THE DEVELOPMENT OF A MODEL FOR IMPROVING REVENUE FROM SALES TAX ON SERVICES IN KHYBER PAKHTUNKHWA, PAKISTAN

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ABSTRACT

Pakistan exhibits one of the lowest tax-to-GDP ratios globally. This causes poor public finances. Consequently, the country is unable to meet government operational expenses, infrastructure development, and socio-economic improvement. A detailed analysis shows a significant discrepancy between the tax revenue potential and actual tax collections among all the major sources of tax revenues. This is particularly true of the sales tax on services (STS). The existing literature underscores the inefficiency of the STS system in generating satisfactory revenues. Thus, to address deficiencies and enhance collection, the study examines the current STS framework and the factors affecting revenue collection. In pursuit of its objectives, the study adopts a qualitative research design, collecting data from three distinct groups, i.e., surveys of taxpayers, in-depth interviews of potential taxpayers, and discussion with the focus groups of officials dealing with STS matters. Data analysis was done using detailed descriptive analysis, thematic analysis and correlation. The study identified Tax Administration, System Effectiveness, and Revenue Mobilization as the major factors affecting tax revenue collections. In addition, the tax officials reported lack of resources and incentives for tax assessment and tax collection activities. The potential Taxpayers' Group reported lack of Public Trust as one of the main factors influencing tax collection. Notably, the study is confined to the STS collections in Khyber Pakhtunkhwa Province. The study presents actionable steps for policymakers and tax-collecting agencies to improve tax compliance and tax collection.

Keywords: Sales Tax on Services (STS), tax reforms, taxation in the province of Khyber Pakhtunkhwa, tax revenue mobilization

APPROVAL

This is to certify that this thesis conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, for the fulfilment of the requirements for the degree of Doctor of Philosophy.

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1 July 2024

DECLARATION

I hereby declare that the thesis submitted in fulfillment of the degree is my own work and that all contributions from any other persons or sources are properly and duly cited. I further declare that the material has not been submitted either in whole or in part, for a degree at this or any other university. In making this declaration, I understand and acknowledge that any breaches in this declaration constitute academic misconduct, which may result in my expulsion from the program and/or exclusion from the award of the degree.

Name: Naveed Khan

Signature of Candidate: **Date**: 1 July 2024

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LIST OF ABBREVIATION

VAT	Value-Added Tax
GST	Goods and Service Tax
STS	Sales Tax on Services
IMF	International Monetary Fund
GDP	Gross Domestic Product
KP	Khyber Pakhtunkhwa
KPRA	Khyber Pakhtunkhwa Revenue Authority
OECD	The Organization for Economic Cooperation and Development

CHAPTER 1

INTRODUCTION

1.0 Background

Pakistan is a developing country in South Asia with a population of more than 208 million people. It has high population growth and inequalities in education, income level, and employment between males and females. Additionally, the residential occupancy ratio between rural and urban areas also widely varies, and the health system is underdeveloped to cater to the needs of the growing population (Goujon et al., 2020). According to the Economic Survey of Pakistan 2020, some of the fundamental problems of this country remained unresolved even in 2020: a low tax-to-GDP ratio, low exports, poor management of finances, ever-increasing debt, twin deficit, and low-value creation in the economy. The survey further indicated that about 40% of its population needs to be educated. The large uneducated population means fewer skilled workers, fewer opportunities for progress, and low worker productivity. Moreover, there is a dire need for substantial investment in Pakistan's education sector to improve the literacy rate and provide technical education to produce skilled workers and build a prosperous society. Due to these low literacy levels, most of the population cannot actively participate in economic development in Pakistan. Although the country is blessed with substantial resources and a rich and diverse culture, geographically and strategically, it is critically important to play its due role in trade and development. Conversely, decades-long political instability and frequent attempts at constitutional disruptions have destabilised the country (Tabassam et al., 2016). Large budget deficit, low tax-to-GDP ratio, lack of financing for development, and other financial and social problems have so far jeopardised the country's future. Despite the numerous issues, Pakistan has a high potential to become a vibrant and prosperous economy, particularly after collaboration with other South Asian economies (Memon et al., 2011; Masood et al., 2022). One of the prominent issues Pakistan's economy faces is generating inadequate tax resources against the required expenditure and poor management of public money.

