

***Nurturing Minds***  
***A Weekly Seminar Series to give impetus to development  
discourse and stimulate intellectual thought***

**PAKISTAN INSTITUTE OF DEVELOPMENT  
ECONOMICS**



**Topic: “Pass-through of Change in Policy Interest Rate to  
Market Rates”**

**M. Idrees Khawaja and Sajawal Khan**

This paper examines the pass through of the change in policy interest rate of the central bank of Pakistan to market interest rates. The market rates examined include KIBOR, six month deposit rate and weighted average lending rate. More or less complete pass-through of the change in policy rate to KIBOR is observed within one month. However the magnitude of change in policy rate to deposit and lending rate is not only low but is slow as well. The pass-through to the weighted average lending rate is 47 percent and occurs with a lag of one to one and half year. The pass through to the deposit rate is only 16 percent and occurs with a lag of one year. The asymmetry between the magnitude of pass-through to lending and deposit rates has served to increase the interest margin of the banks. The slow pass-through to the lending and deposit rate put limits on the effectiveness of interest rate as a policy tool. The pass-through, and hence the effectiveness of monetary policy will increase if all the lending and deposit rates are floating in nature and are quoted as KIBOR-plus and KIBOR-minus respectively.

**Date: August 05, 2009  
Wednesday**

**Time: 11:00 am**

**Location Details**  
**Dr. A. R. Kemal Conference  
Room**  
**Pakistan Institute of  
Development Economics**  
**Quaid-e-Azam University  
Campus**  
**Islamabad.**  
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**About the Speakers...**

Idrees Khawaja graduated from PIDE with a Ph.D. in Monetary Economics. He is currently employed at PIDE. Besides monetary Economics he has also published on topics like Growth, Civil Service and institutional reforms.

Sajawal Khan graduated from PIDE with Ph.D. in monetary Economics. He is currently employed with the State Bank of Pakistan. Besides monetary economics he has published on topics like microeconomic modeling, efficiency of banks and Foreign Direct investment

**Your active participation will make this effort a turning point in  
the importance of intellectual contribution to our development  
processes!**



*In the Name of Allah, the Most Beneficent, the Most Merciful*



# **TWENTY-FIVE YEARS OF TAX REFORMS IN PAKISTAN**

**By**

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**FEBRUARY 2009**

# **Five Key Questions**

- Was there any pressure for tax reforms?**
- What was the process of tax reforms?**
- What Happened? How was the structure of tax system changed?**
- What impact did the reform have on the goals of revenue adequacy, economic efficiency, equity, and capacity to effectively administer the new tax laws? and**
- What general lessons can be distilled from country's tax reform experience.**

**[Tax reforms in Developing Countries  
by Prof Wayne Thirsk (1997)]**



# **Intellectual Foundations of Tax Reforms**

- **Tax Reform Process needs to be analyzed within the normative framework of Optimal Theory of Taxation [Newbery and Stern (1987)];**
  - **For any revenue objective, the optimal tax reform strives to maximize an explicit SWF that balances vertical equity gains against tax-induced losses in the efficiency of resource allocation;**
  - **In other words a pattern of tax rates on different tax bases that minimizes the efficiency cost of taxation;**
  - **Non-uniform taxation to ensure equity and efficiency objectives – higher tax rates on commodities and resources that have inelastic supply or demand and vice versa.**

# **Inadequate Resource Mobilization**

## **The Pressure for Tax Reform**

- **The resources generated through tax and non-tax sources are insufficient to meet growing expenditure needs;**
- **The performance of international trade sector to provide support for fiscal imbalances is generally weak – continuous trade and current account deficit;**
- **Reliance on external sources of finance (either bilateral or multilateral) exposes the economy to additional risks and increases its vulnerability.**



# **Inadequate Resource Mobilization**

## **Some of the Reasons**

- **Modest Tax Effort – Stagnant and low Tax/GDP Ratio** – developed economies have tax/GDP ratios in the range of 30% to 40%, developing economies in the range of 15% to 25%, and less developed economies below 15%;
- **The Performance of sub-national governments is less than satisfactory;**
- **Fuel surcharges as a source of revenue – big question mark;**
- **Complexity of Tax Laws, Rules and Procedures makes it difficult for the taxpayers to exactly know their tax obligations;**
- **Domination of international trade and production related taxes curbing investment and economic activity – reducing the multiplier and accelerator effects;**

