



Tulane Economics Working Paper Series

Tax Policy Effects on Business Incentives in Pakistan

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Working Paper 1705
Jul 2017

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JEL codes: H20, H25, H32, H87.

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*Department of Economics, Tulane University; and Federal Board of Revenue, Government of Pakistan. We are grateful to Mushtaq Ahmad, Musharraf Cyan, and Nydar Mukhtar for their assistance in preparing this chapter, especially the calculations of effective tax rates. We are also grateful to Mr. Anjum Ata Sheikh and Mr. Muzammil Rasheed of Grant Thornton Chartered Accounts in Islamabad for detailed discussions on enterprise taxation in Pakistan.

I. Introduction

The Pakistan system of taxing enterprises has undergone some major changes in recent years. Nevertheless, the corporate tax system remains plagued by a number of problems, problems that relate to the neutrality, the yield, and the simplicity of the tax system. The existence of numerous exemption programs has greatly distorted the allocation of investment across sectors and asset types, and has also significantly reduced tax revenues. There also seem to exist significant amounts of tax evasion, evasion that also distorts resource allocation, reduces tax revenues, and compromises the distributional objectives of the system. In part as a result of tax avoidance and tax evasion, the tax base has shrunk over time, further reducing revenues and leaving many taxpayers out of the tax net. The extensive use of tax incentives is seldom tracked, quantified, and evaluated, and the intended effects on economic growth are uncertain. The incentives are only one feature of the tax system that contributes to an overly complicated system, complications that illustrate the limitations of the tax administration. The tax system was designed for times and circumstances that are long past, and the system has evolved over time in a piecemeal, ad hoc manner with little apparent thought given to the ways in which the pieces of the system need to fit together.

This chapter discusses these issues. The next section briefly describes some recent global trends in taxing enterprises in a globalized world. The basic structure of the Pakistan corporate tax structure is then discussed, followed by a discussion of the system of incentives. The distorting effects of the tax incentives and tax system on investment are demonstrated by calculating both average effective tax rates (AETRs) from tax return information, and also marginal effective tax rates (METRs) from analytical models. The following sections compare Pakistan tax practice to international practices, examine the overall investment “climate” in Pakistan by drawing upon several recent surveys of business practices in Pakistan and elsewhere, and then identify some of the other core issues

in the “system” of corporate taxation. The final section presents some issues that need to be considered in any possible reforms, including some possible reform options.

II. Worldwide Trends in Taxing Companies in a Globalizing World

The tax systems of many countries were designed in a world that is dramatically different from the globalized world that now exists, and these systems have often failed to evolve relevance to the changing economic circumstances of governments in a more integrated world economy. The tax systems of most governments were originally designed for a world in which production and consumption were primarily of *tangible goods*, in which the sale and consumption of these goods generally occurred in the *same location*, and in which the factors of production used to make the goods were for the most part *immobile*. In such a world, taxation was a fairly straightforward exercise. Income (and property) taxes could be imposed on factors where they lived and worked without fear that taxes would drive the factors elsewhere. Similarly, sales and excise taxes could be imposed on the tangible goods that were consumed, by the government in the jurisdiction in which consumption (or production) occurred. In making these tax decisions, a government in one jurisdiction had no need to consider how its actions would affect the governments in other jurisdictions because tax bases were largely immobile.

There is little doubt that, in principle, the current economic environment, characterized by rapidly increasing globalization of economic activity and more fully integrated world markets, brings about radical changes (Alm, Holman, and Neumann, 2003).

First, tax bases are significantly more mobile, especially the capital income base. With integrated national and world markets, factors of production are obviously able to move more easily from one jurisdiction to another. For example, businesses have more flexibility in choosing where to locate because communication and transportation costs have been slashed. Some forms of production

activity require little in the way of traditional capital and labor, so that physical location becomes less important. Labor, especially skilled labor, becomes more mobile in this environment, and financial capital is able to flow quickly across national boundaries.

Clearly, if factors of production can move easily from one location to another, then the ability of a government to tax these factors is greatly diminished. A government that raises its tax rates above those of other jurisdictions risks losing its tax base to these areas. Particularly in the case of income from capital, there is much speculation that taxation will become increasingly problematic (Grubert, 1998). In fact, there is some empirical evidence that factors of production are responding to these types of tax considerations (Hines, 1999).