1.1 Poor Management of Public Finance

Most developing economies' budgets have been in deficit for decades due to overspending and insufficient revenue collection. Whenever a country decides to borrow money instead of levying additional taxes to finance its budget, it creates a liability for itself, which is known as public debt (Karagoz, 2013).

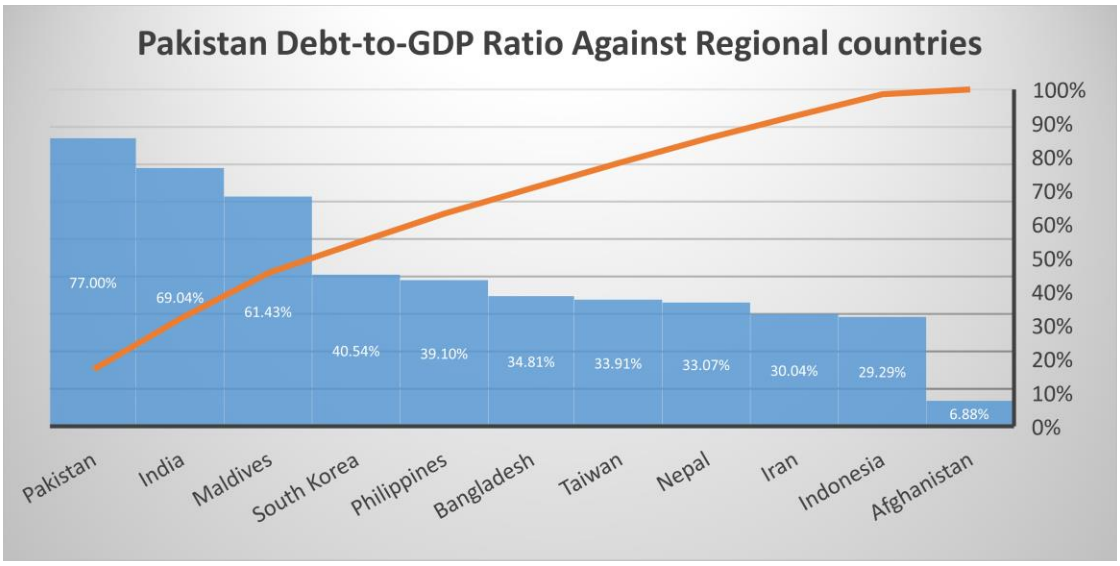
Public debt should be avoided at any cost because it is a future tax paid by upcoming generations to service these loans and utilised by present generations.

In reality, governments often have two options to finance their expenditure, either through the imposition of taxes or through borrowings, where taxes disturb the prices, and unrealistic borrowings can result in the outflow of valuable resources from the country. It can impede economic growth unless borrowing is used for public welfare and boosting economic growth in the country. The Chudhary and Abe (1999) study suggests that a budget deficit leads to hiking inflation.

Pakistan is meeting its public expenditure requirements through borrowing and domestic revenue generation. As a result, the country is facing a high fiscal deficit of up to 6-8% of the GDP, mainly due to scarce savings and meagre revenue generation abilities against ever-increasing public expenditures and a widening current account deficit, which is balanced through borrowings. A considerable portion of the country’s GDP is paid in debt servicing, which is not only hampering developmental planning and resource drainage of necessary limited revenue from the country but also further worsening the country's economic growth and poverty elevation efforts (Akram, 2011).

Pakistan's significant sources of financing for these huge fiscal deficits include loans from external sources such as IMF, World Bank, Foreign Aid, etc.; internal sources include commercial banks, obtaining funds directly from the State Bank of Pakistan and National Saving Schemes, etc. However, it also applies other tactics, such as devaluing money by printing more money and utilizing foreign remittances (Fischer & Easterly, 1990; Ali & Kashif, 2019). Pakistan's debt-to-GDP versus their regional rival economies is as follows;