(continued)

# **Inadequate Resource Mobilization**

## **Some of the Reasons**

- **Reliance on Indirect Taxes leading to regressive tax system and excess burden on final consumers;**
- **Narrow tax base due to exemptions and concessions;**
- **High tax rates and other distortions enticing tax evasion and tax avoidance;**
- **Primitive and antiquated tax administration – persisting with manual record keeping with limited IT support ;**
- **No scientific approach to handle tax matters – until recently virtually no research on critical areas such as tax incidence, enterprise taxation, tax-gap on sectoral basis etc.; and**
- **No respect for the taxpayers.**



# **Tax Policy & Administration**

## **(Prior to Reforms)**

- Major emphasis of tax policy during 1970s and most of 1980s was on increasing tax rates;
- Tax was levied on 'easy to tax' areas – for example at production stage (excise) and at import stage (customs);
- High protective barriers through tariff and para-tariffs (infant industry argument);
- Seriously Regressive Sales Tax Structure;
- Extremely high corporate rates – discrimination between different types of corporations.
- Complexity of Laws & Procedures and arbitrariness in their application; Manual record keeping; Complete assessment and examination; Cylindrical tax administration setup.

# **Winds of Change**

- **Somewhere in 1980s there was a realization that the tax system needs restructuring and reforms. Since then, different Task Forces and Research Groups were constituted and their contribution has resulted into following valuable studies/reports:**
  - **Report by the National Taxation Reform Commission (1986);**
  - **Report by the Resource Mobilization and Tax Reforms Commission (1994);**
  - **Report on Income Tax Reforms (2001);**
  - **Several Reports by the Task Force on Reform of Tax Administration (2001);**
  - **Strategy and Priorities for Tax and Customs Administration Reform (2001)**
  - **The Strategy Document on Tax Reform (2001)**
  - **Pakistan: A Preliminary Assessment of the Federal Tax System (2006) and**
  - **Tax Policy in Pakistan: An Assessment of Major Taxes and Options for Reform (2008)**



# What did they Say?

- **Report by the National Taxation Reform Commission (1986);**
  - **‘The rates of direct taxes too high, tax laws complicated and procedures inconvenient for the taxpayers, harassment of taxpayers by the tax collectors quite common, complaints of corruption against tax collectors in abundance, the bulk of indirect taxes derived from the lower middle income groups, lack of public confidence in the system, customs tariff excessively biased towards revenue, rates of custom duty high leading to mis-declaration and smuggling’**

# **What did they Say?**

- **Report by the Resource Mobilization and Tax Reforms Commission (1994);**
  - **‘The rates of taxes too high, withholding tax rates need rationalization, too many pending appeals and huge burden of litigation, orders are harsh and arbitrary, lack of transparency, no incentive for record keeping, tax education program not working, no research and policy planning, too many exemptions and narrow sales tax base’**



# What did they Say?

- **Report on Income Tax Reforms (2001);**
  - **Purpose: To revise income tax law and move the system in the direction of uniformity of tax treatment, reducing dependence on withholding taxes, reviewing the appellate hierarchy and consolidating, simplifying and redrafting the statute.**
  - **Corner stones of new policy: universal self-assessment, no immunity from audit, efficient audit arrangement, and documentation.**
  - **Wide-ranging recommendations on rate structure, threshold, K-Gains tax, WHT, VC under self-assessment, minimizing tax exemptions, grievance redressal system, and compulsory record keeping.**

# What did they Say?

- **Task Force on Tax Administration (2001);**The report has five volumes and covers finer details of the system to offer new insight for undertaking comprehensive reforms. **Briefly the report recommended that:**
  - The Organizational Structure of CBR and its field offices need fundamental changes, especially it encouraged creating separate slots for Member (Audit) and Member (Legal) within CBR,
  - There should be an improvement in the design of human resource management system, revision is desired in recruitment, training, compensation, evaluation and promotion system and salaries to aligned with market rates
  - There should be maximum autonomy to the tax administration,
  - Internal Audit Divisions be setup at Collectorates,
  - Regional Collectors be established, and
  - Taxpayers Assistance Units be setup to streamline the contact between taxpayers and tax officials.
  - The annual revenue targets should be realistic,
  - The report also required automation of the system to ensure quick data retrieval and use.



