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Looking at Pakistani Presumptive Income Tax through principles of a good tax?

Najeeb Memon*

Abstract

This paper concerns the use of an appropriate Presumptive Income Tax (PIT) regime for informal economies. Regular income tax due to high bookkeeping costs stimulates activities in the informal economy. Consequently, many developing countries rely on PIT regimes. However, the adequacy of the current PIT regimes to tackle informal economies has received little attention from researchers particularly in terms of the principles of a good tax system. This paper analyses the PIT regime of Pakistan, one of the largest informal economies in Asia, for its adequacy in this regard. The findings reveal that being a turnover based PIT design, Pakistani PIT is technically complex and imposes high compliance costs on small business. The Pakistani PIT also does not adhere well with the efficiency and equity principles because it does not secure neutral tax treatment for all types of business sectors. The findings of inadequacy of the Pakistani PIT are also reflected in the stagnant

income tax. Presumptive Income Tax (PIT) regimes are now integral components of tax systems of many Eastern European, Asian, African and Latin American countries.[6]

This tax policy shift is due to PIT's merits of simplicity[7] and efficiency which helps tax compliance by taxpayers.[8] For its simplicity a PIT is easy to enforce, hence, is also a solution to the weak tax administration of these countries.[9] However, whether the PIT regimes used in the developing countries have all these virtues is yet an un explored area. Despite widespread use of PITs in many developing countries such as indicator based PIT in transitional European countries and asset based PIT in Latin American countries to tackle the informal sector, little research has been undertaken to assess existing PIT regimes for tackling the informal economy.

This paper analyses the PIT regime of Pakistan, one of the large informal economies in Asia, for its adequacy to control an informal economy. After reviewing the causes of the informal economy in general and in the context of Pakistan, the design of

2. INFORMAL ECONOMY

Despite considerable research on the informal economy, the subject is still controversial particularly regarding its definition and estimation procedures.[11] Generally, the informal economy is defined as "those economic activities and the

However, despite the above theoretical merits of PIT, there is no conclusive evidence that a PIT can largely tackle informal sectors in developing countries. In Ukraine for example, contradictory findings are recorded for changes in the informal economy in the period after the imposition of a PIT.[34] In Eastern European countries, the lack of stability, transparency and focus and unjustified generosity of the PIT regimes is blamed for their failure.[35]

3. INFORMAL ECONOMY IN PAKISTAN AND THE USE OF PIT

Pakistan is one of the emerging economies of the world. In recent years, the major contribution to its economy has come from the services sector.[36] However, most businesses in the service sector are small in size and these operate in the informal sector. This is reflected in the large share of the informal economy in the country's GDP. The size of the informal sector in Pakistan is estimated at 39.5%.[37]

The services sector or more simply, the informal sector in Pakistan, is dominated by small business. More specifically the service sector contributes 53.3 % to GDP through 2.65 million enterprises[38] which are SMEs.[39] According to the Economic Census of Establishment Pakistan, these entities constitute 80% of the total enterprises in Pakistan (i.e. 3.2 million).[40] The capital investment on average in the SME sector is less than 1 million rupees (A$15,385).[41] For this reason it is stated that Pakistan's economy is an economy of SMEs.[42]

The specific reasons why small business in Pakistan operates in the informal sector are the same as in other parts of world as discussed in the preceding section of this paper. Broadly, taxation is identified as the main constraint in the SME growth.[43] Sixty seven percent of the enterprises surveyed have stated that the tax regulations as most problematic.[44] Pakistan ranks at 140th on the ease of paying taxes.[45]

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[34] Thieben Ulrich, 'The Impact of Fiscal Policy and Deregulation on Shadow Economies in Transition Countries: The Case of Ukraine' (2001) 114: Public Choice, 308.

[35] See Engelschalk, above n 15-17.

[36] 'Trade in Services: An Answer Book for Small and Medium Sized Exporters' ITC/P216.E/TSS/BAS/07-VIII Trade Secrets Series, International Trade Centre UNCTAD/WTO/Small & Medium Enterprise Development Authority (SMEDA) Pakistan, 2007, 143 <http://www.smeda.org/downloads/TradeinServices-Pakistan.pdf> at 8 July 2009.