Figure 1.1: Pakistan's debt-to-GDP ratio against regional countries



Source: International Monetary Fund, World Economic Outlook Database

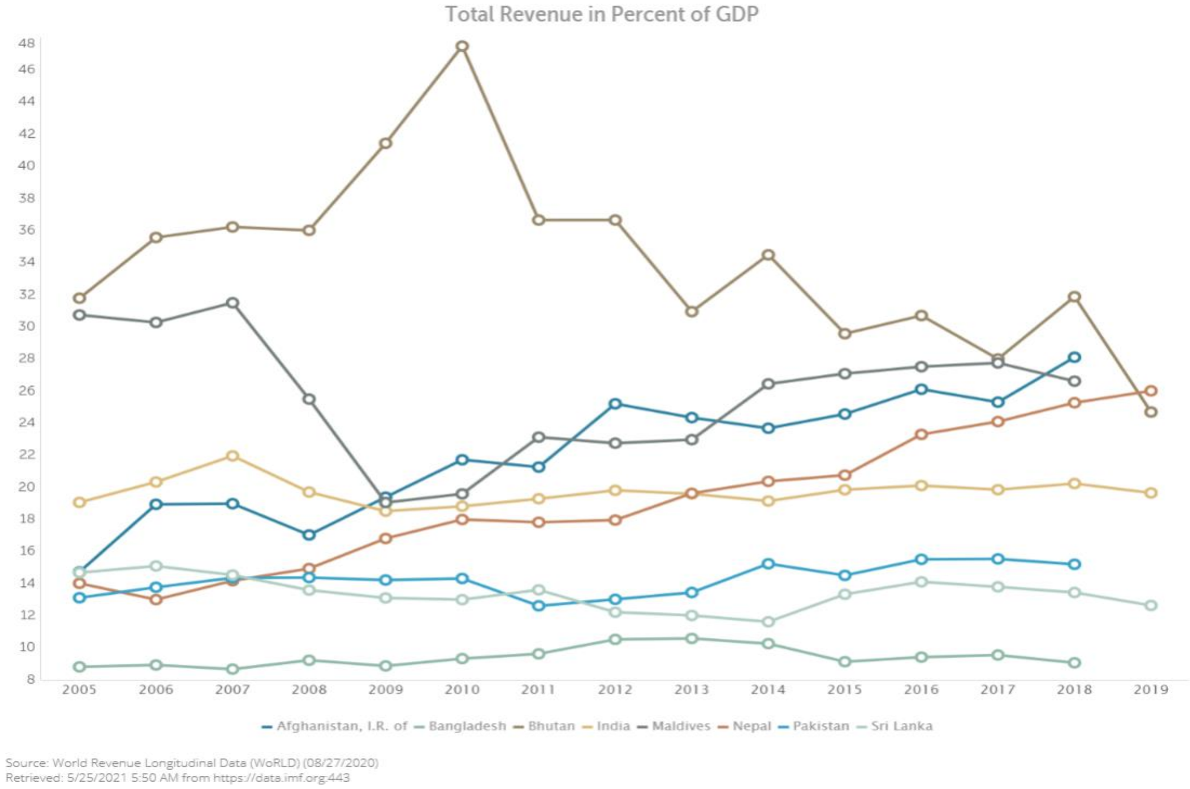
As shown in the latest data published by the World Bank, International Monetary Fund, and World Population Review, Pakistan is sunk in a debt trap, as it has the highest debt-to-GDP ratio versus its rival economies in some of its South and East Asian countries. This indicates the vulnerable picture of their poor public finance management and fiscal mismanagement in raising sufficient funds to meet country requirements, which is why the country is heavily dependent on debts. These debts consist of various sources, including internal and external, although each financing source has pros and cons. As per the study by Tullius (2007), borrowing from internal sources mainly results in increasing interest rates. As a result, inflation grows, which causes reductions in investment and supply in the country. If not appropriately utilised, external borrowing could drain valuable resources from the country at these critical moments. On the other hand, financing through the central bank by issuing currency also causes high inflation (Fischer & Easterly, 1990). Non-bank financing may have little effect on inflation. However, financing deficit through national savings schemes is expensive as it offers as much as 18% debt servicing cost or return rate with tax exemption in such schemes (Ahmad, 2011). Consequently, it decreases banking services in the country and shrinks investment. According to the study by Pasha and Ghaus (1996), borrowing from external sources will not only increase the ever-increasing current account deficit. However, it will also result in a reduction in the country's real exchange rate. All these circumstances have pushed the government into a debt trap.