# **Tax Policy & Administration (The Process of Reforms)**

- Reduced tax rates to minimize tax evasion and allow market forces to work;**
- Switch from tax on 'production and investment' to tax on 'consumption and income' – for example GST in VAT mode and reduced reliance on excise duties;**
- Substantial rationalization and reduction of tariff and complete elimination of para-tariffs (reduction in anti-export bias);**
- Gradual reduction in corporate rates to make investment internationally competitive.**
- Undertake wide-ranging reforms related to tax administration and system and procedures**

# **Finer Details Related to Reforms**

## **Three Areas**

- 1. Tax Policy Reforms**
- 2. Tax Administration Reforms**
- 3. Reforms in Systems &  
Procedures**



# **Tax Policy Reforms**

**related to**

**tax rates and basic threshold level**

- Transition from ST to GST**
  - Zero-rating concept and Multiple Rate Structure
- Decision to Rationalize and Reduce Tariff**
  - Bound and Applied Tariff Structure -- consistency with WTO
  - Resolving Issue of Tariff Peaks and Escalation
- Decision to reduce reliance on Excise Duties**
  - Nevertheless, GST on Services in FED Mode
- Change the composition of Direct Taxes – rate reduction and broadening of base**
  - Change in Advance Tax Regime
- Too quick and too much – fairly high cost (incomplete tax substitutibility)**

# **CHANGES IN INCOME TAX REGIME**

- **Tax-free Basic Threshold increased from**
  - **Rs. 40,000 – Rs. 50,000 in 1996-97**
  - **Rs. 50,000 – Rs. 60,000 in 2001-02**
  - **Rs. 60,000 – Rs. 80,000 in 2002-03**
  - **Rs. 80,000 – Rs. 100,000 in 2003-04**
  - **For salaried persons, it was further raised to Rs. 150,000 in 2006-07.**
  - **PCY in 99-00 Rs. 27,471, increased to Rs. 66,548 in 07-08**
- **Introduction of small company concept with low rate of 20% in FY 2005-06**
- **Special tax rates for salary and non salary taxpayers since 2006-07.**



# **DOWNWARD REVISION IN CORPORATE RATE STRUCTURE (BANKING, PUBLIC AND PRIVATE COMPANIES)**

Assessment Year	Banking Company (%)	Public Company (%)	Private Company (%)
1992-93	66	44	55
2002-03	50	35	45
2003-04	47	35	43
2004-05	44	35	41
2005-06	41	35	39
2006-07	38	35	37
2007-08	35	35	35

# Historical Development of Sales Tax (GST) Standard Rate Structure

Year	Rates
90-91 –1994-95	12.5%
1995-96	18%
1996-97	18% and 12.5%
1997-98	18%
1998-99	12.5% and 15%
1999-2001	15%
2001-2003	15% and 20% on some items Plus 3% further tax
2004-05 onwards	15% rate adopted and concept of zero-rating introduced starting with ginned cotton and extending to export related industries
2007-08	Higher rates of 17.5% and 20% introduced for selected commodities
2008-09	<b>POLICY REVERSAL:</b> Rate Increased to 16%



# **TARIFF REDUCTION**

## **MAXIMUM STATUTORY RATES AND EFFECTIVE RATES OF CUSTOMS DUTIES**

<b>FY</b>	<b>Maximum Statutory Rates</b>	<b>Effective Rate wrt Dutiable Imports</b>	<b>Effective Rate wrt Total Imports</b>
1993-94	80	38	25
1994-95	70	36	24
1995-96	65	33	22
1996-97	65	24	19
1997-98	45	22	17
1998-99	45	18	14
1999-00	35	18	12
2000-01	35	17	10
2001-02	30	12	8
2002-03	25	16	10
2003-04	25	14	10
2004-05	25	13	9
2005-06	25	13	8
2006-07	25	12	7