[37] Friedrich Schneider, Shadow Economies and Corruption All over the World: New Estimates for 145 Countries (2007), Economics 2007-9, 17 (The Open Access, Open Assessment E-Journal) <www.economics-ejournal.org/economics/ journal articles> at 16 November, 2008.

[38] Pakistan, 'Economic Survey of Pakistan 2006-07' Government of Pakistan, 60 <http://www.accountancy.com.pk/docs/economic-survey-of-pakistan-2006-07.pdf> at 12 March 2008.

[39] Economic Census of Establishment of Pakistan (2005) Federal Bureau of Statistics of Pakistan.

[40] Economic Survey, above n 38.

[41] Shahab Khawaja 'Unleashing the Potential of SME Sector with a Focus on Productivity Improvements' presented at Pakistan development Forum – 2006, 2 <www.smeda.org.pk> at 7 April 2009.

[42] 'Developing SME Policy in Pakistan' SME Issues Paper – For Deliberation by SME Task Force' Policy Planning and Development Department, SMEDA, 2006, 1 < www.smeda.gov.pk> at 4 April 2009.

[43] Khawaja, above n 41, 5.

[44] SME Task Force Report, above n 42, 7.

[45] Usman Khan, 'Assessment of the Provincial Legal and Policy Framework Related to Private Sector Development' Final Report of the Economic Advisor, Commerce and In-6(an)-11(0(n-6(an)1n(c)11(e)11(a)-2(nd

Tax related costs are relatively more serious for small business because of its order to help small businesses in the retail, restaurant and hotel sector.[54] In light of these recommendations, a PIT regime was introduced in Pakistan.

4. PRINCIPLES OF A GOOD TAX SYSTEM

Earlier literature on the principles of a good tax system in general and in the context of methodology used by Taylor[63] rather than from the linguistic perspective. In the referred study Taylor had evaluated a possible impact of reducing complexity in the tax code on minimizing the tax compliance costs. Taylor examined the legal complexity of Australian income tax law in terms of redundancy, superfluousness, grouping according to rational scheme, frequency of changes and ambiguity in interpretation of provisions of the law. In the next stage, the Pakistani PIT is qualitatively analysed for operational complexity with reference to the administrative and compliance costs. This qualitative analysis is based on the size of the tax return, the computation details, bookkeeping requirements, documentary requirements, audits and costs related to appellate procedures.

4.2 How to Determine Efficiency in a Tax System

The efficiency of a tax system is mainly assessed from its substitution effect (known as dead weight loss) and its neutrality in tax impact. Despite the clarity of the concept of deadweight loss[64], it is widely acknowledged that it is hard to measure quantitatively the impact of any taxation in terms of the deadweight loss or even in terms of 'the quantum of the substitution effect'.[65] The Meade report mentions this limitation in the following terms:

> 'It is not possible to take into account all the indirect effects of given tax arrangements on economic efficiency'[66]

A qualitative evaluation is also difficult in terms of the substitution and deadweight loss, because, the behaviour of all the actors of economy is quite unpredictable. On the other hand, it is equally hard to make quantitative estimates of the level of the neutrality in a tax system particularly in view of its many facets such as neutrality in tax treatment of various sectors, of various classes of income and of risk exposures.

In view of the above limitations for assessing efficiency, it is suggested that a

5.1.4 Widespread WHT Regime

Besides the above withholding taxes, which fall within ambit of the PIT regime, small business is also liable to WHT in respect of the following activities under various sections of the Income Tax Ordinance, 2001

6. ANALYSIS OF THE PAKISTANI PIT

The Pakistani PIT is analysed against the principles of simplicity, equity and efficiency as follows. Despite describing the Pakistani PIT in section 5, for better comprehension, a reader is advised to have the ITO 2001[82] available alongside due to numerous referencing to bare legislation in this analysis. Nevertheless, most important PIT provisions are annexed to this paper for quick reference. At the end of this section, the results of the analysis are compared to the well known performance benchmarks of a tax system such as taxpayer base and revenue collection.

6.1 The Pakistani PIT and Simplicity

In the first stage, consistent with section 4, simplicity in the Pakistani PIT is analysed qualitatively for the facets of clarity, certainty, consistency, stability and flexibility. This legal analysis, which pertains to the technical complexity of the regime, is conducted in the pattern adopted by Taylor.[83] In the next stage, the operational complexity of the Pakistani regime is analysed qualitatively for compliance costs such as bookkeeping, documentary requirements and details of computation. At this stage, the enforcement costs are also analysed qualitatively

6.1.1

are ten different activities which are subjected to WHT based final tax regimes. All the remaining withheld taxes are allowed as a credit against a taxpayer's assessed income tax liability.