Second, the measurement, identification, and assignment of tax bases are much more difficult (McLure, 1997). Consider a typical multinational business. The product that the firm makes may be designed in one or more jurisdictions; the firm may use inputs purchased in multiple jurisdictions; the inputs may be produced in several places and assembled into a final product in a still different location; and the final good may be sold in multiple locations. Because the business operates in multiple jurisdictions, the firm has considerable leeway to manipulate its prices (e.g., “transfer prices”) to minimize its tax liabilities. This latter problem is well known, but its severity has increased with the enormous expansion in the number of firms operating in multiple jurisdictions.

How will governments respond to these various challenges, especially in their tax choices? Most importantly, globalization implies that the ability of any government to choose its tax policies independently of those in other jurisdictions is greatly curtailed. In the presence of mobile tax bases, a single government’s choice of tax policies will have effects beyond its own borders and will be affected by the actions of other jurisdictions. In short, *tax competition* will increase, and this increase will have a number of effects: on the level of taxation, on the composition and form of taxes, and on the general strategies that a government can pursue in designing its taxes.

The *level* of tax rates seems likely to decline. In particular, if tax bases can move easily from one jurisdiction to another, then they will tend to flow from high-tax to low-tax areas. Owners of capital, skilled labor, and consumers will become increasingly sensitive to tax differentials in their locational decisions. As a consequence, it is commonly argued that governments will face increasing pressures to compete with one another by reducing tax rates or by offering special tax incentives for attracting and retaining the various tax bases. Indeed, with tax competition there could well be what some have referred to as a “race to the bottom”, in which overall tax collections decline precipitously as governments compete to attract or to retain their tax bases. There is much work that suggests in particular that governments will lose completely the ability to tax capital income (Gordon and Hines, 2002; Desai and Hines, 2004).

The *composition* of taxes could also change as a result of increased difficulty in taxing mobile tax bases. The overall tax burden from income taxes on mobile tax bases like capital (and skilled labor) will likely decline across governments; tax rates on these factors should also flatten and converge. In contrast, taxes on immobile bases – unskilled labor, physical capital, and property – should increase. The *form* of taxes may also change. Governments may well decide that, say, a residence-based corporate income tax (in which a country taxes the world-wide income of the enterprise) is preferable to a source-based (or territorial-based) corporate income tax (in which a country taxes only income arising within its own borders).

These latter changes suggest more broadly that there may be scope for greater *harmonization* (or at least greater *coordination*) of tax systems, in an attempt to reduce the negative fiscal externalities that one government’s decisions impose upon other governments. Such harmonization implies that there should be some *convergence* in tax rates across governments, and also in the definitions of tax bases. With harmonization, government autonomy in tax policy will obviously diminish.

Indeed, there is now some emerging evidence that these trends are occurring, at least to some degree. Devereux and Sorensen (2005) and Auerbach, Devereux, and Simpson (2007) identify several “stylized” facts about the evolution of taxes on corporate income in OECD countries in the last two decades:

- Statutory corporate tax rates have fallen significantly since 1982 for most of the 19 countries examined, and continue to decline today. In 1982, 15 of the 19 countries had statutory tax rates above 40 percent; by 2004, no country had a tax rate above 40 percent. Overall, the (unweighted) mean statutory tax rate fell from 48 percent to 32 percent over this period.
- The tax bases of most countries were broadened over much of this period, at least as measured by the (reduced) generosity of depreciation allowances.
- The effective tax rate on corporate income, measured by the “marginal effective tax rate” and the “average effective tax rate”, has tended to fall over time. These measures of effective tax rates are discussed in more detail later.

More anecdotal evidence for other developed and also for developing countries is also broadly consistent with these trends. For example, examination of statutory tax rates in world-wide compilations of corporate tax rates, such as the *KPMG Corporate Tax Rate Survey 2007* or the *PricewaterhouseCoopers Corporate Taxes, Worldwide Summaries* (now available online) also indicate a clear downward trend over time, in many countries. There are now at least 16 countries in the former Soviet sphere, including Russia, Slovakia, Poland, Serbia, Hungary, Moldova, Latvia, Romania, Mongolia, Kyrgyzstan, Macedonia, Estonia, Latvia, Ukraine, Georgia, and Lithuania, that have a corporate tax rate of 25 percent or lower; some of these countries also have a flat rate tax system with identical corporate and individual tax rates. Several countries in the Middle East, such as Kuwait, have dramatically reduced their corporate tax rate. At least 26 developed countries have reduced corporate (or individual) tax rates even in the short period since 2005. The evidence from developing countries is similar, according to *Paying Taxes 2008 – The Global Picture*.