**POLICY REVERSAL: For many items rate increased to 35% in 2008-09 and the number of slabs increased to many from four.**





# **Reforms Related to Tax Administration & Procedures**

- **In an effort to improve efficiency of workforce, the reforms in the area of tax administration took the following shape:**
  - **Transformation of FBR and Field Offices on Functional Lines and Reorganization field offices into two streams dealing with internal and international trade taxes**
  - **Simplification of Laws, Procedures, and Return Forms**
  - **Implementation of Self-assessment Scheme**
  - **Alternate Dispute Resolution System and Reduction in the Litigation Burden**
  - **Automation of Business Processes**
  - **HR Initiatives**

# **OUTCOME OF REFORMS**



# Impact Analysis?

- **It is rather easy to find out what happened and why but not easy to evaluate the success or merit of a particular tax reform episode. Many reasons for that:**
  - **Success or failure has to be judged on the basis of trade-offs made between competing objectives (equity vs efficiency or administrative simplicity vs fairness)**
  - **Lack of precision in measuring the impact of reforms (partial equilibrium vs general equilibrium analysis on the basis of available data)**
  - **More than one approaches to measuring tax incidence and the efficiency benefits**

# **Escalation in Revenue Receipts**

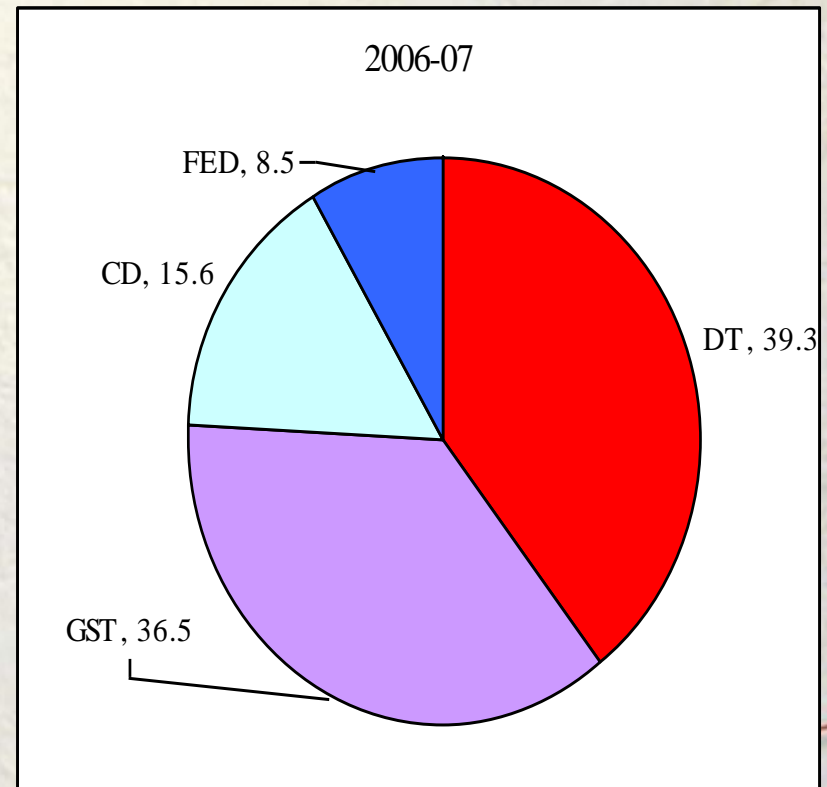
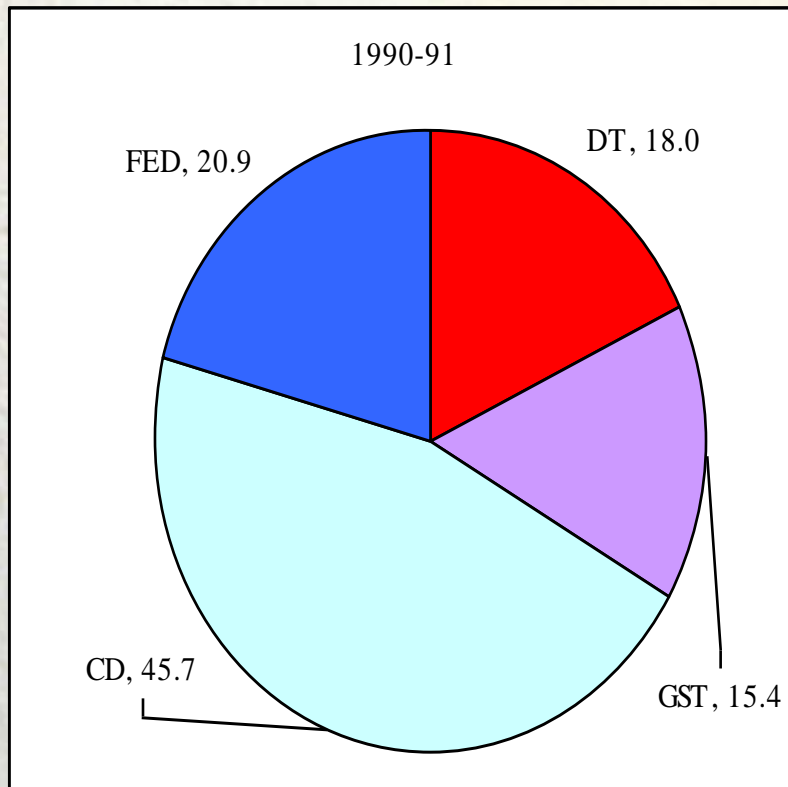
## **(Easier Part)**