A small business is influenced by most WHT provisions, because it usually has parts of different ac

Reserve[86] to issue an exemption to any taxpayer in respect of all or any WHT. More simply, when the blanket power is given to the Board through one provision, there is no need for this separate provision. Such duplication should be avoided to ensure the legislation is concise thus reducing the time needed to comply with it. Thus, s 148(2) should be omitted.

(iii) The scope of 'contract' in s 153(1) is limited as follows:

> "(1) Every prescribed person making a payment in full or part including a payment by way of advance to a resident person or permanent establishment in Pakistan of a non-resident person-
>
> (a) for the sale of goods;
>
> (b) for the rendering of or providing of services;
>
> (c) on the execution of a contract, other than a contract for the [sale] of goods or the rendering of [or providing of] services,
>
> shall, at the time of making the payment, deduct tax from the gross amount payable at the rate specified in Division III of Part III of the First Schedule"

Examination of the scope of contract, as laid out above, shows that the section contains some superfluous words. The use of the words "other than a contract for the sale of goods or the rendering of [or providing of] services" does not bring any clarity to the concept of the 'contract' in general and the contents of the term 'contract' in particular. It may be because every contract involves some kind of services and/or sale of goods. More simply, it is hard to determine when a supply of goods and rendering of services is an execution of the contract; or when a supply of goods and rendering of services is not an execution of a contract. These terms such as 'execution of contract' are artificial and have no commercial distinction on many occasions and therefore adds to ambiguity and uncertainty.

These ambiguities have led to tax litigation and conflicting judgements by the courts. In the case of Assessee v Department[87], receipts of a cricketer from a contract with the Pakistan Cricket Board were taxed under the normal income tax regime as service receipts by the assessing officer. In that case, Mr. Jawaid Masood Tahir Bhatti, Judicial Member of the Income Tax Appellate Tribunal of Pakistan (ITAT), held that these are contract receipts.

On the other hand, the recent decision of the Sindh High Court in the case of M/S Premier Mercantile Services v CIT Karachi[88] says that anything not covered under 'supplies' and 'sale of goods' as per the definition in the ITO 2001 are contract receipts. The relevant clauses of s.153(9), which set out scope of contracts by excludng 'services' and 'sale of goods' are reproduced below:

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[86] Federal Board of Revenue: the income tax authority under Income Tax Ordinance 2001 (Pakistan) s 207.

[87] ITA No. 1850/KB to 1852/KB of 2002 (2004 PTD 2749) decided on 24th May, 2004. The matter was decided in the favour of the cricketer that such receipts are contractual in nature and fall within the

> "services" includes the services of accountants, architects, dentists, doctor, engineers, interior decorators and lawyers, otherwise than as an employee.
>
> "sale of goods" includes a sale of goods for cash or on credit, whether under written contract or not.

In this case stevedoring services of the taxpayer were taxed by the revenue department under the normal income tax regime as services, which fall outside the ambit of the PIT. The court by agreeing with the taxpayer held that service receipts which are not covered within the definition of 'services' as envisaged in subsection (9), shall fall within the ambit of "contract", if these are performed under the contract.

The court failed to give a logical reason as to why it included service contracts of this type, and not other services contracts, within the scope of 'contracts'. A plain reading of s 153 does not even impliedly suggest that all services would be split between those falling in clause 'b'and those falling under clause 'c' on the basis of the definition given in s153 particularly when that definition is 'inclusive' in nature.

(iv) Clause 42 of Part IV of the Second Schedule, which exempts operators of chemical and oil terminals from the application of the PIT, is also superfluous, because all companies which provide services are excluded from the ambit of the PIT by s 153(6). Since all the operators of the terminals in Pakistan currently are organized as companies, and sea terminal busine

(iv) A concession for providers of services to exporters of textile products is inserted as subsection (1A) of s 153. The tax rate for them now becomes equivalent to that applicable to exports generally. Besides the fairness and the neutrality issues in this amendment, the reduction in tax rates should have been grouped with a reduction in the rates for other taxpayers in Part II of the Second Schedule.