III. Pakistan’s Corporate Income Tax Structure

As specified in the Income Tax Ordinance, 2001, the Pakistan corporate income tax is imposed on the world-wide profits of resident companies and the Pakistan source income of non-resident companies. Enterprise profits taxes are in general designed to collect revenues from a firm's economic profits, or its net income. In practice, the tax base is generally some commercial accounting measure of profits. To this base, a tax rate (or rate structure) is then applied. The revenues from the tax reflect these two elements, the rate structure and the definition of the tax base. Consider these, and other, elements of the tax.

Corporate Tax Rates

The rates for the corporate sector were exceptionally high in the past. During 1992-93, banking, public, and private companies were taxed at the rate of 66 percent, 44 percent, and 55 percent, respectively. These rates have been reduced significantly over time. Currently, there is one uniform corporate tax rate of 35 percent for all three types of companies (private, banking, and public companies). In order to encourage “small” companies, a lower rate of 20 percent has been in operation; the definition of a “small” company is discussed in the next subsection. The gradual reduction of corporate tax rates is indicated in Table 1.

Table 1: Corporate Tax Rates (percent)

Tax Year	Banking Company	Public Company other than a Banking Company	Private Company other than a Banking Company
1992	66	44	55
2002	50	35	45
2003	47	35	43
2004	44	35	41
2005	41	35	39
2006 ^a	38	35	37
2007 ^a	35	35	35

Source: Income Tax Ordinance, 2001.

^a The tax rate is 20 percent for “small companies”. See the following discussion.

“Small Companies”

The concept of a “small company” was introduced in the Finance Act, 2005. Currently, a small company means a company registered on or after the first day of July 2005 under the Companies Ordinance, 1984, one that fulfills the following criteria:

- The company has paid up capital plus undistributed reserves not exceeding Rs. 25 million;
- It has employees not exceeding 250 any time during the year;
- It has annual turnover not exceeding Rs. 250 million; and
- It was not formed by splitting up or the reconstitution of business already in existence.

In order to encourage small companies, a lower corporate tax rate of 20 percent (versus the standard rate of 35 percent) was chosen. This is a significant fiscal incentive for small companies. Note that there is no smooth graduation for a company as it moves from small to regular status; that is, if a company increases, say, its employees above 250, then in principle the entire net income of the company is immediately taxed under the regular company regime tax rate of 35 percent. This feature creates a significant notch problem, one in which a company has a strong incentive to remain (for tax purposes) a “small company”. Note also that the various criteria for a “small company” seem to describe companies that are in fact not very small (e.g., 250 employees, annual turnover of Rs. 250 million). Until recently, small companies were not required like all other corporate taxpayers to deduct taxes on payments made on sales of goods, services, rendered, and executed contracts, and were also not required to withhold taxes; these incentives were repealed after 30 June 2008.

Deductions and Special Provisions

The tax base is net accounting profits, which equals gross revenues less various deductions and special provisions such as operating costs and capital adjustments. A range of deductions are allowed in the Income Tax Ordinance, 2001, including: depreciation allowances for tangible assets (including initial allowances) and amortization for intangible assets; bad debts (if classified as “irrecoverable”); pre-commencement expenditures; scientific research and development expenditures; transfers to participatory reserves; expenses for employees training and facilities; losses on non-performing debt of a banking company or a development financial institution; debt on consumer loans for banking companies, non-banking companies, or the House Building Finance Corporation; interest expenses on company debt; compulsory payments to the Workers Welfare Fund and Worker’s Profit Participation Fund, which are separate sources of social security support.

Depreciation Allowances

There are two types of depreciation allowances for tangible goods in the Pakistan corporate income tax: an initial depreciation allowance for some assets and depreciation allowances for other tangible assets.

An initial depreciation allowance of 50 percent of the cost of eligible depreciable assets is allowed in the first year only for assets when first used in Pakistan or when not previously used for commercial production in Pakistan, whichever begins later. Assets that are not eligible for the initial allowance include depreciable assets previously used in Pakistan, furniture, road transport vehicles, and any plant or machinery on which a deduction has been allowed under another section of the Income Tax Ordinance, 2001 for the entire cost of the asset in the tax year in which the asset was acquired.

The basic method of depreciation allowances for tangible assets is a declining balance schedule of depreciation, such as 10 percent for buildings; 15 percent for motor vehicles, and 30 percent for computer hardware. Amortization of intangibles is allowed on a straight-line basis of 10 percent rate if the useful life of the intangible asset is more than one year. Similarly, an amortization rate of 20 percent is allowed in the case of pre-commencement expenditures.

