	Per Cent of quarterly Advance Income Tax to Total Income Tax	Per Cent of Voluntary paid Income Tax to Total Income Tax	Per Cent of Income Tax on Demand to Total Income Tax
2006	243,736	57%	10%	26%	93%	7%
2007	346,900	49%	14%	34%	48%	3%
2008	393,782	52%	2%	35%	37%	11%
2009	461,239	52%	3%	28%	31%	17%
2010	559,698	53%	2%	28%	30%	18%
2011	629,102	57%	2%	29%	31%	11%
2012	811,893	52%	2%	27%	29%	16%
2013	776,009	56%	2%	30%	32%	12%
2014	918,863	62%	1%	27%	29%	9%
2015	1,084,472	64%	2%	25%	27%	11%
2016	1,242,195	65%	3%	24%	27%	7%
2017	1,373,697	69%	3%	24%	27%	7%
2018	1,577,441	66%	8%	21%	30%	7%
2019	1,509,788	64%	8%	23%	31%	7%
2020	1,570,820	70%	4%	22%	26%	4%
2021	1,802,417	69%	3%	23%	26%	4%
2022	2,269,800	68%	3%	26%	29%	3%

Source: FBR Year Books (2006-2022).

Figure 3 explains the above data in the form of a figure to show the trend from these modes of tax collection.

*Figure 3: Comparison of WHTs, Voluntary Payments and Income Tax on Demand*
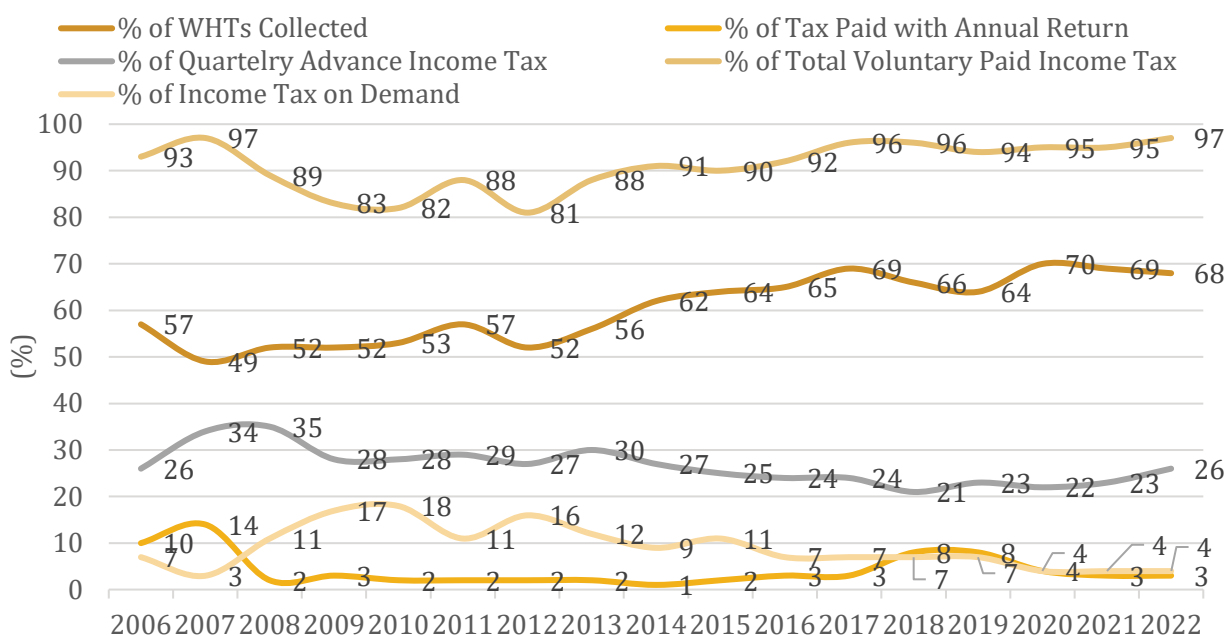
Source: FBR Year Books (2006-2022)

Major Heads of Withholding Taxes

There are more than eighty transactions/heads from which the WHT is required to be collected/deducted. Out of these, the top eight transactions contribute 80-85 per cent to the total WHT collection. These heads include contracts, imports, salary, bank interest, dividends, telephone, electricity, and exports. The summary of the last ten years' contribution of these eight major WHT heads is given in Annexure 2. Figure 4 presents the contribution, in percentage terms, of these top eight heads in the total collection of the WHT.

Figure 4: Comparison of Major Heads of Withholding Taxes (In Percentage)
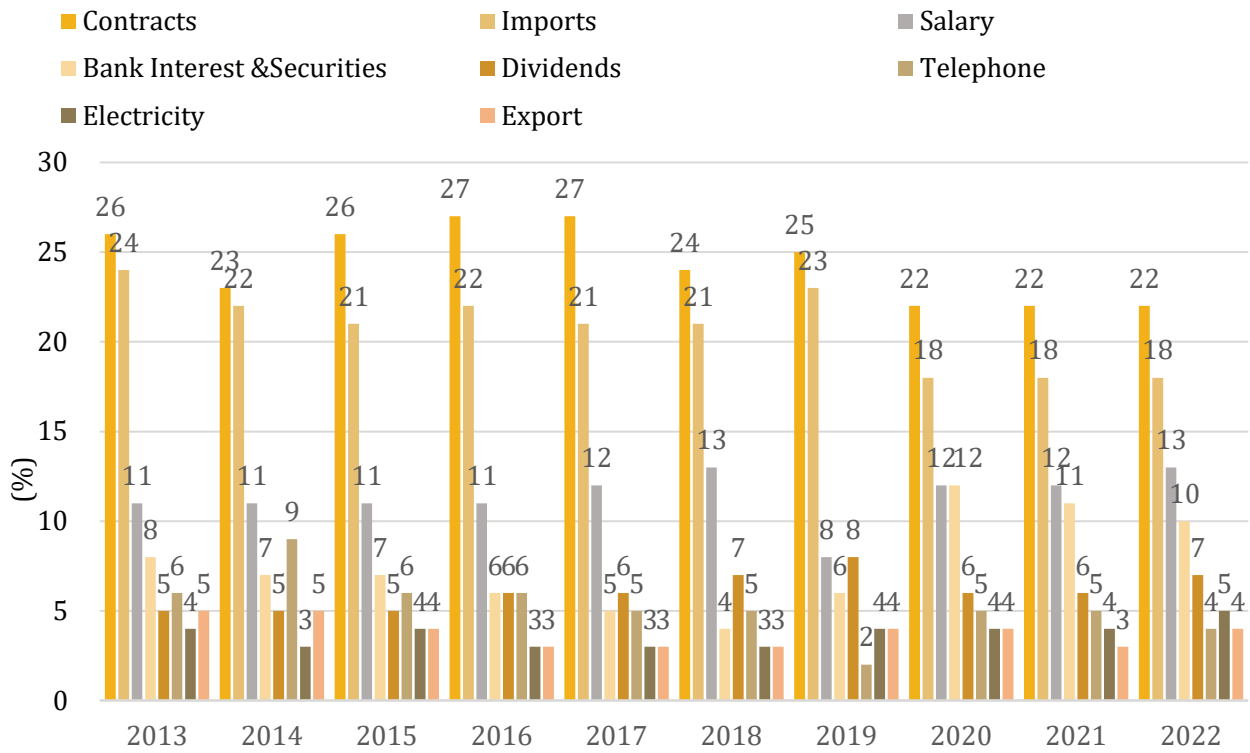
Source: FBR Year Books (2013-2022).

Elasticity of Withholding Taxes

There are many challenges to the economy because of the heavy dependence on the WHT. For example, when the WHT collected from any of the above-mentioned heads is affected due to economic factors or government policies, it leads to a significant change in the total income tax collected.

The collection of the WHT imposed on different types of transactions can have high or low elasticity. The quantum of the WHT collected can change more or less as per the change in the magnitude of those transactions. For example, in the case of interest on securities, if interest rates are high then the WHT from it will be high or vice versa. Government spending on the development work will also affect the WHT collection from the contracts, which is the biggest source of WHT collection. The exchange rate affects the size of the imports in our country, in case of a high exchange rate and other import restrictions, the WHT collected from the imports will be affected. All these things create high or low elasticity of the WHT. While formulating new policies or revising existing policies regarding the collection of WHT, these factors should be thoroughly considered.

Sector-Wise Collection of the WHT

Table 5 represents the sector-wise share of WHTs. There is comparatively low WHT collection from the services and trade sectors. There is a need to introduce new WHT provisions, like income tax in the electricity bills or fixed income tax scheme, for small traders etc., to cover these sectors for maximising their contribution to income tax collection. Biggest

Table 5: Comparison of Share in GDP and Share in WHTs

Sector	Share in GDP (%)	Share in WHT (%)
Manufacturing	12.52%	12.90%
Services	37.43%	11.20%
Traders/retailers	18.75%	3.90%
Others	31.30%	71.60%

Source: Author's calculation based on requested data from the FBR.
Note: Data is for 2020-21.

Table 5 is presented below in Figure 5 to compare the share of different sectors in GDP and WHT collection.

Figure 5: Contribution of Sectors in GDP and Withholding Tax
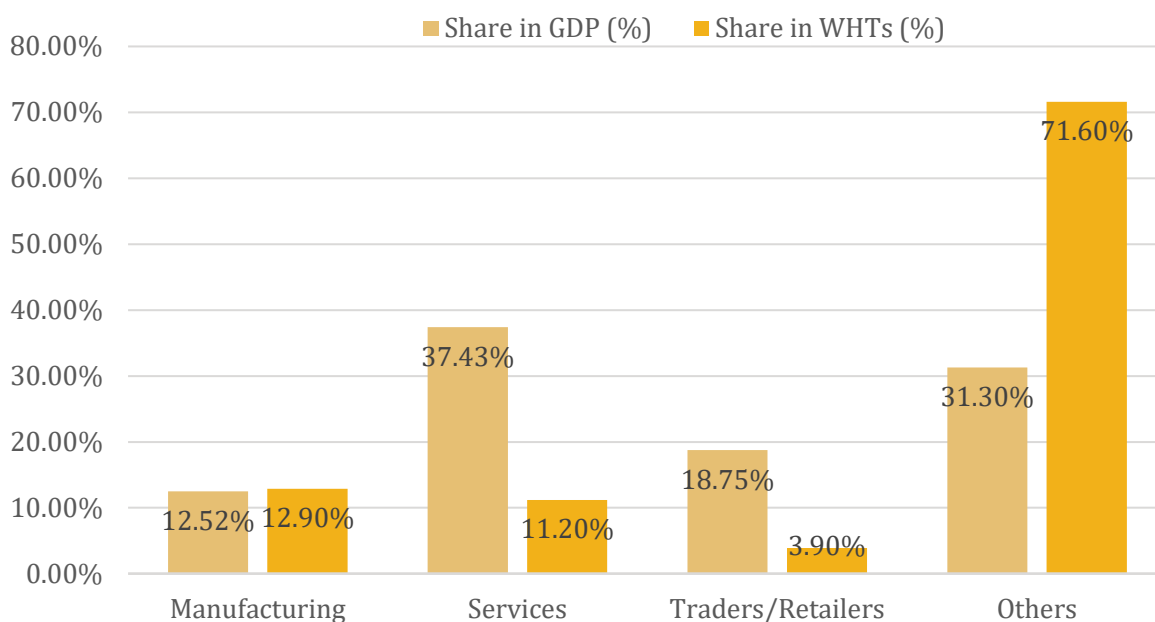
Source: Author's calculation based on requested data from the FBR.