(v) By inserting the second proviso to s 153(6), through Finance Bill 2007, advertising receipts by print media and the sale of goods and execution of contracts by listed companies are taken out of the ambit of the PIT. In the context of principles of a good tax system, although the exclusion of listed companies is explicable, it is difficult to understand the rationale of exempting a type of business (that is, print media) from the PIT regime.[89] Moreover, this exemption should have been inserted in the Second Schedule where other exemptions are grouped.

(vi) Suppliers of own manufactured goods (only companies) were exempted retrospectively from the ambit of the PIT through the insertion of subsection (6A) of s 153 by Finance Bill 2005; which was further amended in 2008 to suspend the retrospective application of the exemption.

(vii) The insertion of clause 47D in Part IV of Second Schedule allowing the PIT regime to apply to cotton ginners coincided with the omission of clause 40 of the Finance Bill 2005, which contained the option of the PIT for all manufacturers. This option was initially withdrawn retrospectively in order to curb tax avoidance through transfer pricing in the pharmaceutical industry, who used to file returns under the PIT option. But later for unclear reasons, clause 41A was inserted by the Finance Bill 2005, which again offered the option for all activities to use the PIT pertaining to periods before 2005. This clause was later also omitted by Finance Bill 2008. Frequent legislative amendments have the potential to create additional uncertainty and compliance costs for taxpayers.

(viii) The insertion of subsection (6B) of s 153 appears to be due to an error because individuals and AOPs were already falling within the ambit of the PIT. This insertion was then later correctly identified as a redundant provision and removed by the Finance Act 2008. This type of arguably hasty insertion and subsequent removal only adds complexity to the law.

(ix) Subsection (8A) of s. 153 of the Finance Bill 2006, which increased the rate of withholding tax rate for the payees when they failed to provide their tax identification number, was also withdrawn immediately after its insertion through Finance Bill 2007.

In all, the Pakistani PIT has been subject to significant and repeated changes even after the promulgation of the new Ordinance in July 2001. For instance, in Part IV of the Second Schedule, which contains the exemption from the application of PIT related WHT and the applicability of the PIT regime, 68 amendments have been made since 2001; which includes 22 new insertions, 35 removals and 11 substitutions. Moreover, even the definition of the prescribed person in s 153 has been amended six

[89] Generally, exempting a high-profit yielding activity from the ambit of PIT is considered as a concession because then such a business declare lower incomes in a collusive arrangement with the accounting professionals and tax administration.

times. Finally, in the simplest regime of retailers, more than seven amendments have been made since its introduction in 2004. In view of the above, it seems that what was opined by Ahmad and Stern in 1991 still holds true:

> "The Pakistani tax system has developed as a series of ad hoc measures dictated largely by short term pressures and the immediate convenience and relative ease with which extra revenue can be generated."[90]

6.1.1.6 Ambiguity of the Interpretative or Explanatory Provisions

Some interpretative and explanatory provisions which suffer from ambiguities are outlined in this part of the paper.

(i) The collection of tax under s 151 on interest payments to individuals is not treated as income under the definition clause 29 of s 2 despite ITO 2001 treating tax withheld on it as the final discharge of tax liability under s 169.

(ii) Although the definition of services and sale of goods is provided in s 153(9), (reproduced earlier in this section), the definitions have created more uncertainty and ambiguity. The definition of the 'contract' is not provided in s 153(9), perhaps because of an inability of the legislature to define it after excluding services and supplies from its scope. A contract without services and supplies would be nothing but a hollow assignment. This is discussed further in the efficiency section of this analysis.

(iii) Since manufacturers are excluded from the ambit of PIT under s 153, a manufacturer is defined in subsection 9 of s 153:

> "manufacturer" for the purpose of this Section means, a person who is engaged in production or manufacturing of goods, which includes-
>
> (a) any process in which an article singly or in combination with other articles, material, components, is either converted into another distinct article or produce is so changed, transferred, or reshaped that it becomes capable of being put to use differently or distinctly; or
>
> (b) a process of assembling, mixing, cutting or preparation of goods in any other manner.

This definition does not seem clear and may add to the ambiguity. For example, under this definition, particularly due to the words 'or preparation of goods in any other manner', even a service provider of any type such as a wood cutter or sizing in the textile industry can claim to be a manufacturer if that treatment provides it some tax benefit.