- In the legacy system it took CBR forty two years to collect the first **Rs. 100 billion** (1947-48 to 1989-90);
- Within next five years, this amount was doubled and crossed **Rs. 200 billion** in 1994-95;
- Another seven years, the collection crossed **Rs. 400 billion** in 2001-02;
- Further five years and the collection crossed **Rs. 800 billion** mark in 2006-07; and
- FBR crossed the historic **one trillion** rupees mark in 2007-08.
- **Concern about absolute vs Relative Increase.**

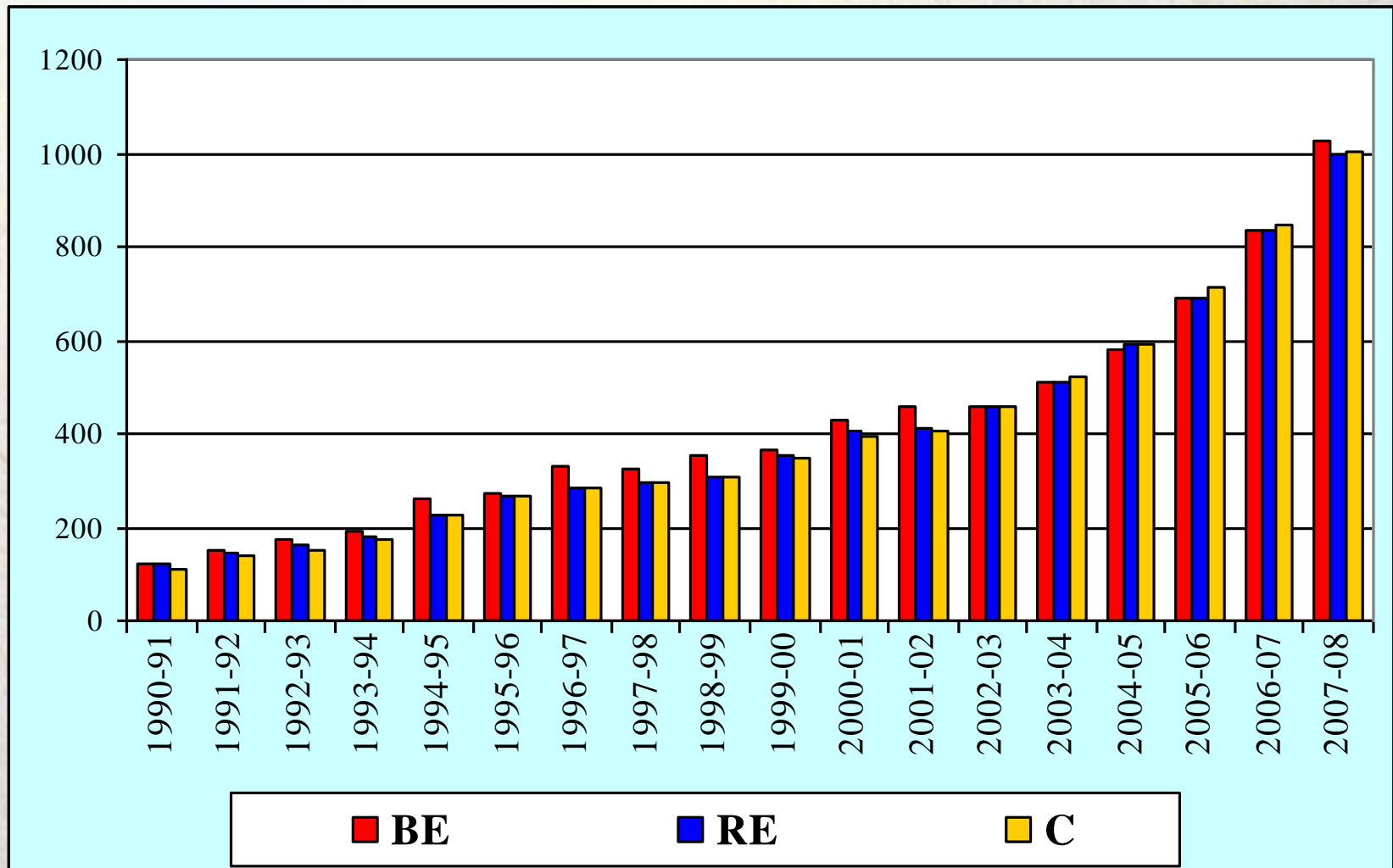


# Tax Structure of Pakistan:

Significant Change in the Tax Mix during 1990-91 & 2006-07; not only between direct and indirect taxes but also within indirect taxes



# Recent Performance of FBR



**Legend => BE: Budget Estimate; RE: Revised Estimate; C: Collection**



# Recent Evaluation

- **The efficiency costs of tax system to the economy continue to be high – METRs vary drastically between sectors;**
- **Frequent changes in tax legislation have made the overall tax structure incoherent and tax base narrow – tax reforms piecemeal disconnected no mechanism of ex ante evaluation of tax policy changes;**
- **Significant horizontal inequities – similar income receives dissimilar tax treatment, issue further complicated by shoddy enforcement – compliant taxpayers bear the maximum burden, non-compliant taxpayers go scot-free;**