Entity-wise Collection of the WHT

Table 6 reports the WHT collection by companies, associations of persons (AoPs), and individuals. On average, 50 per cent of the WHT paid by individual tax payers is collected from salaried individuals. It shows that a significant number of non-salaried individuals who are doing business and other economic activities are still out of the WHT

net. Its basic reason is a cash-based economy. To include more individuals in the tax net, there is a need to transform the cash-based economy into a documented economy.

Table 6: Entity-Wise Collection of WHT (PKR Million)

Years	Companies		AoPs		Individuals		Salaried		Non-Salaried	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
2014	97,923	41%	20,085	8%	119,324	50%	64,552	27%	54,772	23%
2015	111,164	38%	22,659	8%	156,066	54%	79,460	27%	76,606	26%
2016	132,362	38%	27,902	8%	184,891	54%	92,253	27%	92,638	27%
2017	158,606	38%	37,532	9%	221,031	53%	111,188	27%	109,843	26%
2018	181,783	37%	45,248	9%	260,012	53%	133,362	27%	126,650	26%
2019	197,637	42%	44,011	9%	226,762	48%	76,441	16%	150,321	32%
2020	205,328	41%	42,403	8%	257,871	51%	129,423	26%	128,448	25%
2021	230,757	38%	49,955	8%	328,904	54%	151,838	25%	177,066	29%

Source: Author's calculation based on requested data from the FBR

In Figure 6, a comparison of entity-wise payments of the WHT from 2014 to 2021 can be seen.

Figure 6: Contribution to the Withholding Tax by Persons (Percent)
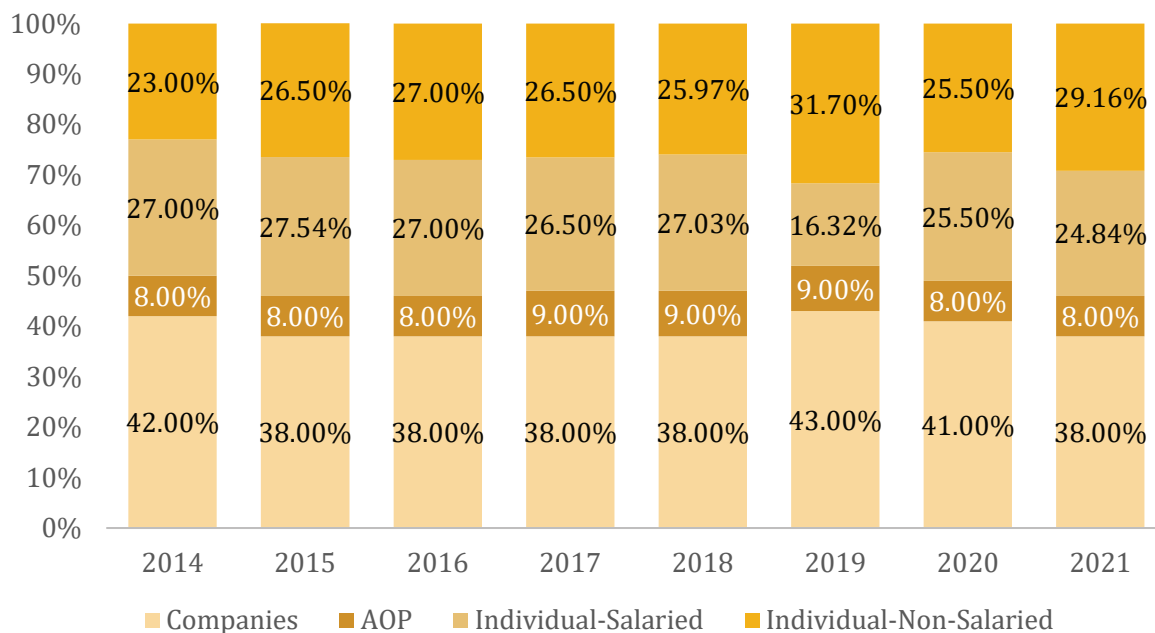
Source: Author's calculation based on requested data from the FBR.

Every company is considered a withholding agent and every company is required to file an income tax return irrespective of its income for the year. The withholding income tax received from different types of companies is explained in Table 7.

Table 7: Types of Companies - WHT Collection (PKR Million)

Years	Private Companies	Public Companies	Other Companies	Companies Total
2014	76,056	2,046	19,821	97,923
2015	84,529	809	25,826	111,164
2016	98,010	1,962	32,390	132,362
2017	118,281	2,104	38,220	158,606
2018	132,901	2,385	46,497	181,783
2019	142,613	2,368	52,656	197,637
2020	152,570	2,961	49,796	205,328
2021	174,792	2,973	52,992	230,757

Source: Author's calculation based on requested data from the FBR.

Contribution to the WHT by private companies is bigger than by public or other companies because the majority of the registered companies are private companies.

Tax Treatments of Withholding Taxes

As per law, there are three types of tax treatments of the WHT collected/deducted at the source:

- In some cases, the WHT collected/deducted at the source is treated as a full and final discharge of tax liability. It is called the Final Tax Regime (FTR). It means that there is no further income tax liability on that particular transaction on which the WHT is being collected/deducted. The WHT deducted on the payment of dividends to individual taxpayers is a common example of this tax treatment.

- In other cases, the WHT is adjustable against the income tax liability at the end of the year. It is called the Normal Tax Regime (NTR). The taxpayers compute their income tax liability in a normal manner and adjust the WHT collected/deducted on specific transactions from that liability. Its examples include the WHT collected on the sale or purchase of the property and the WHT deducted from the payment of salary.

- In some other cases, the WHT is considered the minimum tax liability of the taxpayer. It is called the Minimum Tax Regime (MTR). It means if income tax calculated in a normal manner is less than the WHT collected/deducted on specified transactions then this WHT is considered the minimum tax liability. Its example is the WHT collected from commercial importers on their imports.

Filing of Income Tax Returns

The filing of income tax returns is mandatory for persons specified by ITO 2001. A filer is required to show their total income from all heads of income and pay income tax on taxable income. At the time of filing of return, a taxpayer enters all the WHT paid in the respective sections of the income tax return.

Table 8 shows eight-year details of income tax returns filed with the WHT adjustments.

Table 8: Total Income Tax Return and Return Filed with WHTs Adjustments (PKR Million)

Tax Year	Total Returns Filed	WHT Income Tax Returns
2014	1,193,057	164,262
2015	1,448,933	788,069
2016	1,725,636	991,331
2017	2,079,367	1,210,517
2018	2,986,699	1,829,410
2019	3,339,616	2,155,762
2020	3,617,621	2,124,800
2021	4,274,618	2,305,534

Source: Author's calculation based on requested data from the FBR.

From the above data, it is evident that almost 55 per cent of the returns filed in the tax year 2021 included the adjustment of the WHT. The Auditor General of Pakistan (AGP) found irregularities in the adjustments of WHTs in the income tax returns filed by taxpayers. As per its report for 2019-20, the excess claims of the WHTs amounted to PKR 10,780 million. The AGP found similar irregularities in other years, which resulted in a significant loss of income tax. There is a need to establish a mechanism for desk audit of income tax returns filed by the taxpayers to control this irregularity which ultimately will increase income tax collection.

7. EFFECTS OF WITHHOLDING INCOME TAXES ON BUSINESSES

Business organisations are affected by this system in two ways. On the one hand, they are withholding agents and are required to collect/deduct income tax at the source on different transactions. On the other hand, they are taxpayers and other withholding agents deduct/collect income tax on transactions made with them. Its most common examples are the income tax deducted on the payments made on account of the sale of goods, the provision of services, and the execution of contracts, etc.

Problems as Tax Payer

- The number of WHTs is very high in the current tax framework. Businesses deal with 15-20 types of transactions that come under the WHT provisions. In approximately 90 per cent of the transactions made by the businesses either you are deducting withholding tax or your tax is being deducted by other parties on these transactions. These transactions have different rates, exemption limits, and tax treatments. It is a complex task for a business to handle these provisions, and in case of non-compliance, penalties are imposed on business organisations in the form of fines, additional taxes, and inadmissibility of expenses.

- Businesses face stuck-up of funds in the form of tax refunds resulting from the payment of higher WHT than income tax liability calculated for the year. An analysis of the financial statements of the companies

from different sectors shows that there are billions of rupees receivable from the FBR because of the WHT payments. We analysed the financial statements of the companies from different sectors and found that in some cases, refunds receivable against the payments of the WHT consist of almost 4-5 per cent of the current assets. For large listed companies, this amount reaches billions of rupees. It is because of the non-finalisation of the assessments of the companies and the delay in the disbursement of the refunds by the FBR.

- The majority of small and medium entrepreneurs and general taxpayers do not have sufficient knowledge of WHT rates and other matters. They face problems in the adjustments of the WHTs due to non or late payment of the WHT, non-availability of payment receipts, and non-verification by the FBR database.

- Taxflation is also a burden on the taxpayers due to the WHT. Businesses are also adversely affected by taxflation, like general consumers. It increases their cost of production and cost of services.

Problems as Withholding Agent

- According to industry professionals, in small and medium enterprises, sometimes suppliers of goods and services are not willing to pay the WHT on their supplies. As a result, taxes are paid by the recipient of these goods or services, which is completely against the objective of this system.

- WHT management responsibilities have some administrative costs for the WHAs. They are related to human resources and other documentation costs, technical and professional tax advisory costs, etc. Therefore, in many budget proposals by professional accounting bodies, it is suggested that a percentage, ranging from 2-3 per cent of the WHT collected should be given to the WHAs as service charges to cover administrative costs.

- Annual withholding tax audits also cause many problems for businesses. Business organisations are required to deal with this type of audit in addition to other tax audits, such as sales tax audits, etc. The FBR should combine all these types of audits and perform a "comprehensive audit" of related provisions of all the tax laws. This will not only reduce the burden of WHAs but it will also be convenient for the FBR to manage the audits.

Excessive documentation and filing requirements regarding tax withheld also create an administrative burden for the WHAs in the form of issuance of deduction certificates, filing of quarterly and annual statements of the WHT, etc. These filing requirements should be reduced and include only minimum necessary documentation and reporting.

8. CRITICISM ON WITHHOLDINGISATION

There is a strong criticism of the scope and application of the WHT system. The following is a summary of some of the criticisms of this system.

Mismatch with Progressive Taxation System: Our income tax system is based on progressive tax rates for individuals and AoPs but through this system, the tax is collected/deducted at the same rate irrespective of the taxable income of the taxpayers. For example, the WHT rate for dividend income and profit on debt is 15 per cent irrespective of the relevant income tax rate slab of the taxpayer. This rate is applied equally to the taxpayers earning either PKR 2 million or PKR 20 million. This is against the spirit of progressive taxation.

Over-Reliance on WHT: In Pakistan, the WHT is considered an easy mechanism to collect taxes (Cyan et al., 2016).

To increase income tax collection, the policymakers have adopted a practice of increasing WHT rates, a practice which can be observed from the finance bills of previous years. This leads to the withholdingisation of the whole income tax system.

Undocumented Economy: Sometimes, the WHT becomes a reason for undocumented transactions. People prefer to transact in cash to avoid the WHT imposed on these transactions. Besides, the WHT system is unable to cover the undocumented economy, therefore a substantial number of persons are still out of the tax net.