Minimum Tax Provision

Prior to the 2008-09 budget, resident companies were subject to a minimum tax of 0.50 percent of the gross turnover; non-resident companies were exempt from this minimum tax. The minimum tax provision was applied when no tax was payable or paid by the company for the tax year or when the tax payable or paid was less than one-half percent of the amount representing the gross turnover from all sources for the tax year, and the minimum tax was required even if the company reported losses. This minimum tax was abolished in the 2008-09 budget.

Filing of Returns

The tax year for income tax purposes is from July 1st to June 30th of the following year. With some exceptions, all companies are required to file their annual return for the preceding financial year by December 31st. After the introduction of the Universal Self Assessment Scheme (USAS) in 2002 (see below), all returns are considered to be finalized, although 5 percent of the returns are randomly selected for a detailed audit. Companies pay advance tax on a quarterly basis on the last assessed income with certain prescribed adjustments. The discharge of total liability is made at the time of the filing of the return. Advance tax and some taxes withheld at source are adjustable against the final tax liability at filing. If a company has paid more than its final tax liability, it can apply the excess against future tax liability. It is apparently quite difficult to claim and receive any tax refunds.

Universal Self Assessment Scheme (USAS)

For many years, companies believed that their tax returns were subjected to full assessment, resulting in many cases in an unmanageable litigation process and an unnecessary waste of taxpayer time. One of the major issues was the scope for ample contacts between taxpayer and tax collector, contacts that (it was believed) provided the opportunity for corruption and connivance. Honest taxpayers believed that the burden of full assessment was considerable and unjustified.

Accordingly, in July 2002 the Universal Self Assessment Scheme (USAS) was introduced in the income tax. The goals of USAS were several: to restore the confidence of taxpayers, to minimize the contact between taxpayers and tax collectors, and to speed up the pace of income tax revenues. The introduction of USAS has provided taxpayers a chance to pay their due taxes in a more congenial environment. Following its introduction, voluntary compliance has increased substantially, perhaps due to the restoration of taxpayers' confidence in the tax system and in the Federal Board of Revenue.

Presumptive Taxation Regime (PTR)

Some companies or types of income are taxed under a presumptive taxation regime (PTR), in which gross receipts (and not income) are taxed at a specified rate. These taxes are collected via withholding.

Treatment of Losses

Operating losses may be carried forward for up to 6 years; unabsorbed depreciation can be carried forward indefinitely. Brought forward losses cannot be utilized if the ownership of business changes by 50 percent or more or if a new business is started with the goal of simply using the losses. Also, operating losses can be carried forward up to a period of six years in case of the amalgamation of two companies, with the condition that the same business will continue for a minimum period of five years. The subsidiary of a public listed company can surrender its operating losses for up to 3 years to its holding company (with a holding of 75 percent), for the set off against its profit of the current and the subsequent two years; these consolidated returns have only been allowed since 2006.

International Taxation Treaties

Pakistan has signed full scope treaties on double taxation with 54 countries. Limited purpose treaties have also been negotiated with Kenya, Greece, India, and Jordan.

Compliance and Coverage

The base of taxation of the corporate sector is quite narrow. Out of 2.2 million National Tax Number (NTN) holders in 2006, only 28,756 (or 1.4 percent) are related to the corporate sector (Table 2), and of these only 13,946 filed a tax return. As discussed in more detail later, the majority of filers either declared losses or reported no taxable income.

Table 2: Filing Rate of Corporate Tax

Tax Year	Corporate NTN Holders	Filers	Filing Rate (percent)
2004	19,020	12,526	65.9
2005	22,290	14,191	59.2
2006	28,756	13,946	48.4

Source: Federal Board of Revenue.

Revenue Performance and Buoyancy of Corporate Taxes

Income tax collections from the corporate sector have increased at a fast pace during the past few years. Despite the gradual but steady reduction of corporate tax rates, especially for banking and private sector companies, overall collections have improved substantially, and the corporate share in gross income taxes has jumped from 60 percent in 2004-05 to 76 percent in 2006-07. As far the overall contribution of corporate taxes is concerned, Rs. 250 billion has been realized during 2006-07 against Rs. 171 billion in 2005-06. The corporate sector witnessed robust growth of 47.6 percent, 36.9 percent and 69.6 percent during 2006-07 in public, private, and banking companies respectively. In absolute terms, their collections stood at Rs. 92.9 billion, Rs. 112.1 billion, and Rs. 44.6 billion, respectively.