(v) The insertion of the presumptive regime in the Second Schedule for shipping business is ambiguous regarding the return filing and assessment requirements. All other incomes falling within the ambit of the final tax regimes are deemed to have been assessed under s 120 and consequently such b sue h]2g(s)-2(h)1a ma subsection (3) of s 169. The ectopic insertion of this final tax regime for shipping activities or its incorrect grouping has resulted in the omission regarding its assessment and filing requirements in subsection (3) of s 169.

6.1.1.7 Provisions Where the Literal Meaning is Never or Rarely Enforced

The pertinent example here is clause (d) of subsection 153(5) which is related to payment for securitization of receivables by a Special Purpose Vehicle to the Originator. In the real business world, these situations are quite rare. Similarly, the literal meaning of 'manufacturer' cannot be applied to the definition given under s 153 because it has an inclusive feature and therefore has widespread connotation. The same is also true for the definitions of contract, sale of goods, and services given under s 153. More aptly, it is hard to strictly include all business activities and sectors within the the literal meanings of these terms. The use of such words therefore only adds to the technical complexity.

6.1.2 Operational Complexity

As follows, the operational complexity of the Pakistani PIT regime is analysed qualitatively in terms of the compliance burden such as bookkeeping and other documentary requirements. More specifically, it is examined in the context of the average liability of small business (that is, the ratio of compliance costs to tax liability).

As discussed in section 5, small taxpayers in Pakistan mostly have to maintain books of accounts[91], because the probability that all the transactions undertaken will fall within the ambit of the PIT regime is very low.[92] The only exception when a taxpayer is not required to keep accounts is when 80 percent or more of his/her receipts are subjected to WHT.[93]

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Section 4 thereof provided that there shall be charged and levied basic tax at uniform rate in respect of all lands in the state of Kerala of whatever description and held under whatever tenure.

The Indian Supreme Court held that:

> "Similarly, different kinds of property may be subjected to different rates of taxation, but so long as there is a rational basis for the classification. Art. 14 will not be in the way of such a classification, resulting in unequal burdens on different classes of properties. But, if the same class of property similarly situated, is subjected to an incidence of taxation, which results in inequality, the law may be struck down as creating an inequality amongst holders of the same kind of property". (Kunnathat Thathunni Moopil Nair etc. v State of Kerala and another at page 90)

The classification and rates in the Pakistani PIT is also without any rationale and therefore appear confiscatory because they result in unequal tax burdens on different classes of businesses. This shows that the lack of classification and rates (which results in a loss of neutrality) in the PIT legislation, being confiscatory in nature, not only has adverse economic consequences, but arguably also destroys the legitimacy of such legislation. Taxing the turnover without further distinguishing the economic activity is not a neutral classification.

Further, originally the Pakistani PIT had some sub-categories for the different types of exports depending on the extent of value added by the exporter and some sub-categories in terms of the difference in values of the contract and these were subjected to different tax rates. This shows that there is a scope of improving the classification

Similarly, the tax rate for rental income at the lowest bracket is 5 percent. In both the treatment between the corporate and the non-corporate sectors. This would have exactly identical consequences as discussed in respect of the services sector in the preceding paragraph.

(iv) The income of listed corporations from the sale of goods and execution of contracts is outside the ambit of PIT by clause (ii) of the second proviso to subsection (6) of s 153. It perhaps is done to encourage listings in the stock exchange but it may cause wider negative economic ramifications. For instance, all the private companies or partnerships may not be ready in terms of other financial indicators to change their form and obtain listing and consequently the tax system would be discriminating against them. This intervention through tax policy, to influence the choice of form of business organization, appears unu-5(i1)11(77l)-5(8(r)-2Tf0rhgdior definition of services under s 153. The tax administration, in order to collect more revenue or sometimes for dishonest motives, also uses the same loopholes. For instance, manufacturing activities such as dyeing have been taxed by the revenue administration under the PIT as service receipts. More simply, there are claims and counterclaims regarding the nature of the same receipts.

Additionally, the exclusion of services from contracts in the subsection defining the scope of PIT under s 153, as reproduced earlier in section 6.1.1.4, also has created another series of litigation.. For instance, in the same earlier mentioned case of Premier Mercantile Services v CIT Karachi, the Sindh High Court despite the exclusion of the word 'professional' from the definition of services, the Court upheld that the taxpayer fell under the ambit of PIT as a contract and that its services were not those which were covered within the definition provided in subsection (9).