Tax on Transactions, not on Income: Many types of WHT are applied to the taxpayers' expenses rather than to incomes, for example, the WHT collected on the purchase and sale of property, tax on cellular and internet services, etc. If someone sells the property even at a loss, they have to pay the WHT on that transaction. In the case of the purchase of property, it is completely unjustified.

Taxflation- A Type of Indirect Tax: It increases taxflation. For example, if someone imports an item and pays the WHT on it, then he will add all types of taxes paid on these imports to the price of the items and shift the burden to the end consumer (Akram, 2016; Ahmed, 2020).

Undeposited WHTs: The WHT is deducted/collected from the payments but not deposited in the national treasury by WHAs is a common practice in Pakistan (AGP Performance audit report of FBR, 2021). Therefore, sometimes, it becomes an additional source of income for the WHAs.

Double Taxation of Income: In some cases, it leads to double implementation of the income tax. For example, if someone earns income from dividends, salary, etc., income tax is deducted from these payments. Afterwards, if they buy a car from a company, they are again required to pay income tax on this transaction. If the effective tax rate paid on all these transactions is calculated, it is more than the normal income tax rate.

Taxation in Cases of Losses: The WHT collection/deduction in case of losses is also a problem for taxpayers. For example, the tax deducted from the payment for the execution of contracts, the taxpayer is required to pay this tax even if they suffer a loss in that contract, which is completely unjust and unfair.

Problems in Widening of Tax Base: Over-reliance on withholdingisation is a major cause of a narrow tax base. As long as revenue targets are achieved by simply changing the WHT provisions, no sincere efforts will be made by the tax authorities to broaden the tax base and the inclusion of those persons in the tax net who are still out of it.

Inefficiency of FBR: Tax administration hides its inefficiency by collecting a major portion of income tax through the WHT. As discussed earlier, even though the administration has no direct role in the tax collection through this mode, the FBR still uses the WHT collection to measure its performance against tax targets (FBR Year Book, 2022).

Burden on Current Tax Payers: Due to the continuous increases in WHT rates, existing taxpayers have suffered from the extra tax burden. It has become the practice of the government to increase the rates of indirect taxes and the WHT to achieve the tax targets.

9. FEDERAL BOARD OF REVENUE

The FBR is the institution responsible for the collection of federal direct and indirect taxes. Previously it was called the Central Board of Revenue (CBR) but through the FBR Act of 2007, it became the Federal Board of Revenue. The FBR is responsible for the collection of income tax, sales tax, excise duty, customs duty, workers' welfare fund, workers' profit participation fund, etc. Figure 7 shows the organogram of the management of the FBR.

Figure 7: FBR Management
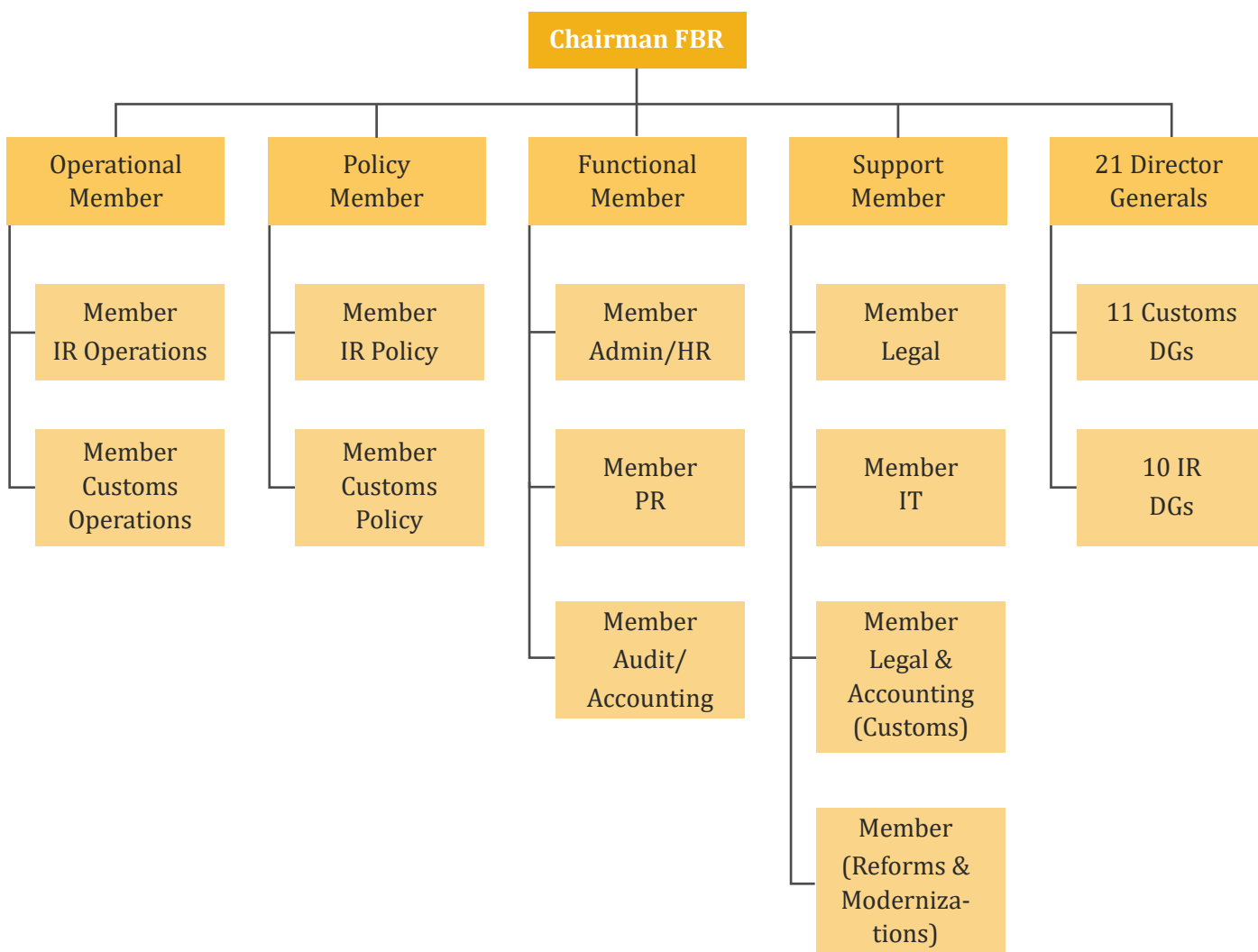
Source: FBR Year Book, 2022.

The FBR has nine wings, and the Inland Revenue wing is responsible for the collection of income tax, sales tax, and federal excise duty. Currently, the FBR has almost 32,000 personnel employed. There is a consistent decline in the portion of income tax on demand by the FBR. Only an inconsequential portion of income tax is collected through the direct efforts of FBR officials. For many years the cost of administration of different regions of the FBR has been more than the income tax collection through the efforts of those regions (AGP Performance audit report of FBR, 2018). This shows the poor performance of the FBR in the collection of income tax. In Table 9, a comparison of the tax on demand and cost of tax administration for the last 5 years is presented.

Table 9: Comparison of Tax Collected on Demand and FBR Expenditures (PKR Million)

Year	FBR's Expenses	Inland Revenue Division's Expenses	Total Expenses	Total Income Tax on Demand	Total Expenses as Per Cent of Income Tax on Demand
2016	3,284	10,165	13,452	87,884	15%
2017	4,324	11,594	15,918	92,819	17%

2018	3,967	12,816	16,783	102,905	16%
2019	4,368	13,741	13,741	102,648	13%
2020	3,404	13,396	16,800	60,807	28%

Source: AGP Performance Audit Reports of FBR (2016-2020).

FBR and Withholdingization

The FBR is responsible for collecting income tax from taxpayers but through withholding tax provision, the collection of income tax is entrusted to the WHAs. The FBR collects only 4-5 per cent of the total income tax with its core efforts. The WHT system has become a dominant feature of the tax structure of Pakistan (Cyan et al., 2016). Because of the persistent increase in the rates and provisions of the WHT, tax targets are fulfilled automatically without the direct involvement of the FBR. It shows overdependence on this system by the FBR.

The following are some major reasons for the adoption of this system by the FBR:

1. It is a convenient and easy way to collect income tax without any direct efforts by the administration of the FBR.

2. No costs are incurred by the FBR to collect the WHT in Pakistan. WHAs collect the tax and deposit it in the national treasury.

3. Through this system, the people who are involved in specified transactions pay income tax even if they do not file annual income tax returns.

4. It is very easy to increase income tax collection by enhancing the WHT rates and including more items in the WHT regime.

5. By charging double rates of the WHTs to non-filers, the FBR has created another source of revenue.

6. The FBR's performance is measured by meeting tax collection targets. The WHT contributed almost 25 per cent to the total tax collection.

Tax administration hides its inefficiency by collecting a major portion of income tax through the WHT. A complete restructuring is required to make the FBR an efficient and effective tax authority.

Reforms in FBR

It is difficult to reduce the reliance on the WHT and receive the income tax in a direct tax mode without strong reforms in the FBR. There are many studies on the structural reforms in the tax collection system of Pakistan (Bukhari & Haq, 2020). Here is a summary of some valuable suggestions:

1. There is a need to establish a National Tax Authority (NTA) comprising specialists, not bureaucrats, to deal with all national, provincial, and local tax matters.

2. At present, there are too many unqualified and redundant staff occupying non-technical positions. Due to the large proportion of salaries and wages paid to them, the FBR is unable to recruit high-level professionals. The recruitment, training, remuneration, progression, and incentive structure of tax administration should be completely revamped.

3. Performance evaluation systems with real KPIs should be introduced to turn the FBR into a result-oriented, highly professional, and performance-based organisation.

4. A special wing/division should be established in the FBR, which will be responsible for expanding the tax net. The government should give time-based targets to this division to bring all the taxable persons into the tax net.

5. Currently assessing officers of the FBR are overworked and unable to perform quality assessments of the taxpayers' cases. Additional professional human resources should be hired to solve this problem.

6. The adoption of the latest information technology tools and data analytics techniques can also improve the tax collection capacity of the FBR and reduce tax evasion.

7. A strong and efficient internal mechanism of accountability should be established in the FBR to control the corruption and inefficiencies in this institution.

10. ADMINISTRATION OF WITHHOLDING TAXATION SYSTEM- DIRECTORATE GENERAL OF WITHHOLDING TAXES

For the administration of the WHT system, the FBR has a special office to manage its affairs called the Directorate General of Withholding Taxes. This directorate was established through Finance Act 2008 under section 230A of the ITO 2001.

The following are some major functions performed by this directorate:

- To deal with the matters relating to WHAs.

- To give recommendations regarding the WHT in Pakistan.

- To ensure the enforcement of the WHT provisions of ITO 2001 in Pakistan.

- To maintain the record of the WHT and WHAs.

- To investigate the cases of non-deduction/short-deduction of the WHT by WHAs.

- To verify and cross-check the record of the WHT collected with the statements and other documents filed by WHAs and taxpayers.

Unfortunately, there are many inefficiencies and irregularities in the functions performed by the directorate. Many of them have been identified by the AGP in its different reports. These include non-deduction of the WHT by WHAs, wrong treatment and claim of the WHT, etc. These inefficiencies cause billions of tax losses to the government. In the following section, these inefficiencies are discussed in detail.

Following are some important issues being faced by the WHT system and need the attention of the DG-Withholding.

Treatment of the WHT

Significant losses emerged due to the wrong application of the tax treatments given by ITO 2001 regarding the WHT. The AGP often reports cases of wrong treatments which cause the losses of billions of rupees in the income

tax collection. Table 10 reports the losses from 2017 to 2020. The FBR and DG Withholding should strictly monitor these wrong treatments to control this loss of revenue.