The profitability of the banking sector has been instrumental in this revenue performance. The robust growth in the collections from public companies is mainly due to the oil and gas sector. Private companies exhibited a reasonably high growth rate but one that is lower than for public and banking companies. This outcome spotlights the need of revisiting the extent of tax compliance by the private sector.

The collection of corporate taxes is mainly generated from advance taxes, payment with return and other sources (including realization from arrears), and withholding taxes. Advance tax collections are mainly related to the corporate sector, with only 2 percent stemming from the non-corporate sector. Out of total corporate advance tax payments in 2006-07, 28 percent is contributed by banking, 21 percent by oil and gas, 6 percent by telecommunication, 2 percent by fertilizer, and 1.5 percent each by tobacco and pharmaceuticals. The remaining collections are shared in small amounts by the other sectors.

The buoyancy of direct tax collections (of which the corporate income tax is the most important) has been estimated using liner regression methods. The natural logarithm of direct taxes is regressed on the natural logarithm of GDP, using data for the period 1984-85 to 2006-07. The estimated coefficient for GDP measures the response of direct taxes to a change in GDP. This estimated coefficient is 1.21, which indicates that, say, a 1 percent change in GDP leads to a 1.21 percent change in direct tax revenues. Similarly derived estimates for the sales tax, federal excise taxes, customs duties, and all federal taxes combined are 1.45, 0.90, 0.48, and 0.90, respectively.

IV. Tax Incentive Systems in Pakistan

The burden of the corporate income tax is significantly affected by the presence of numerous fiscal incentives available to firms. Fiscal incentives are used as a tool for promoting investment in most developing (and developed) economies, and Pakistan is no exception. Pakistan offers a generous package of tax incentives to the corporate sector, of several types. Indeed, the Income Tax Ordinance, 2001 contains numerous exemptions and concessions for the corporate sector, as indicated by the 70 pages in the Ordinance that describe exemptions and concessions, including a number of incentives that identify a specific company name as the recipient. One of the most conspicuous exemptions is for the agriculture sector, which contributes a significant part of the GDP of the country but a miniscule share of tax revenues.

In general, Pakistan's corporate tax laws do not discriminate among different sectors of the economy in terms of concessionary rates or special tax breaks. However, there are some notable exceptions. For example, Pakistan offers income tax incentives for firms that set up operation either in an export processing zone (EPZ) or a special investment zone (SIZ). There are also other incentives that operate in these zones. Certain types of economic activity (and the resulting incomes) are also exempt from the corporate income tax. These include the income earned by micro-finance banks

(provided that no dividends are paid out and that all profits are reinvested in micro-finance operations). The profits or gains of a venture capital company are also exempt, until 30 June 2014; the profits or gain on the sale of immovable property to a real estate unit trust up to 30 June 2010 enjoy a similar exemption. Any profits earned by a computer training or vocational institute are exempt from the income tax. Electric power companies are exempt as well. There are also preferential tax rates given for certain types of firms or activities, such as a reduced corporate income tax rate on “small companies” of 20 percent; small companies were also exempt from the withholding tax under Section 153 of the Income Tax Ordinance, 2001, although this incentive was repealed after 30 June 2008. Some imports are taxed at reduced rates (e.g., the import of capital goods and raw materials imported exclusively for its own use by a manufacturer registered with the sales tax, cement coal, some trucks, dump trucks, imports of the five major export-oriented industries, including textiles, carpets, leather, sports, and surgical goods). There are also incentives that stem from the standard structure of the corporate income tax, such as depreciation allowances, a new investment incentive scheme for purchases of moveable and immoveable assets, and allowable deductions, as well as some miscellaneous direct and indirect tax incentives.

V. The Investment Climate in Pakistan

The taxation of corporations in Pakistan is an important part of the picture of how taxes affect the investment climate. However, there are other relevant factors, and the analysis of corporate taxation only in Pakistan does not provide a complete picture of its competitiveness, in terms of its overall investment climate.

The World Bank, working with PricewaterhouseCoopers, has recently conducted a survey on the ease or difficulty in conducting business (including “the ease of paying taxes”) in 178 countries around the world, *Doing Business 2008*. The survey is based on a “case study company” approach, in

which a standardized, common company is constructed, and then the specific institutional features of each country are applied to this identical company in order to determine how easy (or difficult) it is to conduct business in the country.¹ There are various dimensions along which doing business is examined: starting a business, dealing with licenses, employing workers, registering property, getting credit, protecting investors, trading across borders, enforcing contracts, closing a business, and paying taxes. The study also calculates a “Total Tax Rate” (TTR), which is meant to include all taxes that are paid by companies, including corporate income taxes as well as property taxes, labor taxes and contributions, sales, and other indirect taxes. See Box 1 for Pakistan’s rankings in each of the ten categories, relative to the 178 countries included in the rankings.