On the other hand, the services of the cricketer, as mentioned earlier in the case of Assesse v Department[103], were also held by the Income Appellate Tax Tribunal (ITAT) of Pakistan to fall outside the ambit of the services both under ITO 2001 and the now repealed ordinance. The Tribunal held that these kind of services are a contract and not services by giving a reasoning based on the Contract Act, 1872, which was completely different than the reasoning followed in the earlier decisions:

> "It is elaborated that the term services is applied where the person is dictated in respect of 'what to do' and 'how to do', whereas under the strict definition of the contract a person is only explained for 'what to do'. He is not explained that how he has to do his work. Otherwise, under the Contract Act, there are only three ingredients of the contract i.e. offer, acceptance and consideration. In the present case, there is a contract but under the contract, there is no limitation upon the appellant 'how to do'." (page 4)

Conversely, in the case of CIT v Khursheed Ahmad[104], the taxpayer filed a return under the normal income tax regime for its income from janitorial services and the tax department taxed it as a contract under the PIT. The Lahore High Court decided the matter in favour of the taxpayer as follows:

> "A plain reading of the provision Section 80C will not leave any doubt that rendering of services have been provided exemption even if the same are in execution of a contract. The various principles of interpretation of fiscal statute like application of law in its natural meaning and favour to the taxpayer in case of doubt, provides guideline and following the same it we hold that the department's presumption is without any support or argument[105]".

The above conflicting claims and judicial pronouncements are evident of the embedded complexity in the regime, which provides a breeding ground of tax arbitrage opportunities and corruption[106].

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[103] ITA No. 1850/KB to 1850/KB of 2002 (2004 PTD 2749).

[104] CIT v Khurshid Ahmed 2008 PTD 1243, Paragraph 8 of the order.

[105] This case pertains to the repealed ordinance which had an almost identical PIT regime.

[106] In addition, the argument of the court is bad in law as it ignored the fact that the definition is inclusive' which broadens the scope of the services falling in its ambit. A similar finding was given while describing the scope of 'income' in the Constitution (where income has an inclusive definition) by the

6.2.1.6 Neutrality in Assigning the Role of Withholding Tax Agent

When the tax agency assigns a business the role of being a WHT agent, then, it increases its compliance costs. It involves shifting the role of tax collection to business and such a role incurs time and monetary costs. On the other hand, when some businesses are specifically exempted from performing that role, then, it means they have been favoured in terms of the compliance costs. For example, AOP is required under the law to act as a WHT agent under s 153 whereas other legal persons such as individuals are exempted from this role. Therefore, AOP is comparatively at a disadvantageous position in terms of compliance burden.

6.2.2 Overall Tax Burden

The Pakistan PIT is detrimental to work and entrepreneurship for several reasons. First, it is noted that differential tax treatment for each class of income discourages a taxpayer to take multiple ventures, because doing so increases the volume and cost of compliance. Second, the fixed tax rates on turnover without relation to the intricacies of this proxy base, generates higher tax liability with the increasing turnover irrespective of the level of actual profits. Since the turnover is a direct reflection of increased effort as a result, this regime becomes a disincentive to carry out more effort. Moreover, the tax rates are too high in some sectors e.g. supplies and contracts and consequently business risk is multiplied in those sectors. More aptly, a PIT with a low tax rate is helpful in tackling the informal economy, because it decreases economic gains from operating in the informal sector by reducing the technical compliance burden.[112] Thus, the Pakistani PIT is not appropriate in this regard. However, despite the higher burden, the marginal tax rate in the Pakistani PIT is zero, when the income is beyond the level where tax liability corresponds with the prescribed tax rates of PIT, which is an incentive for high performing taxpayers and businesses.

6.3 Pakistani PIT and Equity

Since neutrality is a bedrock of both efficiency and horizontal equity, the findings of analysis made in section 6.2 for the efficiency principle are equally relevant to horizontal equity. Nevertheless, in this section, those aspects of neutrality, which have a direct impact on horizontal equity, are analysed. Vertical equity, on the other hand, is assessed by the level of progressivity in the PIT regime.