Table 10: Loss of Income Tax Due to Wrong Treatments of the WHT

Tax Year	2016-17	201 7-18	2018-2019	2019-2020
PKR Million	2,933.52	539.82	6,337.95	10,780.65

Source: AGP Performance Audit Reports (2016-2020).

To counter this irregularity, which causes billions of losses in income tax, the FBR should activate its desk audit system in which income returns filed by taxpayers should be scrutinised to verify compliance with relevant legal provisions.

Problems in Collection/Deduction of Tax at Source

All WHAs dealing in the specified transactions are required to deduct/collect the WHT at the source from these transactions and in case of failure to comply with this requirement, certain penalties can be imposed on the WHAs. Sometimes, these WHAs fail to comply with these requirements. This practice can be eliminated by enforcing the prescribed penalty provisions and taking strict actions against defaulting WHAs. The AGP, in its audit reports, showed the following short/non-deduction of the WHT by WHAs. Table 11 shows some major heads in which these non or short deductions of the WHT were made. The table also shows the total loss of income tax because of these irregularities.

Table 11: Transaction Wise Non/Short Deduction of WHTs

Sr.#	Type of Transactions (Only Major Heads)	Amount (PKR Million)			
		2017-18	2018-19	2019-20	2020-21
1-	Payments to suppliers and contractors	29,785	5,320	11,340	12,568.30
2-	Payment of dividends	599	199	1,569	1,946.18
3-	Payment of brokerage and commission	123	103	166	1,725.35
4-	Payment of rent from immovable property	982	138	113	476.49
	TOTAL (Abovementioned and other items)	**33,111.76**	**8,258.34**	**17,326.07**	**31,424.14**

Source: (AGP Performance Audit Reports of FBR (2016-2020).

Timely Deposit of Tax

WHAs are required to deposit the tax deducted at the source into the national treasury within the stipulated time, otherwise, they are charged with a default surcharge.

The AGP identified in its report the amount of default surcharge for the late payment of income tax liability, which is not levied on taxpayers by the FBR. The total amount of default surcharge is shown in Table 12. There is a need to impose a prescribed default surcharge on the WHAs on account of this irregularity and FBR should also ensure

its receipt from the WHAs. This will reduce the practice of late payments of the WHT collected by WHAs.

Table 12: Default Surcharge on Late Payment

Tax Year	2015-16	2016-17	2017-18
PKR Million	1,103.01	10,201.42	2,367.32

Source: AGP Performance Audit Reports of FBR (2016-2020).

Refund of WHTs

The WHT collected on specified transactions is treated in two ways. In some cases, it is treated as the full and final discharge of tax liability of the particular transaction on which it is being deducted. Its common example is tax deducted on profit on debts received by the individuals or tax deducted against the payment of the execution of the contracts. However, for some other transactions, such as salary, sale of goods, etc., the tax deducted on these transactions is adjusted against the tax liability of the persons calculated at the end of the year. If the amount of this adjustable WHT is more than the amount of tax calculated on the income of the year, then this amount is considered a refundable amount to the taxpayer. This amount can be carried forward to the next tax year as an adjustment against the tax liability of the next year. Due to the mechanism of the WHT, in most cases, these refunds accumulate from year to year. Table 13 shows the summary for 2012 to 2022 of income tax refunds paid by the FBR to the taxpayers.

Table 13: Refunds of Income Tax

Year	Amount (PKR Million)
2013	53,400
2014	63,711
2015	62,326
2016	26,923
2017	49,975
2018	69,487
2019	83,897
2020	68,604
2021	91,278
2022	54,221

Source: Author's calculation based on requested data from the FBR.

The payment process of refunds has created many administrative problems for the FBR because before initiating refund payments, the FBR needs to verify the whole tax record of the taxpayer. A delay in the payment causes many problems in cash flow management for business organisations. Associations of different business organisations and industries always demand from the FBR to make this system speedy and more transparent. The refund establishment and disbursement system should be fully automated and regulated. Refunds should be granted within the time specified in the ITO 2001.

Withholding Tax Audit

The whole system of income tax is based on self-assessment and declaration. All declarations are made by the taxpayers on a self-assessment basis but ITO 2001 empowers the commissioner of inland revenue to audit the tax record of the selected taxpayers. During this audit, compliance with all legal requirements is verified including the legal responsibilities of WHAs regarding WHT deduction/collection, reporting, record keeping, etc.

The FBR, with the help of a risk-based audit management system, selects the taxpayers through balloting by applying risk-based parameters. The parameters of selecting taxpayers for audit purposes are highly confidential and, therefore, not disclosed by the FBR. However, different classes of taxpayers, such as salaried individuals, persons whose entire income falls under the final tax regime, and some other persons, are excluded from the process of selecting taxpayers for audit. In the audit policy for the tax year 2019, 10,441 persons were selected by the FBR for income tax audit. During the audit, the FBR checked all the relevant financial and other records and also verified the responsibilities of persons as WHAs. However, the FBR did not meet the tax collection targets through audit and inspection (AGP Performance Audit Report of FBR, 2021). There is a need to improve the system of taxpayers' audits and the FBR should endeavour to make it more result-oriented.

The following are some recommendations to improve the withholding tax audit system.

1. The audit staff should be properly educated and trained to perform their duties in a better way.

2. Because of digitalisation in business processes, it has become a complicated task to do tax audits. Current audit staff of the FBR should be trained to face this challenge and more personnel should be recruited (AGP Performance Audit Report of FBR, 2019).

3. The FBR should develop a specialised tax audit force for each sector of the economy on scientific lines. These specialised persons should be properly trained to handle the audit matters of these sectors.

4. Proper implementation of a desk audit system will reduce many operational problems in audit and it may also reduce the burden of the final tax audit.

11. IMPLEMENTATION STRATEGY OF WITHHOLDING TAXATION REGIME

Income tax law describes the applicable rates of the WHTs and also specifies persons who will deduct/collect WHT on specified transactions. The WHT regime is entirely based on the withholding agents. Criteria to become a withholding agent are prescribed by the ITO 2001. These agents are the persons who collect/deduct withholding tax from the transactions generated by them. These WHT-related operations are performed by WHAs and the law also has explained the role and responsibilities of WHAs.

Who is the Withholding Agent?

Section 153(7) of ITO defines the following persons as withholding agents (prescribed persons):

•   The Federal Government

•   A company

•   A non-profit organisation

- A foreign contractor or consultant

- A consortium or joint venture

- An exporter or an export house

- An association of persons, having a turnover of PKR one hundred million or above in any of the preceding tax years

- An individual having a turnover of one hundred million rupees or above in any of the preceding tax years

- A person registered under the Sales Tax Act of 1990 having a turnover of one hundred million rupees or more in any of the preceding tax years.

- A person deriving income from the business of construction and sale of residential, commercial or other buildings (builder)

- A person deriving income from the business of development and sale of residential, commercial or other plots (developer).

Types of Withholding Agents

Table 14 shows the number of WHAs, person- and province-wise, from 2014 to 2022. The FBR should make continuous efforts to increase the number of WHAs to maximise the collection of the WHT.

Table 14: Person/Province-Wise Number of Withholding Agents

Years	Persons			Provinces				
	AOPs	**COYs**	**INDs**	**Balochistan**	**Islamabad**	**KPK**	**Punjab**	**Sindh**
2014	164,133	58,804	334,143	7,170	38,823	25,941	344,519	140,627
2015	172,570	62,670	348,756	7,643	41,296	27,293	361,670	146,094
2016	181,008	69,219	367,992	8,712	44,776	29,276	381,344	154,111
2017	190,611	76,388	390,703	9,668	48,685	31,600	405,513	162,236
2018	201,227	87,318	423,114	10,477	55,098	34,589	438,936	172,559
2019	212,785	104,462	455,107	11,264	63,921	38,162	474,173	184,834
2020	225,523	123,967	494,929	12,159	73,114	42,316	518,579	198,251
2021	242,595	150,911	521,857	13,096	84,557	46,726	560,953	210,031
2022	262,974	179,201	538,738	14,127	94,386	50,866	599,819	221,715

Source: Author's calculation based on requested data from the FBR.

Figure 8: Withholding Agents by Persons (In Percentage
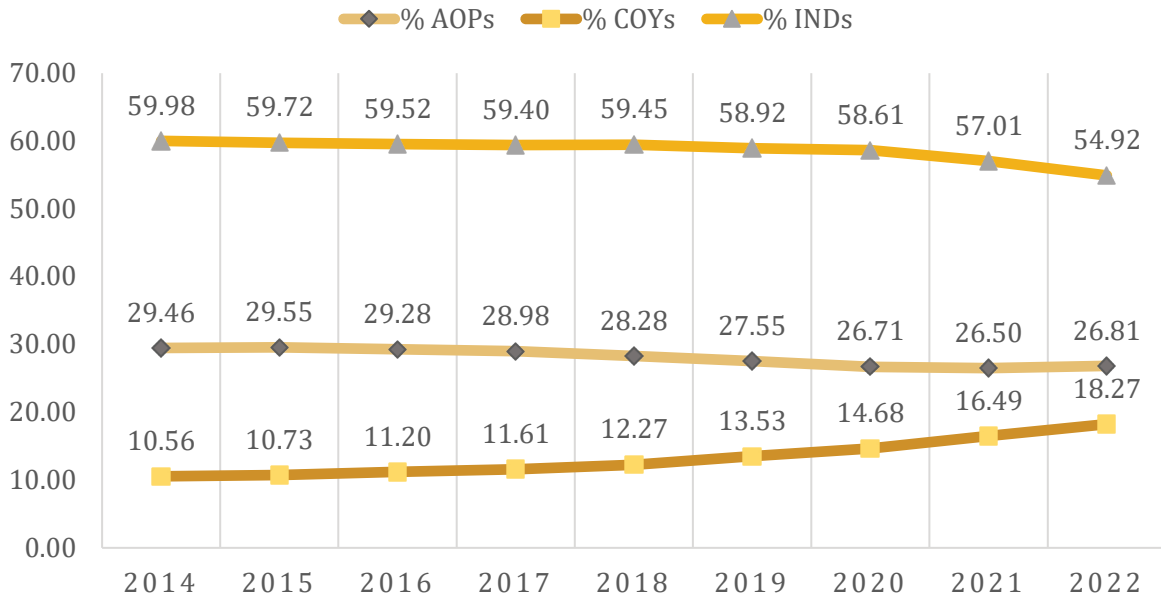
Source: Author's calculation based on requested data from the FBR.

In Figure 9, the rise in the number of WHAs in all provinces of Pakistan and their figures during the last 9 years can be observed. There is a substantial increase in the number of WHAs during the mentioned period.

Figure 9: Withholding Agents by Provinces

Source: Author's calculation based on requested data from the FBR.