Looking at Pakistan’s rankings relative to some select and relevant countries, Pakistan is placed well ahead in ranking from India and Sri Lanka in 3 out of the 4 indicators of taxation. These include the overall ease of paying taxes, the number of payments, and the TTR. Despite this, Pakistan is quite low by international standards. Pakistan’s ranking of 156th in time to comply is well below all the South Asian countries. It should be noted that Pakistan’s worldwide ranking in paying taxes has improved slightly in the last three years, moving from 149th to 146th. However, this improvement is quite small. Further, time for compliance (560 hours) per year is stagnant, and has not improved in the last three years. The time for compliance is inordinately high when compared to Singapore (49 hours), Malaysia (166 hours), Thailand (264 hours), and Korea (290 hours). There is also little change in the

¹ The company is assumed (among other things) to:

- be a limited liability, taxable company in its second year of operation
- be domestically owned, with five resident owners
- be engaged in general industrial and commercial activities (e.g., producing and selling ceramic flower pots)
- have 60 resident employees (4 managers, 8 assistants, and 48 workers)
- have a turnover of 1050 times income per capita
- distribute 50 percent of its profits as dividends.

number of payments (e.g., 47 payments in one year). However, tangible progress has been made to bring down the total tax rate from 42.2 percent to 40.7 percent.²

Box 1: Pakistan's Rankings in *Doing Business* 2008

The number in parentheses is the overall ranking of Pakistan in the relevant category. There are 178 countries that are included in the rankings.

Starting a business (59)

Procedures (number): 11

Time (days): 24

Cost (percent of income per capita): 14.0

Minimum capital (percent of income per capita): 0.0

Dealing with licenses (93)

Procedures (number): 12

Time (days): 223

Cost (percent of income per capita): 869.5

Employing workers (132)

Difficulty of hiring index (0-100): 78

Rigidity of hours index (0-100): 20

Difficulty of firing index (0-100): 30

Rigidity of employment index (0-100): 43

Nonwage labor cost (percent of salary): 11

Firing costs (weeks of salary): 90

Registering property (88)

Procedures (number): 6

Time (days): 50

Cost (percent of property value): 5.3

Getting credit (68)

Strength of legal rights index (0-10): 4

Depth of credit information index (0-6): 4

Public registry coverage (percent of adults): 4.6

Private bureau coverage (percent of adults): 1.4

Protecting investors (19)

Extent of disclosure index (0-10): 6

Extent of director liability index (0-10): 6

Ease of shareholder suits index (0-10): 7

Strength of investor protection index (0-10): 6.3

Trading across borders (94)

Documents to export (number): 9

Time to export (days): 24

Cost to export (U.S. \$ per container): 515

Documents to import (number): 8

Time to import (days): 19

Cost to import (U.S. \$ per container): 133

Enforcing contracts (154)

Procedures (number): 47

Time (days): 880

² The top five of the 178 countries included in the overall ranking of ease of doing business are Singapore (1st), New Zealand, the United States, Hong Kong, and Denmark (5th). The bottom five countries are Burundi (174th), Republic of Congo, Guinea-Bissau, Central Africa Republic, and Democratic Republic of Congo (178th). In the specific category of paying taxes, the top five countries are Maldives (1st), Singapore, Hong Kong, United Arab Emirates, and Oman (5th); and the bottom five countries are Venezuela (174th), Central Africa Republic, Republic of Congo, Ukraine, and Belarus (178th).

Cost (percent of claim): 23.8
<u>Closing a business (51)</u>
Time (years): 2.8
Cost (percent of estate): 2.8
Recovery rate (cents on the dollar): 39.1
<u>Paying taxes (146)</u>
Payments (number per year): 47 (138)
Corporate income tax payments (number): 5
Labor tax payments (number): 25
Other taxes payments (number): 17
Time (hours per year): 560 (156)
Corporate income tax time (hours): 40
Labor tax time (hours): 40
Consumption tax time (hours): 480
Total Tax Rate (percent of profit): 40.7 (80)
Corporate income tax rate (percent): 25.8
Labor tax rate (percent): 12.6
Other taxes rate (percent): 2.3
<u>Overall Ease of Doing Business (76)</u>
<i>Source: Doing Business 2008.</i>

In terms of tax rates, Pakistan's corporate income tax is 35 percent, while its General Sales Tax (GST) standard rate is 15 percent.³ Pakistan's corporate and VAT tax rates are higher than many selected countries; for example, both rates in Pakistan are higher than in India (33.7 percent and 12.5 percent, respectively).