6.3.1 Neutrality in Tax Treatment of Employed and Self-Employed Taxpayers

The Pakistani PIT for self-employed persons violates the equity principle. The main concern is that those who are falling within the PIT are not allowed any basic exemption. Thus, a taxpayer under the PIT regime which has turnover of just PKR 1 million (A$ 9,000) has to pay tax at rate of 5% (that is, PKR 50,000 (A$550)). Alternatively, under the normal income tax, this taxpayer, if it is assumed that the net profit margin is 10%, would declare income of PKR 100,000 (A$1,100) and will pay no tax as this level of income as it falls below the taxable limit. The tax paid under the PIT by this taxpayer is more than

[112] Memon, above, n 20.

In Table 4 below, it highlights that despite the same volume of turnover, trader of rice bears a different tax liability as compared to a trader of yarn.

Table 4: Comparative Tax Liability of Suppliers of Different Commodities Falling Within the

Table 7: GDP and Tax to GDP ratio of Pakistan for last ten years[119]

PKR in millions

Source:
Federal Board of Revenue Year Book 2010-11. Source: Statistical data (Historical) Fiscal Research and Statistics, Directorate Research & Statistics accessed through http://www.fbr.gov.pk/DRS/Default.asp on 25/1/2013

More aptly, the 'estimates show that the informal sector over the years is grown in Pakistan from 36.8% in 1999-2000 to 39.5% in 2004-05'[120], which reflects at least partly the failure of the regime to encourage the transition from informal to formal sector.

In all, the poor performance of the PIT may be reflection of the findings of the above analysis such as the existing complexity in the procedures and the lack of perception of fairness arising from poorly designed tax rates which fails to provide neutrality in its tax treatment.

7. CONCLUSION

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Many developing countries rely on the PIT regimes to collect tax(eg)13(o3(y9t)8(s at64

The findings reveal that being a turnover based PIT design, the Pakistani PIT is technically complex and imposes high compliance costs on small business. The Pakistani PIT also does not adhere well to the efficiency and equity principles because it does not secure neutral tax treatment for all types of business sectors. The findings of inadequacy of the Pakistani PIT are also evident in a stagnant taxpayers base, lower tax to GDP ratio and a persistently large informal economy in Pakistan.

The above findings suggests that current turnover PIT designs may be replaced with a better alternative such as an asset based PIT design or a PIT design based on economic indicators. In the event that the replacement of the PIT is not currently possible, complexities identified in the section of simplicity are suggested to be removed through a legislative review; and for efficiency, a detailed classification of industrial sectors with separate tax rates for each class could be provided to ensure neutrality in tax treatment.

Like any other study, the findings of this paper also suffer from some limitations such as these are not supported with sufficient empirical analysis particularly with respect to PKR value of compliance and enforcement costs resulting from the legal complexities identified in this paper, quantum of tax revenue which is lost due to existing tax arbitrage opportunities in the tax code and actual volume of shifting of tax incidence in the turnover based PIT design.

Lastly, there is scope of further research with respect to Pakistani PIT regime. As stated earlier, some more empirical evidence may be gathered to endorse the findings of the qualitative analysis made in this paper. For replacing the existing turnover based PIT design with a better alternative, an experimental study at a small scale is suggested to evaluate pros and cons of all other PIT designs which are in practice in several transitional European and other developing countries such as an asset based PIT design or an indicator based PIT design. However, the willingness of the government in this regard is a prerequisite.

APPENDIX: MAIN PIT PROVISIONS OF THE INCOME TAX ORDINANCE, 2001

Section 67 Apportionment of Deductions.- (1) Subject to this Ordinance, where an expenditure relates to –

(a) the derivation of more than one head of income; or

(ab) derivation of income comprising of taxable income and any class of income to which sub-Sections (4) and (5) of Section 4 apply, or;

(b) the derivation of income chargeable to tax under a head of income and to some other purpose,

the expenditure shall be apportioned on any reasonable basis taking account of the wh11(s)-se(f)9onco;ia-4-3(as)sie: -4(4 ( )Tj 0.196 Tw -)53ID 6 >>s tC0 Td 3as0 Td

(c) the Federal Government, a Provincial Government or a Local Government pays to any person profit on any security other than that referred to in clause (a) issued by such Government or authority; or

(d) a banking company, a financial institution, a company referred to in clauses (i) and (ii) of clause (b) of sub-Section (2) of Section 80, or a finance society pays any profit on any bond, certificate, debenture, security or instrument of any kind (other than a loan agreement between a borrower and a banking company or a development finance institution) to any person other than financial institution the payer of the profit shall deduct tax at the rate specified in Division I of Part III of the First Schedule from the gross amount of the yield or profit paid,…………, at the time the profit is paid to the recipient.