In Figure 10 the percentage-wise breakup of WHAs in provinces and the capital territory is given. The highest proportion of WHAs is in Punjab, while Sindh is in second place.
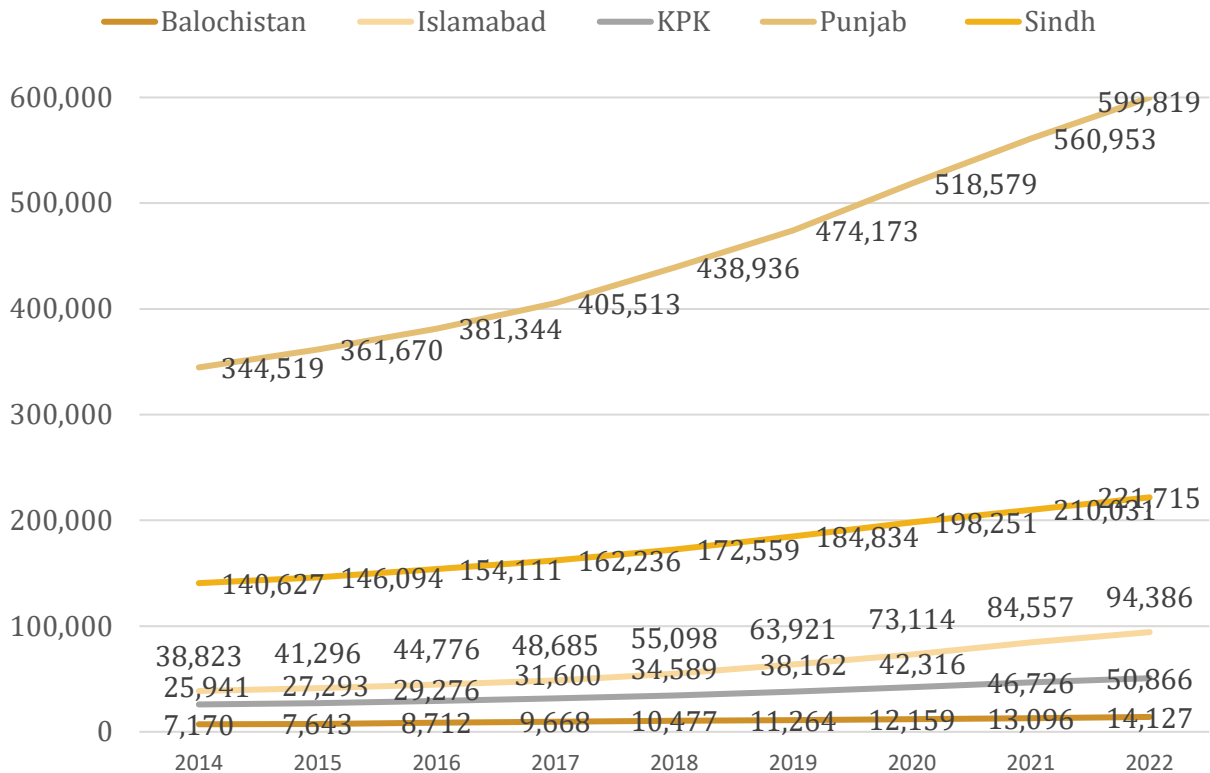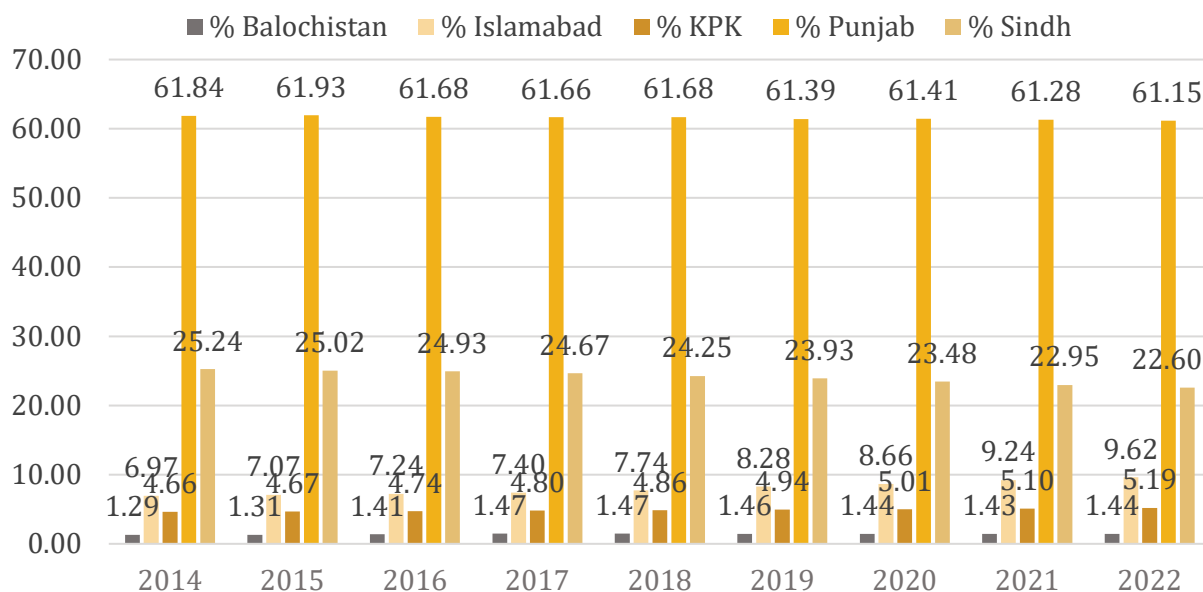
Figure 10: Withholding Agents by Provinces (In Percentage)

Source: Author's calculation based on requested data from the FBR.

The ITO 2001 has defined some reporting and record-keeping responsibilities for WHAs. The ITO 2001 also describes the penalty provisions on defaults by WHAs in the collection/deduction of WHT, its timely payment, recording keeping, and reporting. The Directorate General of the WHTs within the FBR oversees the matters of WHTs and WHAs. According to the ITO 2001, WHAs are required to strictly comply with the following responsibilities.

Collection/Deduction of Tax at Source

All WHAs are required to collect/deduct income tax at the source from the specified transactions generated by them. However, the AGP found many cases involving transactions worth billions of rupees on which WHAs failed to collect/deduct the WHT at the source (AGP Performance Audit Report of FBR, 2021). There are the following penalty provisions in ITO 2001 regarding the failure to deduct/collect the WHT or failure to deposit this tax in THE national treasury.

- The WHA will be personally liable to pay the required tax.

- The amount of tax will be paid with the default surcharge at the rate of 12 per cent per annum for the period of its non-payment.

- While computing the taxable income of the WHA, the payment on which the WHT was not deducted shall not be allowed as admissible expenses.

The FBR should strictly impose these penalty provisions on defaulter WHAs to eliminate this irregularity which causes billions of rupees in losses in income tax collection (AGP Performance Audit Report of FBR, 2021).

Deposit of Tax into Treasury

Tax withheld by the WHAs will be deposited in the national treasury as per the period specified by the ITO 2001. As per ITO 2001, the following time frame is given for the payment of the WHT collected/deducted by WHAs.

- Where tax is collected by the government, on the same day on which tax is collected or deducted.

- In all other cases, within seven days from the end of each week ending on Sunday.

However, as reported in Table 12, a large amount is deposited with delay in the government treasury by WHAs and the FBR has failed to impose penalties for this irregularity (AGP Performance Audit Report of FBR, 2021). The solution is the imposition of penalty on the defaulter WHAs by the FBR.

Maintaining of Tax Record

In addition to reporting requirements, ITO 2001 also requires WHAs to keep records regarding WHTs to be produced to the income tax authorities at the time of the audit of WHTs. However, a significant number of WHAs do not comply with this requirement.

Filing of Periodic Statements

As per ITO 2001, the WHAs should comply with certain reporting obligations. Every agent is required to furnish a quarterly/annual statement showing the details mentioned in Section 165 of the ITO 2001. In the performance audit report prepared by the AGP, it has been identified that a significant number of WHAs comply with this requirement and file the required statements on a timely basis. The FBR should ensure 100 per cent compliance with the reporting obligation by all WHAs (AGP Performance Audit Report of FBR, 2019).

Synchronised Withholding Administration and Payment System Agent

To resolve the issue of non-payment/late payment of taxes withheld by the WHAs, the FBR has introduced a new system. This system was introduced through the Finance Act of 2022 and Section 164A of ITO 2001 explains this system. It deals with the real-time depositing of the WHTs collected by selected WHAs. The FBR can notify any person or class of persons to collect or deduct the WHT through the Synchronized Withholding Administration and Payment System Agent (SWAPS). Currently, only big banks are included on the list for the application of this system, but in future, this system will apply to all major WHAs. Such agents remit the collected/deducted WHTs to the FBR digitally. In future, a SWAPS Payment Receipt (SPR) shall replace computerised payment receipts. The notified SWAPS agent will be integrated with the FBR and the WHT will be deposited to the government treasury in real-time at the time of making third-party payment processed through SWAPS by a SWAPS agent. Penalties are introduced for non-compliance with this system. It will also result in auto-generated withholding statements, thereby saving time and reducing the cost of compliance for businesses. The SPR will be generated upon the depositing of tax, which can be used as a valid document to claim credit against tax payable.

12. PRACTICES IN OTHER COUNTRIES

Collecting income tax is always a challenge, particularly in developing countries. Figure 11 shows the tax-to-GDP ratios of some developed and developing economies including Pakistan for the year 2020. Pakistan's tax-to-GDP ratio is quite low (10.40%) as compared to other countries. It was below the Asia and Pacific countries' average of 19.10 per cent by 8.70 percentage points. It was also below the OECD average (33.5%) by 23.10 percentage

points. The highest tax-to-GDP ratio was 11.4 per cent in 2017, while the lowest was 9.0 per cent in 2012. In developed countries, it ranged between 25 per cent and 45 per cent. Improving the tax-to-GDP ratio has been a big challenge for Pakistan. Due to the low tax-to-GDP ratio, the government relies on domestic and international loans to meet its expenses.

Figure 11: Comparison of Tax to-GDP Ratio of Pakistan with Other Countries (2020)
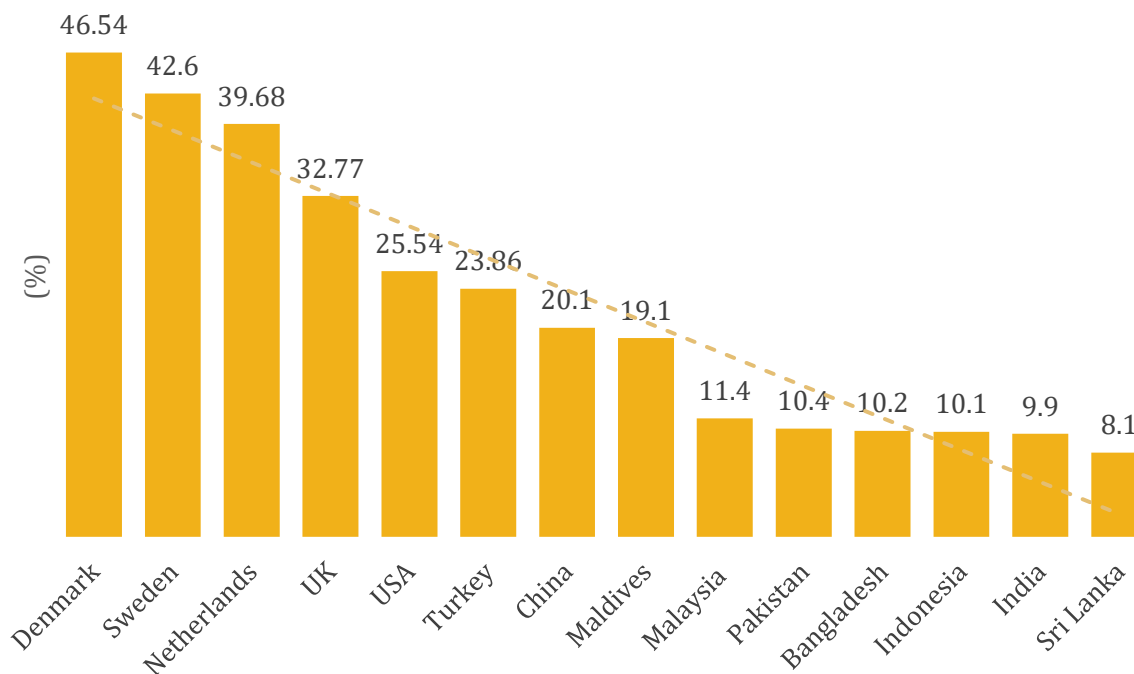
Source: OECD (2023).