Similarly, Pakistan's fiscal deficit is persistently high due to a shortfall in revenue collection. As a result, the Tax-to-GDP ratio shrunk to the lowest level in South Asia, only 11%, and is constantly decreasing, while expenditures are advancing upward mainly due to payment of high debt servicing costs and current expenditures. Government-supported corporations such as PIA (Pakistan International Airlines), Railways and Steel Mills, etc., also suffered losses. The country's exports are stagnant, and the currency depreciated by 21 % in just one fiscal year, 2018-19, with vulnerable foreign remittances and unstable fiscal and current account deficit entering new zones of danger as the fiscal deficit currently stands at 7.3% with current account deficit at 6.3% of the GDP. Considering the country’s outlook, it could be concluded that the problems mentioned above pose severe macroeconomic challenges to the economy, primarily because of the low levels of savings and insufficient revenue collection in the country (Srinivas, 2020). Therefore, it is essential to have sufficient tax resources to meet required expenditures and revive the wheel of the economy by reducing debts and meeting expenditures from one's resources. To do so, the country needs a robust taxation system capable of generating sufficient taxes for the government.

1.2 Taxation in Pakistan

However, when we dream about generating our resources and self-reliance, lifting the debt burden, and maintaining a sustainable economy, we must increase the collection of taxes to the level demanded by the size and need of the economy. Its tax collection has remained quite volatile since the beginning, and its taxation structure has occasionally changed. However, the taxation policies have remained centric for governments for the last two and half decades. However, compared to their regional and international economic counterparts, Pakistan's tax-to-GDP position is not satisfactory, which is often used as one of the reasons for the budget deficit by successive governments (Chaudhry & Munir, 2010). The following figure compares the tax-to-GDP ratio of Pakistan vs. some of their regional countries.

Figure 1.2: Pakistan tax-to-GDP ratio vs. regional countries



The above figure clearly explains Pakistan's low tax collection level compared to other regional countries. Even smaller economies in the region, such as the Maldives and Nepal, are ahead of Pakistan in terms of higher revenue collection relative to their GDP. Despite being much lower in tax-to-GDP collection in percentage relative to their rival economies in the subcontinent, similar-sized economies are much ahead. They are growing while Pakistan’s tax collection has declined significantly over time.

According to IMF publications on Creating Fiscal Space (2018). The developing countries must have at least 15% of the tax-to-GDP ratio to run the country's operations smoothly. Countries with a higher tax-to-GDP ratio tend to have more investment and infrastructure development funds than low-tax-yielding countries. The average ratio for OECD countries is 34% of their GDP, while some individual countries have even much higher ratios in Europe, which ranks above 40% (Gaspar et al., 2016). Hence, this low tax on GDP indicates serious flaws and calls for reform in Pakistan's taxation system. Therefore, from the very beginning, Pakistan's economy has been dependent on foreign donors like the World Bank, the International Monetary Fund (IMF), and other international and local funding institutions like the State Bank of Pakistan, National Bank of Pakistan, and saving schemes because of its weak financial system and control. This system must be upgraded to cater to the country's pressing financial needs (Ahmad et al., 2018).

Pakistan's taxation system originated from the British taxation system in the form of the Government of India Act, 1935, which was constituted before the independence of Pakistan and India in 1947. In the first decade of independence, the country's tax collection remains constant because of the British adopted system. However, in the second decade, the ratio grows from 5% in the 1950s to 9% in the 1960s of the GDP. After that, the story of taxation efforts to broaden the tax base begins in the country to eliminate discrepancies hindering developments in improving tax administrations that support a sustainable economy (Amad et al., 2018).

The initial problem was Pakistan’s over-reliance on indirect and international trade taxes. The country was in need of taxation reforms right from the beginning; however, serious reform efforts began in the 1990s with the introduction of withholding tax (Hussain, 2009; Ahmad et al., 2018). However, the country is still; the country is facing various challenges on its fiscal node.

As of the financial year 2018, the country's total revenue (including tax and non-tax receipts) stood up at 15 % against the target of 16% of the total GDP. However, it should be kept in mind that, according to Nicholas Kaldor's study (1963), the minimum percentage of GDP for a developing country should be 25% to 30% to transform itself into a developed country. Therefore, Pakistan needs to improve its tax ratio to achieve sustainable growth. Hence, considering the lowest tax-to-GDP collection among the regional countries and its higher revenue potential (Ikram et al., 2020).