148. Imports.- (1) The Collector of Customs shall collect advance tax from every importer of goods on the value of the goods at the rate specified in Part II of the First Schedule. s - 3 (y) 1 s t 3

Additional Collector of Customs, or an officer of customs appointed as such under the aforesaid section;

"value of goods" means the value of the goods as determined under the Customs Act, 1969 (IV of 1969), as if the goods were subject to ad valorem duty increased by the customs

(6) The tax deducted under this section shall be a final tax on the income of a resident person arising from transactions referred in subsection (1) or (1A):

Provided that sub-section (6) shall not apply to companies in respect of transactions referred to in clause (b) of sub-section (1) [Provided further that this sub-section shall not apply to payments received on account of

(i) advertisement services, by owners of newspapers and magazines;
(ii) sale of goods and execution of contracts by a public company listed on a registered stock exchange in Pakistan; and
(iii) the rendering of or providing of services referred to in sub-clause (b) of sub-section (1):

Provided that tax deducted under sub-clause (b) of subsection (1) of section 153 shall be minimum tax.]

(6A) The provisions of sub-section (6) in so far as they relate to payments on account of supply of goods from which tax is deductible under this section shall not apply in respect of [a company] being a manufacturer of such goods.

154. Exports. —(1) Every authorized dealer in foreign exchange shall, at the time of realization of foreign exchange proceeds on account of the export of goods by an exporter, deduct tax from the proceeds at the rate specified in Division IV of Part III of the First Schedule.

(2) Every authorized dealer in foreign exchange shall, at the time of realization of foreign exchange proceeds on account of the commission due to an indenting commission agent, deduct tax from the proceeds at the rate specified in Division IV of Part III of the First Schedule.

(3) Every banking company shall, at the time of realization of the proceeds on account of a sale of goods to an exporter under an inland back-to-back letter of credit or any other arrangement as prescribed by the [Board], deduct tax from the amount of the proceeds at the rate specified in Division IV of Part III of the First Schedule.

(3A) The Export Processing Zone Authority established under the Export Processing Zone Authority Ordinance, 1980 (VI of 1980), shall at the time of export of goods by an industrial undertaking located in the areas declared by the Federal Government to be a Zone within the meaning of the aforesaid Ordinance, collect tax at the rate specified in Division IV of Part III of the First Schedule.]

(3B) Every direct exporter and an export house registered under the Duty and Tax Remission for Exports Rules, 2001 provided in Sub-Chapter 7 of Chapter XII of the Customs Rules, 2001 shall, at the time of making payment for a firm contract to an indirect exporter defined under the said rules, deduct tax at the rates specified in Division IV of Part III of the First Schedule.]

(3C) The Collector of Customs at the time of clearing of goods exported shall collect tax from the gross value of such goods at the rate specified in Division IV of Part III of the First Schedule.]

(4) The tax deducted under [this section] shall be a final tax on the income arising from the [transactions referred to in this section].

113A. Tax on Income of certain persons.— (1) Subject to this Ordinance, where a retailer being an individual or an association of persons has turnover upto rupees five million for any tax year, such person may opt for payment of tax as a final tax at the rates specified in Division IA of Part I of the First Schedule.

(2) For the purposes of this section,

(a) "retailer" means a person selling goods to general public for the purpose of consumption;

(b) turnover shall have the same meaning as assigned to it in sub-section (3) of section 113.

(3) The tax paid under this section shall be a final tax on the income arising from the turnover as specified in sub-section 1[(1)]. [The retailer shall not be entitled to claim any adjustment of withholding tax co Tw -12.9tiectw [(m)17(e)-2lu5(i)6b5(e)11(ov)11(e)-2(r)9(j)-15(uct)-be entduisg tae

(2) If the agent retains Commission or brokerage from any amount remitted by him to the principal, he shall be deemed to have been paid the commission or brokerage by the principal and the principal shall collect advance tax from the agent.

(3) Where any tax is collected from a person under sub-section (1), the tax so collected shall be the