The only solution to the low tax-to-GDP ratio is widening the tax net and increasing the contribution of all the sectors of the economy in the total tax collection, which can only be possible by reforming our tax collection system and institutions.

Withholding Taxes in Other Countries: The WHT is a common procedure to collect income tax in most countries. The basic principle behind the imposition of the WHT is known as the pay-as-you-earn (PAYE) principle. Tax authorities argue that if a transaction is generating income, like salaries, dividends, etc., it is justified and also convenient for the tax authority to impose withholding tax on it. WHT rates vary across countries, depending on the country's tax laws and regulations (Mahpudin et al., 2022). The WHT itself is not a problem but the real problem is overreliance on this system. In Pakistan, almost eighty-plus different kinds of transactions are covered under the WHT regime. In 2022, 69 per cent of the total income tax was collected through the WHT system. In India, this figure ranges between 38-40 per cent. The concept of higher rates of withholding taxes on non-filers also exists in India. As in Pakistan, non-filers are charged double the normal WHT rates in India as well. In most countries, the WHT regime includes few transactions, for example, dividends, interest, salaries, royalties, etc. In Pakistan, almost half of the provisions of the WHTs are related to expenses. The collection from the WHT ranges from 15 per cent to 25 per cent of the total income tax collected in most of the countries (OECD, 2023). However, in Pakistan, there are excessive WHT provisions that indicate the failure of the tax system to collect the income tax through normal assessment procedures.

13. DIGITALISATION OF WITHHOLDING TAXATION SYSTEM

On December 16, 2008, the FBR signed a contract with Pakistan Revenue Automation Ltd. (PRAL), a fully owned subsidiary and information technology (IT) wing of the FBR. PRAL was initially required to help the FBR in business process reengineering, automation, and managing information communication technology (ICT) infrastructure.

Journey and Current Structure of Digitalization

With the help of PRAL, the FBR is continuously striving to increase the tax base and revenue collection, facilitate taxpayers, and minimise the incidence of leakages with the help of digital tools. The World Bank Data shows that the FBR's digitalisation initiatives helped in reducing the time involved in paying taxes (Bukhari & Haq, 2020). The indicator "time to prepare and pay taxes" specifically measures the improvement in online filing and tax payments. The lower the magnitude of this indicator, the higher the digital procedures implemented in the tax system. For example, between 2016 and 2017, Pakistani taxpayers spent about 312 hours per year preparing, filing, and paying taxes, such as corporate income tax and general sales sax. According to the World Bank's Raises Revenue Project for Pakistan, the time to prepare and pay taxes indicator had been reduced by almost 22 per cent, to 243 hours from 312 hours in 2017.

For the digitalisation of the taxation system in Pakistan, the following major steps have been taken in previous years:

- Computers were introduced for office work and data processing in the FBR.

- Pakistan Revenue Automation Limited (PRAL) was formed.

- E-Filling of income tax and sales tax returns started.

- Launching of "IRIS" portal for filling of income tax returns.

- Payments through E-Banking "Alternate Delivery Channels (ADC)" in all commercial banks.

- Online submission of withholding income tax statements.

- Issuance of system-generated notices and assessment orders.

- Online filing of refund application.

- Online application and issuance of exemption certificates.

- Online filing of appeals to commissioner appeal.

- Online issuance of orders by commissioner appeal.

The FBR has created a new inland revenue field formation namely the Directorate General of Digital Invoicing and Analysis (DGDIA) in 2022 and launched a Synchronized Withholding Administration and Payment System (SWAPS) for real-time payment of the withholding income taxes. The availability of withholding transections' data in the digital mode has been benefiting FBR in the following several ways.

- Making informed decisions through real-time monitoring

- Analysis of the WHT data

- Auto-generating withholding statements thereby saving time and reducing compliance costs for WHAs

- Generating agent-, section-, or sector-wise WHT collection reports,

- Tracking past performance, improving efficiency, and curtailing tax evasion.

The FBR is also planning to establish a high-capacity data warehouse to support big data analysis and the integration of databases of taxpayers. Taxpayers can get the information about their assets online.

Effect of Digitalisation on Efficiency of the Tax System

Recent advancements in the tax collecting machinery in terms of digitalisation have facilitated taxpayers and enhanced revenue collection. The FBR helped more taxpayers than ever to pay their taxes quickly and easily online. For example, 4.27 million people filed income tax returns for the tax year 2021 as compared to 1.72 million in 2016. This becomes possible by the use of information technology.

Technological Problems in the Current Tax System and Recommended Solutions

1. Currently, the tax paid by a Pakistani taxpayer is the highest among other developing countries with lower or comparable tax-to-GDP ratios.

2. According to media reports, the PRAL Data Center does not have any international standard certification. Its last certification expired in December 2020. The Data Center has a systematic flaw and is not equipped with any intrusion detection system. PRAL should restore its reputation affected by recent legal allegations.

3. FBR lacks an IT-based tracking system or database of different valuable initiatives and ventures made by the FBR.

4. End-to-end automation, computerisation, and digitisation through cloud computing, blockchain, machine learning, expanding functionality of websites and e-filing and e-payment systems should be accelerated. The total time spent in organisations complying with taxation laws is still more than double the time spent in different countries (World Bank, 2020).

5. Digital security and confidentiality of the data of taxpayers should be ensured. This is still a challenge for the FBR as it may cause severe adverse legal consequences for it.

14. WITHHOLDINGISATION – KEY FINDINGS AND POLICY RECOMMENDATIONS

As mentioned earlier, the WHT system is the backbone of the income tax collection system in Pakistan. The major portion of income tax is collected through this system therefore there is a need to improve and upgrade this system.

In light of the analysis made by using available data on the WHT system, the following are the key findings and recommendations to make the system suitable for the economy and business environment.

Reduction of Reliance on WHT System: Overreliance on the WHT exists in our income tax collection system. This should be reduced because, in most cases, it is partially an indirect tax in the form of a direct tax. Overreliance on the WHT affects the collection of income tax. In almost every budget, the government changes the

rates of the WHT and indirect taxes to meet the tax collection targets. Income tax is a direct tax and it should be collected in a direct tax mode.

Reduction in Number of Transactions: Currently, more than eighty types of transactions are included in the WHT regime. This number should be reduced only to those top 15 items that contribute almost 95 per cent of the total WHT collection. Out of the total items, 45 items of WHT contribute only 2 per cent. Thus, these marginal items should be eliminated from the WHT regime (Nasir et al., 2020).

Correction in the System to Claim Adjustable Taxes: There are many flaws in the WHT adjustment system that cause billions of rupees in losses (AGP Performance Audit Report of FBR, 2021). Claiming of the adjustments of WHTs should be based on system-generated figures. For example, income tax deducted from salary appearing on IRIS is editable, which it should not be. Hence, it will not be possible to claim unpaid amounts of WHTs by the taxpayers. It will eliminate the figures of WHTs claimed for adjustments but not paid in the national treasury by the WHAs.

Desk Audit System: The wrong treatment of the WHTs in the annual income tax return causes billions of rupees of losses due to the wrong treatments of WHTs (AGP Performance Audit Report of FBR, 2021). To make sure that the WHTs appearing on the income returns are correctly treated as per income tax laws, the FBR should enforce a desk audit system. By effective implementation of the desk audit system, irregularities in the area of WHTs and other declarations can be eliminated.

Replacement of Withholding Income Tax System with the Monthly Advance Tax System: Concerning several problems that exist in the system of the adjustments of WHTs, tax professionals' bodies recommend that this system should be replaced with the monthly advance tax system for the listed companies (ICAP, 2023). It will reduce the unnecessary documentation and problems in the verification and eliminate the chances of committing fraud by WHAs. It will also improve the cash flow of the companies and minimize the exposure of tax refunds.

Widening the Tax Net: No sincere efforts have been made by the FBR to include more persons in the tax net. Figures of the collection of income tax through the efforts of the FBR can be seen in Table 3. The FBR should aggressively work to minimise tax evasion and focus on the inclusion of more persons in the tax net instead of just changing the tax rates in the WHT regime. New taxpayers should be brought into the net through the use of the NADRA database, data analytics, and digitalisation. The present taxation regime is highly complex, narrow, and mostly skewed towards the urban, industry and formal sectors. It has low compliance and enforcement and an inefficient administrative structure.

In Pakistan, according to different estimates, the tax gap is about 70 per cent of the actual tax receipts. Its basic reason is reliance on indirect taxes and WHTs and the absence of fruitful efforts to broaden the tax net (Bukhari & Haq, 2020).

Validity of WHTs – Rationalisation of the Transactions: There are many items which are expenses of the consumers, not the income, like the WHT paid on the purchase of motor vehicles, cash withdrawals from banks, the WHT on cellular and internet services, etc. It is irrational and unjust to collect the WHT on these items. Therefore, all these items should be removed from the list of the WHT. In the majority of the countries, the WHT is implemented on a few income items, like salaries, profit on debt, dividends, royalties, etc. (OECD, 2023). It is not a valid practice to include items that are by nature expenses on the list of the WHT. This practice is against the philosophy of income tax.

Non-Filers' Data: Obtaining the data of non-filers is always an issue for the tax authorities (Alm, 2021). Through the WHT system, the FBR has obtained huge data on the persons who are non-filers but spend money on valuable purchases, like property, motor vehicles, international air tickets, etc. But still, the FBR has not been able to include these persons in the tax net. By using this data, tax collection can be increased and tax evasion can be

minimised. The FBR should use this data effectively for this purpose.

Real-Time Availability of WHT Data: A taxpayer can only view WHTs on limited transactions made by them on the FBR system online. Its scope should be expanded to the entire WHT regime, such as the WHT paid on utility bills, banking transactions, etc. This will help the taxpayers to reconcile the position of income tax paid on a real-time basis. Therefore, any irregularity that exists on the part of the WHAs can also be pursued by the taxpayers.

15. CONCLUSION

The collection of taxes has always remained a challenge for the government in Pakistan. The WHT system helps in the collection of income tax but its effects on the taxpayers are similar to indirect taxes, which result in taxflation. Measures should be taken to control these harmful effects. Higher dependence on the WHT depicts the failure of the tax collection system. Our study suggests that the dependence on the WHT system should be reduced for the collection of income tax. There are many other problems associated with the WHT regime that cause a shortfall in the collection and deposit of WHTs.

The WHT regime cannot be eliminated from our current taxation system. Removing the regime will create problems in tax collection because still, a major portion of our economy is undocumented and out of the tax net. Surprisingly, our government is not striving to expand the tax net. In every budget, only changes are announced in the WHT rates and normal tax rates to increase the income tax collection. This practice should be avoided and strict steps should be taken to add more people to the tax net. Similar to the practices of many other countries, a few items like salaries, profit on debt, dividends, and royalties should only be included in the list of the WHT regime.