1.3 International Best Practices Adopted for Increasing Revenue Yields in Developing Nations

As we have evaluated the different aspects of taxation and its collection, it is evident that increasing tax collection is not an independent phenomenon; instead, it depends on many factors and steps required by the government and taxpayers to boost revenue in a country. A study by Di John (2006) has revealed that developing countries in Africa have one of the best and fast-growing Tax-to-GDP ratios mainly due to several empirically driven factors, which include high-level cooperation and coordination between bigwigs of higher income groups and government, which are on tax reforms, which supports the government, which advocates higher autonomy to tax organisations and closer cooperation.

In South Africa, after 1960, when the tax records were computerised, it immensely helped the Inland Revenue Services in revenue mobilization efforts. One of the measures that helped boost revenue was pay-as-you-earn (PAYE), where the withholding agent was incentivised to withhold the due taxes and pay them to the government. This reward action has made employees or withholding agents more responsible and smoothened the monthly payment of due taxes.

Similarly, the study of Basheer, Ahmad, and Hassan (2019) found after study data from Oman and Bahrain that revenue can be increased based on some favourable financial and economic indicators, e.g., reducing deficient balance, increasing bank capital to their assets ratio in the country, the enhanced inflow of foreign direct investment, and risk premium charged on lending by the bank also have long term effect on revenue mobilisation in the country.

Although countries often cannot do much about the microeconomic factors (Balvir, 2024), they do have the option to change their fiscal mix in terms of taxes to save the unfavourable effects on businesses and government by giving lesser or no importance to sources of revenue which are volatile and prefer a type of taxes that provide more sustainable revenue necessary for long term growth. Once the economies become stable, the states can impose more aggressive taxes to achieve higher equitability, balance, and economic growth in the country. The state that relies on sales tax often has achieved slower growth but with a lesser cost of collection, while relying on income tax often results in volatile tax collection (Cornia et al., 2010).

Since revenue enhancement in developed and developing countries results from mixed factors and elements based on their economic mix, extensive research is needed to conclude the fundamental factors that impact revenue growth in individual economies. In the context of Pakistan, Income tax, Sales Tax, and Excise are the prominent taxes, and sales tax has the highest potential to generate sufficient revenue to overcome the obstacles its economy faces.

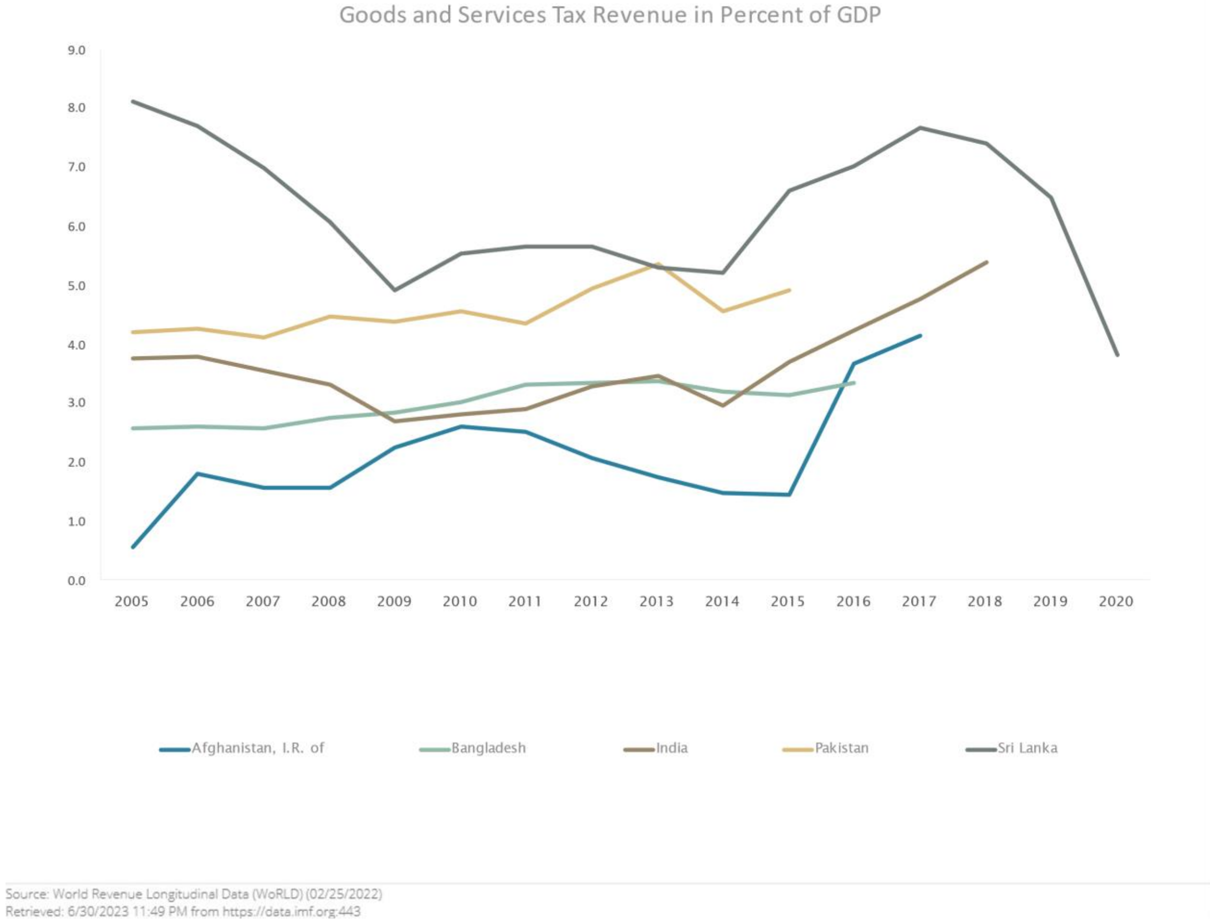
1.4 Role of Sales Tax in Pakistan's Economy