- **Tax system remains overly complex due to preferential treatment, exemptions, and ad hoc changes in tax structure;**
- **Tax administration remains weak – tax reliance on easy to tax handles rather than innovative thinking and application.**

# CHALLENGES AND CONSTRAINTS

- **The major challenges are:**
  - 1. Ownership (or lack of it) of REFORMS**
  - 2. Policy Reversals – inconsistency of policies**
  - 3. Lack of political will to address the issue of low Tax/GDP Ratio in relation to comparable economies;**
    - **Mismatch between Sectoral Contribution in GDP and Taxes;**
    - **Low Contribution of Sub-national Governments**
  - 4. Low Level of Compliance;**
    - **Deliberate inaction to understand tax base**
  - 5. Large Underground and Informal Economy; and**
  - 6. Absence of Tax Culture.**



# Tax/GDP Ratio

FY	Total Revenue	Tax Revenue	Federal Taxes*	FBR Revenue	Sur-charges	Provincial Taxes
1999-00	13.4	10.6	10.1	9.1	1.0	0.5
2000-01	13.2	10.5	10.1	9.3	0.7	0.5
2001-02	14.0	10.8	10.3	9.1	1.2	0.4
2002-03	14.8	11.4	11.0	9.4	1.4	0.4
2003-04	15.1	11.9	11.4	9.2	1.1	0.5
2004-05	14.3	10.6	10.1	9.1	0.4	0.5
2005-06	14.9	11.3	10.9	9.4	0.7	0.5
2006-07	15.6	10.9	10.5	9.7	0.7	0.4
2007-08	15.3	10.6	10.1	9.6	0.5	0.5