The indicator of the Total Tax Rate (TTR) in *Doing Business 2008* is also of relevance here. The TTR is a standardized indicator that is used to gauge the overall burden of corporate taxes after adjusting for necessary exemptions and the like. Pakistan's TTR of 41 percent is significantly lower than that of India (70 percent), Australia (50 percent), and Turkey (46 percent). It is, however, slightly higher than Malaysia (37 percent), Indonesia (37 percent), and Thailand (38 percent).

Another set of rankings is provided by the World Economic Forum's *The Global Competitiveness Report 2007-2008*. Several indices are provided, including a "Business Competitiveness Index" (BCI) and a more comprehensive "Global Competitiveness Index" (GCI).

³ In budget 2007-08, two additional rates of sales tax were introduced for some items, at 17.5 percent and 20 percent. In the budget 2008-09, sales tax rates have been increased by 1 percent, and the sales tax rate for telecommunication has been increased from 15 percent to 21 percent.

Both provide a broad array of competitiveness indicators for a large number of industrialized and developing economies. The current report includes 131 economies. The indices are based in part on the Executive Opinion Survey carried out by the World Economic Forum, which is intended to measure the perceptions of several thousand business leaders across the countries covered on topics related to national competitiveness, as well as on a wide range of other data sources that measure relevant factors. See Box 2 for detailed information on the pillars that are used to construct the rankings and on Pakistan's rankings.

Pakistan's 2007-2008 GCI ranking is 92nd (out of 131 countries), which represents a slight deterioration from its previous years ranking of 83rd (out of 122 countries); Pakistan's 2007-2008 BCI ranking is somewhat higher, at 79th, which again reflects a decline from the previous year's ranking of 64th. In both cases, Pakistan ranks well below a number of other countries, including Korea, Australia, Malaysia, Thailand, India, Turkey, and Indonesia.⁴

The most problematic factors working to lower Pakistan's rankings are, in descending order: inadequate supply of infrastructure, inefficient government bureaucracy, corruption, policy instability, inadequately educated workforce, and government instability/coups. Regulation and tax rates are also identified as concerns.

Another issue is whether Pakistan's overall tax *structure*, and especially its reliance on the corporate income tax, is similar to that of other countries. Using International Monetary Fund data for 2000, with taxes divided into four groups (income and payroll taxes, property taxes, indirect taxes, and taxes on international trade), it is possible to calculate for a range of countries their relative reliance on each of these groups. These calculations indicate that Pakistan's tax structure is not very far from the international norm in its relative reliance on total income taxes, with about 28 percent of Pakistan tax revenues coming from income taxes relative to the mean value for this category for the sample of

⁴ The top five countries in the overall ranking of 131 countries are the United States (1st), Switzerland, Denmark, Sweden, and Germany (5th). The bottom five countries are Timor-Leste (127th), Mozambique, Zimbabwe, Burundi, and Chad (131st).

countries of 33 percent. Where Pakistan differs considerably from international practice is its very heavy reliance on corporate income taxes rather than on individual income taxes. Other calculations for a large sample of developing and transitional countries examine the relative reliance on individual income taxes and corporate income taxes. Of the 28 percentage points in total revenues collected from income taxes in Pakistan, only 4 percentage points come from personal income taxes. In contrast, for a representative sample of countries, individual income taxes of the 32 percentage points in total revenues on average collected from income taxes, 19 percentage points come from personal income taxes. More recent data indicate an even heavier Pakistan reliance on corporate income taxes. However, As noted earlier, the level of tax rates in the Pakistan corporate income tax is comparable to international norms, although the 35 percent standard rate is now somewhat on the high end of international comparisons.⁵

VI. Some Distorting Effects of Pakistan's Corporate Taxes⁶

The Pakistan corporate income tax introduces a range of distortions in corporate behavior, distortions that reduce the efficiency of resource allocation. Reforming the tax structure to minimize these tax-induced distortions can significantly increase taxpayers' welfare without decreasing their taxes paid. However, measuring these distortions is quite difficult. In this section, several methods are used to suggest the magnitude of these efficiency losses.