It is not possible to implement reforms in the WHT regime and the overall taxation system without strong institutional reforms in the FBR. According to professionals, the only solution is to establish a National Tax Authority (NTA) to deal with all types of taxes in Pakistan (Bukhari & Haq, 2020). Sooner or later, our government will realise that the structural reforms in tax authorities, laws, and the collection system are the only solutions to the revenue problems of Pakistan and moving towards a just and equitable taxation system.

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ANNEXURES

Annexure 1: Break up of Income Tax under Each Collection Head (PKR Million)

	Total Tax Collected	Direct Taxes Collected	Gross Income Tax Collected	Refunds	Net Income Tax Collected	Withholding Tax Collected	Voluntary Payments of Income Tax	WHTs as Per Cent of Total Taxes	WHTs as Per Cent of Total Income Tax	WHTs as Per cent of Direct Taxes
2000-01	392,277	124,585	130,574	13,112	117,462	79,155	34,993	20%	67%	64%
2001-02	404,070	142,505	152,986	16,444	136,542	78,884	50,855	20%	58%	55%
2002-03	460,627	151,898	164,407	19,141	145,366	84,973	53,895	18%	58%	56%
2003-04	520,843	165,079	178,207	20,759	157,448	91,782	66,543	18%	58%	56%
2004-05	590,387	183,372	202,801	29,033	173,768	111,499	73,803	19%	64%	61%
2005-06	713,442	224,988	243,736	34,001	209,735	139,274	87,360	20%	66%	62%
2006-07	847,236	333,737	346,900	32,200	315,152	169,191	165,736	20%	54%	51%
2007-08	1,008,091	387,861	393,782	25,822	367,959	205,144	145,616	20%	56%	53%
2008-09	1,161,150	443,548	461,239	38,798	422,441	242,137	141,680	21%	57%	55%
2009-10	1,327,382	525,977	559,698	54,204	505,494	295,249	165,801	22%	58%	56%
2010-11	1,558,014	602,451	629,102	46,678	582,424	357,836	196,066	23%	61%	59%
2011-12	1,882,693	738,424	811,893	91,561	720,332	420,457	237,366	22%	58%	57%
2012-13	1,946,360	743,409	776,009	53,397	722,612	436,088	244,920	22%	60%	59%
2013-14	2,254,531	877,255	918,863	63,711	855,269	571,667	262,598	25%	67%	65%
2014-15	2,589,978	1,033,720	1,084,472	77,649	1,006,835	691,181	287,608	27%	69%	67%
2015-16	3,112,472	1,217,474	1,242,195	47,523	1,192,247	803,116	340,820	26%	67%	66%
2016-17	3,367,874	1,344,226	1,373,697	49,975	1,323,722	944,068	370,506	28%	71%	70%
2017-18	3,843,755	1,536,583	1,577,441	69,461	1,515,086	1,046,917	467,007	27%	69%	68%
2018-19	3,828,482	1,445,508	1,509,788	83,897	1,425,891	960,239	462,164	25%	67%	66%
2019-20	3,997,408	1,523,445	1,570,820	68,604	1,502,216	1,091,737	407,170	27%	73%	72%
2020-21	4,744,997	1,731,253	1,802,417	91,278	1,711,139	1,237,338	467,754	26%	72%	71%
2022-22	6,148,500	2,284,900	2,269,800	54,221	2,215,579	1,534,400	676,408	25%	69%	67%

Source: FBR Year Books (2001-2022).

Annexure 2: Item-Wise Collection of Withholding Income Tax (PKR Million)

Sr. #	Items	2013	%	2014	%	2015	%	2016	%	2017	%	2018	%	2019	%	2020	%	2021	%	2022	%
1	Contracts	111,516	26%	129,901	23%	176,783	26%	220,062	27%	259,539	27%	249,889	24%	235,476	25%	237,479	22%	271,991	22%	341,419	22%
2	Imports	103,235	24%	123,808	22%	147,352	21%	179,728	21%	197,041	21%	218,691	21%	221,835	23%	199,691	18%	218,499	18%	281,607	18%
3	Salary	50,056	11%	64,552	11%	79,460	11%	92,253	11%	111,188	12%	133,362	13%	76,441	8%	129,423	12%	151,838	12%	196,249	13%
4	Bank Interest & Securities	35,339	8%	40,675	7%	49,785	7%	48,200	6%	42,595	5%	45,646	4%	58,134	6%	128,107	6%	134,927	11%	154,962	10%
5	Dividends	19,191	5%	24,182	5%	29,399	5%	42,042	6%	49,489	6%	57,847	7%	57,056	8%	55,046	8%	63,781	6%	83,328	7%
6	Telephone	27,102	6%	51,974	9%	44,676	6%	47,653	6%	51,773	5%	47,382	5%	17,187	2%	54,635	2%	63,167	5%	67,889	4%
7	Electricity	16,026	4%	19,758	3%	27,541	4%	25,526	3%	25,840	3%	33,832	3%	35,558	4%	45,427	4%	51,264	4%	71,412	5%
8	Export	23,201	5%	26,371	5%	26,231	4%	24,898	3%	24,252	3%	28,279	3%	34,448	3%	38,443	4%	42,249	3%	64,972	4%
	TOTAL	385,666	89%	481,221	85%	581,227	85%	680,362	86%	761,717	82%	814,928	79%	736,135	78%	888,251	83%	997,716	82%	1,261,838	83%
	Total WHT	436,087		571,716		691,185		803,116		944,068		1,046,917		960,239		1,091,737		1,237,338		1,534,365	

Source: FBR Year Books (2013-2022).

PART II

PUBLIC FINANCE MANAGEMENT

Policy Briefs

TAMING THE LEVIATHAN FOR PUBLIC SECTOR RESOURCE EFFICIENCY IN PAKISTAN: FISCAL FEDERALISM OR FISCAL DECENTRALISATION?

Muhammad Ahmad Barula

INTRODUCTION

Fiscal decentralisation has gained substantial attention worldwide as a pivotal component of governance and economic policy. The idea of redistributing fiscal powers and responsibilities between central and subnational governments has been implemented in diverse contexts to enhance local decision-making, improve public service delivery, and foster economic development. In the case of Pakistan, a country characterised by its intricate federal structure and multi-tiered governance system, fiscal decentralisation has been a subject of significant policy experimentation and discourse.

With the advent of liberalised policies worldwide during the 1990s, many countries have favoured decentralisation a fiscal aspects. A major motivation behind fiscal decentralisation is to achieve government resource efficiency and improvement in public sector service delivery. However, mixed results are found in the case of developing countries, including Pakistan. In the case of Pakistan, there is asymmetric decentralisation of the fiscal and political institutions, i.e., the political structure is completely decentralised, while the fiscal system is centralised. In Pakistan, a higher degree of fiscal centralisation is observed due to a greater share of the federal government in tax autonomy and spending as well as heavy reliance of the federating units on federal transfers.

Fiscal decentralisation increases the competition between subnational governments in the provision of public goods leading to economic growth. In Pakistan, recent research showed how fiscal decentralisation can lead to economic growth by improving the efficiency of subnational governments. This shows how simply giving more revenue-generating responsibilities to subnational governments can lead to such a considerable impact on economic growth. Following such a positive impact on the economy, it is important to explore how a growing economy can progress its public sector efficiency through the process of fiscal decentralization to escape the Leviathan. Proponents of the Leviathan hypothesis (Hobbes) view that national and subnational governments act to maximise their expenditures when they have to draw resources and compete from a common divisible pool, resulting in rent-seeking and inefficiencies.

The research on which this policy brief is based examined the effect of decentralization in this context. A major move towards decentralization in Pakistan was through the 18th Amendment Act in 2010, which included significant changes like the transfer of taxation powers to provinces, increased revenue sharing, increased provincial autonomy, and provincial resource mobilisation.

Since the 18th Amendment, Pakistan has gradually decentralised more fiscal responsibilities to the provincial governments through the introduction of federal and concurrent lists. The paper also examined whether government service delivery has increased as a result of fiscal decentralisation in Pakistan or not. It is argued that Leviathan can be kept in check by effective decentralisation, i.e., delegating spending and revenue generation to the local tiers of the government, which are better informed on spending requirements. The research looked at whether fiscal decentralisation measures have been effective in

achieving this by examining provincial expenditure.

METHODOLOGY

For the analysis, historical data was explored, while the data was collected from secondary sources such as annual reports published by the Ministry of Finance, the Pakistan Bureau of Statistics, and the State Bank of Pakistan. Data on spending at the subnational level was also collected from provincial finance ministries. The period covered was from 2010 to 2022 depending on the availability of data in annual reports of SBP and statistical supplements. Also, federal and provincial government annual accounts for FY22 were used to show the current situation.

Ten variables were classed into three objectives, namely, fiscal federalism and decentralisation, fiscal discipline, and public sector service delivery. The data sources for the above were SBP Annual Reports (various issues), SBP Statistical Supplements (various issues), the Economic Survey of Pakistan (various issues), Pakistan Bureau of Statistics, the Ministry of Planning Development and Special Initiatives, PSDP reports (various issues), and ADP reports (various issues). The outcome was in the form of an analytical analysis using descriptive statistics, graphical illustrations, and comparison bar charts.

FINDINGS

The federal nature of Pakistan's fiscal operations is obvious as there is the heavy reliance of the provincial governments on federal resource transfers, especially tax transfers. The provincial tax collection as a percentage of GDP is minimal, which points to a constrained fiscal capacity at the subnational level. This phenomenon has implications for both fiscal autonomy and effective governance of the provinces. The central government's control over fiscal transfers leads to the centralisation of power and resources, aligning with the Leviathan model's predictions. This limits the effectiveness of fiscal decentralisation in promoting local governance and development.

Fiscal transfers to provinces have increased as a direct result of the new resource-sharing formula under the 18th Amendment. Provinces' expenditure has continued to increase at a rate between 10-20% till FY22 when the Leviathan went unchecked. Provinces' sources of revenue generation have been low.

Provincial and federal governments' expenditures have continued to increase, and provincial governments now account for a bigger size of government as a percentage of GDP. The budget deficit at the federal level is now aligned with fiscal performance at the subnational level with vertical imbalance increasing. Spending on public service delivery, including health and education, has continued to increase.

Revenue generation capacity at the provincial level is limited and draws revenue from one or two major tax sources despite there being a large number of tax heads and over five collection departments. The provincial governments have limited control over revenue sources as the bulk of tax collection is done by the federal government. This dependency restricts their ability to generate sufficient revenue independently.

CONCLUSIONS & KEY POLICY RECOMMENDATIONS

As a direct effect of increased revenue transfers after the 18th Amendment and the updated NFC Award, provincial governments have turned into mini-Leviathans of their own. The vertical imbalance has increased showing evidence of the common pool hypothesis. This also leads us to the conclusion that the budget deficit at the federal level is now aligned with fiscal performance at the subnational level. Policy reforms should be such that they balance the need of the need for central oversight (federal) while empowering provinces to become more self-reliant financially.

The taxation power should be transferred to the provinces with the initial plan of equating taxes collected by provinces to match those that need to be transferred through the NFC award. The federal government can begin with the end in mind by calculating upcoming transfers and, using that magnitude, devise tax policies with the help of provincial governments that enable the provinces to raise tax revenue equating to those that would have

otherwise been transferred through NFC.

The government should enhance the capacity and autonomy of local government bodies, such as municipalities and district governments, to manage their finances. This can be done by providing training, resources, and technical support to local officials.