*\* Also includes collection on account of Foreign Travel Tax, Airport tax and other minor federal levies*

# **Narrow Tax Base:**

## **Sectoral Contribution in terms of Net Indirect Taxes**

- **Nearly 80%** of all indirect (net) taxes originate from **only eighteen commodities** and close to **70%** from **ten commodities**;
- **About 50%** of all indirect taxes during FY 07-08 generated by **five commodities**, namely **POL, Telecom, Automobiles, Edible Oil, and Cigarettes and Tobacco**;
- **POL including LPG** has the highest contribution – nearly a quarter of all tax receipts;
- The **Telecom** sector is the second largest contributor with close to **8%** share in indirect taxes;
- **Cement** industry paid **1.9%** of indirect taxes;
- The contribution of **Sugar industry** during Current fiscal year was only **1.7%**; and
- The share of **Textile Sector** was close to is **1%** in gross terms but **negative** in net terms.



# **Narrow Tax Base:**

## **Sectoral Contribution in terms of Direct Taxes**

- **The direct tax contribution of major sectors is also fairly skewed;**
- **On the whole, Oil & Gas, Banks, and Telecom are the leading contributors to direct tax collection;**
- **The share of oil and gas sector till February 2008 was close to 19%, followed by financial sector contribution of 16.2% and telecom 7.2%;**
- **Within Manufacturing Sector, the contribution of leading sectors is as follows:**
  - **Fertilizer 1.8%; Misc. Manufacturing 1.7%; Textile 1.5%, Cooking Oil and Ghee 1%; Pharmaceuticals 1% etc;**
  - **The contribution of sugar and cement industries is 0.1% each!**
- **Within services sector, after banks, commerce and trade, construction, and transportation sub-sectors have contributed towards direct taxes. All other services have negligible contribution.**

# Level of Compliance Income & Corporate Tax

- **Overall Position**

- **NTN Holders:** 2.75 million
- **NADRA Verified NTN Cases:** 2.16 million
- **Returns Processed:** 1.75 million
- **Share of Processed to Verified Cases:** 81%

- **Corporate Position**

- |                                       | <b>2006</b> | <b>2007</b> |
|---------------------------------------|-------------|-------------|
| • <b>Verified NTN Cases:</b>          | 32,742      | 37,189      |
| • <b>Returns Filed and Processed:</b> | 14,006      | 16,444      |
| • <b>Compliance:</b>                  | 42.8%       | 44.2%       |



# Analysis of Corporate Cases

- **Of 14,006 cases of TY 2006, those showing**
  - **Business Income\*:** 4,763 (34%)
  - **Business Losses:** 3,354 (24%)
  - **NIL Income:** 5,889 (42%)
  
- **Of 16,444 cases of TY 2007, those showing**
  - **Business Income:** 4,395 (26.7%)
  - **Business Losses:** 2,571 (15.6%)
  - **NIL income:** 9,478 (57.6%)

***\* Income means Taxable Income***

# **Corporate Returns for TY 2006 & TY 2007:**

## **Trends in Business Income**

- **Of 4763 & 4395 corporations declaring taxable income in 2006 & 2007\***, respectively
  - **1098 (23%); 768 (17.5%)** declared income of up to Rs. 100,000 only – i.e., monthly income of up to Rs. 8,333 only!!!!!!
  - **1193 (25%); 1309 (29.6%)** declared income within the range of Rs. 100,000 and Rs. 500,000;
  - **1968 (41%); 1778 (40.5%)** have shown business income of above One million;