The sales tax is a well-recognized indirect tax in the world; as per a study by Charlet & Buydens (2012), its contributions to the total collection of taxes are so substantial that it is the world's third largest after social security and income tax. Its primary VAT model has gained worldwide acceptance quickly, mainly due to its efficient revenue mobilisation abilities. Although the General Sales Tax has existed in Pakistan since its independence in 1947, GST in the VAT model was inaugurated correctly in the 1990s by enacting the Sales Tax Act of 1990 for having sufficient revenue to equate and meet the budgetary demand. As per the study by Sarker and Hassan (2012), sales tax in Pakistan is an essential and necessary element of value-added tax as it is paid at the point of sale, and input adjustments are allowed.

The sales tax on goods collections is the central government domain, while the sales tax on services is the provincial government’s mandate. The VAT on goods rate is around 17%. However, 0% is charged to goods for export purposes (Hassan, 2015). The Study of Hassan (2013) revealed that since the introduction of sales tax on the VAT model in 1990-91, the sales tax share in total tax revenue has substantially increased from Rs 20.8 billion in the 1990s to Rs 804 billion in 2012, growing at 21% annually and, at some point in time, growing as high as 68%, particularly during 1999-00 and as low as -3% in the financial year 1997-98.

Pakistan's tax collection is mainly dominated by indirect tax, particularly sales tax, as more than 60% of the total collection is from indirect taxes. The economic survey for FY 2018-19 by the Ministry of Finance indicated that sales tax reported 11.8% growth during 2018-19 compared to last year's 2 %. Moreover, the sales tax is proliferating in the country, which has showcased the phenomena of sales tax in a beautiful manner for policymakers in Pakistan and has attracted substantial importance, mainly due to its significant share in total revenue collection. However, some reasons, e.g., reduction in rate, reduction of GST on natural gas, and import compression in the country, have resulted in a slight reduction of 1.8 % compared to last year's collection. While sales tax collection in Pakistan is not still to the industry standard as compared to other economies among South Asian nations, it is contributing substantially to Pakistan's total tax to GDP collection versus regional players, which can be seen as follows;

Figure 1.3: Pakistan and regional country's sales tax on goods and services revenue in percentage of GDP



The above figure shows sales tax collection compared to their regional players, as some other economies, such as India, rely significantly on direct taxes. However, Pakistan is more inclined toward indirect taxation. Therefore, it further increases the importance of sales tax as the central revenue pillar in fiscal space in Pakistan and elsewhere in the region. Although Pakistan collects very minimum revenue from sales tax compared to their regional countries, which are collecting more resources for their economies using sales tax means, on the positive side, indicates high potential in sales tax collection in Pakistan (Inam et al.; S., 2008). However, it is pretty worrisome that Pakistan's sales tax proceeds are relatively low compared to their regional competitors, and they are lagging far behind even smaller economies in the region, such as Maldives and Bhutan.