Addressing challenges requires a multifaceted approach involving policy reforms, capacity building, improved tax administration, and coordination between the federal and provincial governments. Enhancing the revenue generation capacity at the provincial level is crucial for effective fiscal decentralization, as it allows provinces to have greater fiscal autonomy, make informed policy decisions, and provide essential services to their citizens. Some reforms that can be considered to mitigate these issues within the context of fiscal decentralization in Pakistan:

1. **Enhance revenue generation capacities:** Encourage subnational governments to diversify their revenue sources and explore alternative avenues for generating income. This could include improving tax administration and expanding revenue streams such as property taxes, local user fees, and charges for services.

2. **Improve fiscal responsibility and accountability:** Establish clear rules and guidelines for fiscal discipline at the subnational level. Encourage transparency in financial reporting and ensure that local governments adhere to fiscal targets and benchmarks. Strengthen auditing mechanisms to ensure effective utilization of resources.

3. **Incentivise efficiency and performance:** Link revenue transfers to performance indicators and outcomes, such as improved service delivery, infrastructure development, and public welfare. Implement incentive-based mechanisms that reward subnational governments for efficient resource allocation and effective governance.

4. **Capacity building and technical assistance:** Provide training and capacity-building programmes to enhance the fiscal management skills of subnational officials; equip local governments with the tools and knowledge necessary to manage their budgets effectively and make informed financial decisions.

5. **Decentralise service delivery:** Devolve responsibility for service delivery to the level of government closest to citizens' needs; empower local governments to take charge of essential public services, which can lead to more efficient and responsive resource allocation.

6. **Strengthen intergovernmental coordination:** Enhance communication and coordination mechanisms between the central and subnational governments; develop frameworks for consultation and collaboration to ensure that both levels of government work together to optimize resource allocation and prevent duplication of efforts.

7. **Gradual reduction of transfers:** Gradually reduce the dependency on central government transfers as subnational governments build their revenue capacities. This can be achieved through a phased approach that includes a mix of revenue diversification, improved governance, and capacity development.

8. **Promote local economic development: Encourage local governments to foster** economic growth within their jurisdictions by supporting entrepreneurship, attracting investment, and promoting industries that can contribute to revenue generation.

9. **Public awareness and participation:** Raise awareness among citizens about the importance of fiscal responsibility and efficient resource allocation; encourage public participation in the budgeting process to ensure that local priorities are aligned with the allocation of resources.

10. **Regular review and adjustment:** Continuously monitor and evaluate the

effectiveness of fiscal decentralization policies and their impact on dependency and efficiency; Adapt strategies based on lessons learned and changing circumstances.

By implementing a combination of these strategies, Pakistan can work towards reducing subnational governments' dependency on transfers and improving efficiency under the common pool hypothesis. It is important to recognise that these reforms may require a long-term perspective and commitment from both central and subnational governments as well as active engagement from various stakeholders and civil society.

WITHHOLDINGISATION OF TAXATION SYSTEM: BENEFICIAL OR NOT?

Amer Shakeel

INTRODUCTION

Tax is a compulsory payment by the people to the government, which is ultimately used for the common interest and welfare of the public and running the expenses to carry out the governmental functions. Tax is considered the largest financial source for development work like public service, poverty relief, and the establishment of physical and social infrastructure that leads towards the long-term growth of a country. However, for long, many developing countries, like Pakistan, have been facing a great challenge in generating revenues from taxes.

Withholding tax (WHT), also called a retention tax, is an act of deduction or the collection of tax at source, which is generally in the form of an advance tax. Withholding tax is a tax system in which the payer withholds a portion of a payment and remits it directly to the government. Its common example is tax deducted from the salary of an employee by the employer. After the deduction, the employer deposits this tax into the national treasury in the name of the employee. This tax system is used by many countries around the world, including developing countries. WHT has several advantages and disadvantages for governments and taxpayers. The WHT system has the benefit of reducing the cost of tax collection and enhancing the government's cash flow and budgetary management because of the advance collection of taxes.

METHODOLOGY

The required data were collected from the different reports published by the FBR, the Finance Division,

research institutions, and other departments. The additional data, which is not publicly available, was obtained from the FBR. Discussions were also held with tax professionals, taxpayers, and businessmen to identify the effects of the WHT system.

COLLECTION OF INCOME TAX IN PAKISTAN

The following table shows the total income tax collected, income tax collected through the WHT system, income tax paid by the taxpayers with the income tax return, quarterly advance tax (collectively they are called voluntary payments), and income tax paid on demands generated by the FBR officials through assessments and audit.

KEY FINDINGS

Following are the key findings regarding the benefits of the WHT system and its criticism. Recommendations to improve the system of withholding taxation in Pakistan are also given.

BENEFITS OF WITHHOLDING TAXATION SYSTEM

Following are some major benefits associated with the WHT system.

- It is easy to collect income tax through this system because it is collected and deposited in the treasury when transactions are generated. A country like Pakistan has limited

resources and it is difficult to cover every type of income, assess it, and impose the required income tax on it. Thus, the WHT system is very useful.

- For taxpayers, it is easy to pay the required tax conveniently. For example, salaried persons pay the total tax due on their salary through a deduction at source from the monthly salary payment. Through this system, the income tax burden of the taxpayer is spread over the year in easy small instalments.

- The WHT reduces the cost of income tax collection because its collection depends completely on the withholding agents, who collect the tax for specified transactions and deposit the tax to the national treasury. Therefore, no direct collection cost of FBR is involved in this procedure.

- The government gets the money promptly and throughout the year through this system. Because the major portion of the income tax is collected through this system, WHT improves the cash flow management of the government.

- Tax avoidance and evasion are not possible for those transactions covered under the WHT system. Withholding agents are responsible for the collection/deduction of this tax and they cannot avoid it because of the penalties imposed by the income tax law.

CRITICISM OF THE WITHHOLDING TAXATION SYSTEM

There is a strong criticism of the scope and application of the WHT system. Over-reliance on this system always creates problems in the collection of income tax. Here is a summary of some criticisms of this system.

- Pakistan's income tax system is based on progressive tax rates for individuals and AoPs but through this system, the tax is collected/deducted at the same rate irrespective of the taxable income of the taxpayers.

- Sometimes, WHT becomes a reason for undocumented transactions. People prefer to transact in cash to avoid the WHT imposed on these transactions.

Table Amount of Voluntary Tax Payments and Payment on Demand (PKR Million)

Years	Gross Income Tax Collected (A)	Withholding Income Tax (B)	Income Tax Paid with Annual Return (C)	Quarterly Advance Income Tax (D)	Total Voluntary Payments (B+C+D)	Income Tax Paid on Demand by FBR
2011	629,102	357,836	11,852	184,213	553,902	72,182
2012	811,893	420,457	14,968	222,398	657,823	130,054
2013	776,009	436,088	14,770	230,150	681,008	89,427
2014	918,863	571,667	13,761	248,837	834,265	80,582
2015	1,084,472	691,181	17,915	269,693	978,789	115,495
2016	1,242,195	803,116	38,462	302,358	1,143,936	87,884
2017	1,373,697	944,068	45,394	325,112	1,314,574	92,819
2018	1,577,441	1,046,917	131,216	335,791	1,513,924	102,905
2019	1,509,788	960,239	117,830	344,334	1,422,403	102,648
2020	1,570,820	1,091,737	60,674	350,664	1,503,135	60,807
2021	1,802,417	1,237,338	54,091	413,664	1,705,092	80,143
2022	2,269,800	1,534,400	78,534	586,880	2,199,814	101,095

- There are many types of WHTs which are applied to the taxpayers' expenses rather than incomes, for instance, WHT collected on internet services and the purchase and sale of property. If someone is selling the property even at a loss, they have to pay WHT on that transaction. In the case of the purchase of property, it is completely unjustified.

- It increases taxflation in the country. For example, if someone imports an item and pays WHT on it, they add all types of taxes paid on the import to the price of the items and shift its burden to the end consumer.

- WHTs are deducted/collected from the payments but not deposited in the national treasury by withholding agents, which is a common practice in our country. Therefore, sometimes, it becomes an additional source of income for the withholding agents.

- In some cases, it leads to double implementation of income tax on an amount. For example, if someone earns income from dividends or salary, income tax will be deducted from these payments. Afterwards, if they buy a car, they are again required to pay income tax on this transaction.

- WHT collection/deduction in case of loss is also a problem for taxpayers. For example, the tax deducted from the payment for the execution of contracts, the tax is required to be paid even if a loss is incurred on that contract.

- Over-reliance on withholdingisation is a major cause of the narrow tax base in Pakistan. As long as the country achieves revenue targets by simply changing WHT provisions, no sincere efforts will be made by the tax authorities to broaden the tax base.

- The tax administration hides its inefficiency by collecting a major portion of income tax through WHTs. FBR uses WHT collection to measure its performance against the tax targets.

- Due to the continuous increase in WHT rates, existing taxpayers are suffering from extra tax burdens. It has become the practice of the government to increase the rates of indirect taxes and WHTs to attain the tax targets.

KEY POLICY RECOMMENDATIONS

In light of the analysis made by using available data on the WHT system, the following recommendations are made to make it convenient and suitable for the economy and business environment.

- Reliance on the WHTs should be reduced because it is partially an indirect tax in the form of a direct tax. Over-reliance on WHTs affects the collection of income tax. In almost every budget government changes the tax rates of WHTs and indirect taxes to meet the target of tax collection.

- Currently, almost more than eighty types of transactions are included in the WHT regime. This number should be reduced to the top 15 items which contribute almost 95% of the total WHT collection.

- Claiming of the adjustments of WHTs should be based on system-generated figures. For example, income tax deducted from salary is written in the IRIS manually, which should be automatically included by the FBR system on the annual tax return of the individual.

- Because of many problems with the adjustments of WHTs, it is recommended by the tax professionals' bodies that this system should be replaced with the monthly advance tax system for the listed companies.

- No sincere efforts have been made by the FBR to include more persons in the tax net. New taxpayers should be brought into the net through the use of NADRA databases, data analytics, and digitalisation. In Pakistan, according to different estimates, the tax gap is about 70% of the actual tax receipt. Its basic reason is reliance on indirect taxes and WHTs and the absence of fruitful efforts for broadening the tax net.

- There are many items that are actually expenses of the consumers not incomes like the purchase of motor vehicles, cash withdrawals from banks, and cellular and internet services. All these items should be eliminated from the list of WHTs.

- Through this system, the FBR has obtained huge data on the persons who are non-filers but spend money on valuable purchases like property, motor vehicles, and international air tickets. But still, the FBR is unable to include these persons in the tax net.

CONCLUSION

Higher dependence on the WHT depicts the failure of the tax collection system. The study suggests that the dependence on the WHT system for the collection of income tax needs to be reduced. There are many other problems associated with the WHT regime that cause short collection and deposit of WHTs.

The WHT regime from the current taxation system cannot be eliminated as it will create problems in tax collection because still major portion of Pakistan's economy is undocumented and out of the tax net. In every budget, only changes are announced in WHTs and normal tax rates to increase the income tax collection. This practice should be avoided and strict steps should be taken to add more people to the tax net. Similar to the practices in many other countries, a few items like salaries, profit on debt, and dividends and royalties should only be included in the list of the WHT regime.

It is not possible to implement reforms in the WHT regime and the overall taxation system without strong institutional reforms in the FBR. According to professionals, its only solution is to establish a National Tax Authority (NTA) to deal with all types of taxes in Pakistan. This is the only solution to the revenue problems of Pakistan and moving towards a just and equitable taxation system.

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