***\* These include e-Portal and Banxis Returns***

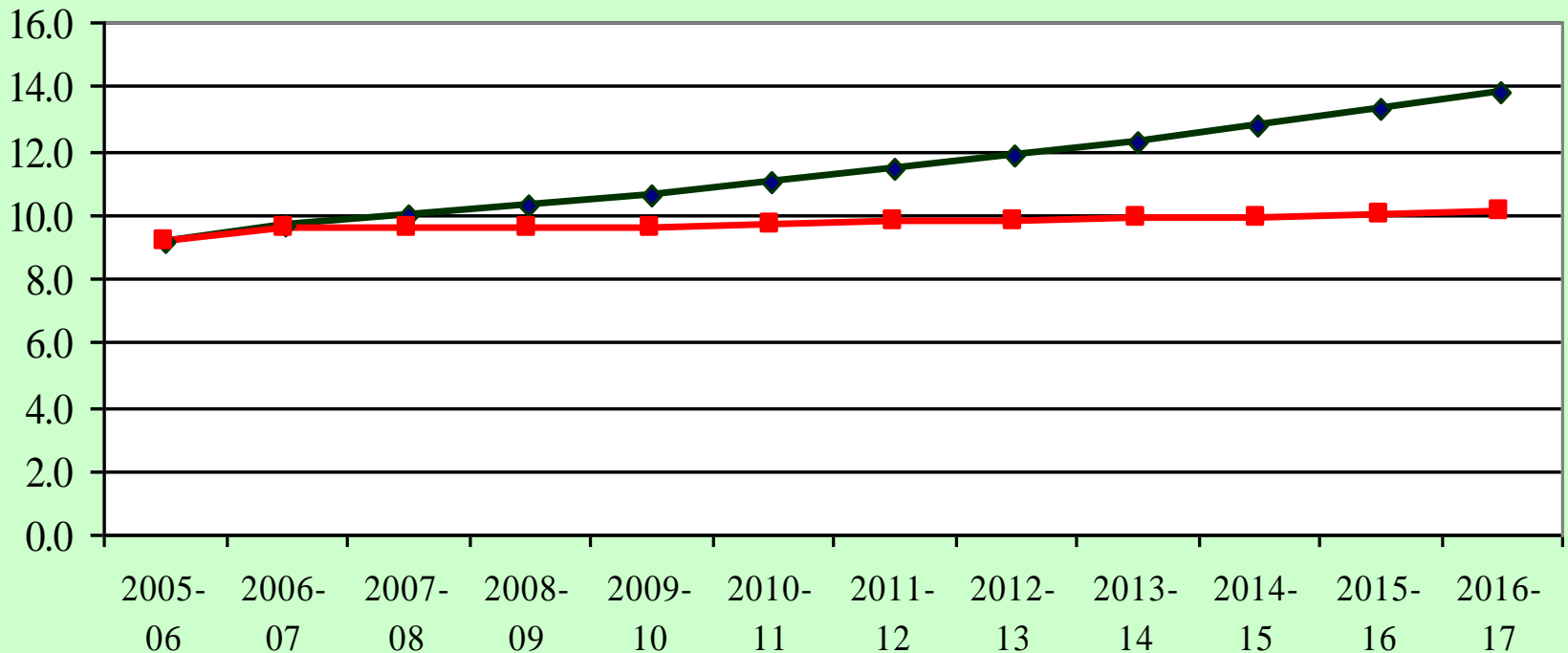


# **What Needs to be Done?**

- **The Tax/GDP ratio has to improve by at least 5 percentage points within next ten years to be among competing countries; Specifically, the overall Tax/GDP ratio has to increase from 10% to 15%, and Total Revenue to GDP ratio from 14% to 19%.**

# GAP Between Status Quo and Alternative Scenarios

Tax/GDP Ratio under Alternative Scenarios



◆ Tax/ GDP Ratio under AS ■ Tax/GDP under SQ



# **Policy Prescription for 5% Increase!**

- **Within the taxation system, the weaknesses in the two future taxes, namely income and corporate and GST, especially low level of compliance and narrowness of base, will have to be addressed through tax-gap analyses and microsimulation models;**
- **Tax Policy reforms to emerge from further research on enterprise taxation and tax incidence;**
- **(continued)**

# **Policy Prescription for 5% Increase!**

- **Efficiency gains have to be ensured through frequent perception surveys and comprehensive list of Key Performance Indicators (KPIs);**
- **Loopholes in the system will have to be plugged thru automation and other Administrative/ Legislative Steps; and finally,**
- **Base expansion thru withdrawal of exemptions and minimization of the SRO culture**
- **Of course there are many other options – but only if there is motivation for investigative research and political will to implement it.**



**THANK YOU  
and God Bless**

**February 2009**