One simple approach is to measure the average effective tax rate (AETR), calculated as total taxes actually paid as a fraction of gross corporate (accounting) income. If this measure differs across sectors – as it does in Pakistan – then these differences give an indication of the ways in which the

⁵ Also, see Tanzi and Zee (2000) for more general comparisons.

⁶ It is well-known that the corporate income tax can also distort a firm's "financial policies", such as the decision on paying dividends to shareholders versus retaining the profits within the firm, and the decision to finance new investment with debt versus with equity. It is not possible to estimate the exact magnitude of these distortions in Pakistan, and these distortions are not discussed here. See, for example, Auerbach (2002) for further discussion.

corporate income tax (together with all of its special provisions) creates incentives for resources to move between sectors and therefore creates distortions in the allocation of resources.

Box 2: Pakistan's Rankings in *The Global Competitiveness Report 2007-2008*

The World Economic Forum defines “competitiveness” as “the set of institutions, policies, and factors that determine the productivity of a country”, and identifies 12 “pillars” of competitiveness. Pakistan's Global Competitiveness Index (GCI) rankings (out of 131 countries) in these 12 pillars in the 2007-2008 study are:

	<u>Pakistan Ranking</u>
<u>Subindex A: Basic Requirements</u>	98
1 st Pillar: Institutions	81
2 nd Pillar: Infrastructure	72
3 rd Pillar: Macroeconomic Stability	101
4 th Pillar: Health and Primary Education	115
<u>Subindex B: Efficiency Enhancers</u>	81
5 th Pillar: Higher Education and Training	116
6 th Pillar: Goods Market Efficiency	82
7 th Pillar: Labor Market Efficiency	113
8 th Pillar: Financial Market Sophistication	65
9 th Pillar: Technological Readiness	89
10 th Pillar: Market Size	28
<u>Subindex C: Innovation and Sophistication Factors</u>	78
11 th Pillar: Business Sophistication	79
12 th Pillar: Innovation	69
<u>Global Competitiveness Index, 2007-2008</u>	92

Note that Pakistan's GCI ranking in 2006-2007 (out of 122 countries) was 83rd. Note also that the World Economic Forum computes a Business Competitiveness Index (BCI), and Pakistan's 2007-2008 ranking was 79th, which represents a decline from its previous year's ranking (out of 122 countries) of 64th.

Source: World Economic Forum, *The Global Competitiveness Report 2007-2008*.

Another approach is to calculate the marginal effective tax rate (METR).⁷ METRs attempt to measure the impact of taxes on the marginal (or incremental) decision by economic agents to invest in capital; more precisely, the METR is defined as the additional tax paid by a firm when it decides to invest in one more unit of capital. A positive METR indicates that investment is discouraged; a negative METR indicates that investment is subsidized even in the presence of the corporate income tax via such special provisions as accelerated depreciation, investment tax credits, tax holidays, and the like. METRs can be calculated by sector and also by asset types. Differences in METRs across sectors and across assets generate incentives for resources to reallocate due entirely to tax

⁷ See Boadway, Bruce, Mintz (1984), King and Fullerton (1984), and Chen and Mintz (1993) for detailed discussions.

considerations, and therefore create efficiency losses (or “excess burdens”). A summary of METR calculations is given in Box 3.

Note that both methods may accurately capture the effective tax rates on those businesses that actually pay taxes. However, both methods are almost certain to overstate – perhaps quite significantly – the overall average effective tax rates on all businesses, including those that comply and those that do not comply. The widespread existence of tax evasion means that many businesses face an effective tax rate (marginal or average) of zero.

Box 3: A Numerical Example of Calculating Marginal Effective Tax Rates

The calculation of a marginal effective tax rate (METR) for a hypothetical industry X and its assets is explained here using a numerical example. Assume that there are domestic investors as well as foreign investors, where the foreign investors are assumed to be from the United States. Suppose the following values hold for important tax parameters in hypothetical industry X, as given in Box Table I:

Box Table I: Tax Parameters (in percent except last three rows)

Tax Parameter	Investor	
	U.S.	Pakistan
Statutory CIT Rate	34	35
Tax on Transfer of Property, Import Duty on Capital Goods	*	5
Capital Tax Rate	*	0
Tax Depreciation Rate-Building	*	10
Tax Depreciation Rate-Machinery	*	15
Property Tax Rate	*	5
Gross Receipt Tax Rate or Presumptive Tax	*	0.5
Sales Tax Rate	*	15
Present Tax Value of Accumulated Capital Cost Allowance for Building	*	0.093
Present Tax Value of Accumulated Capital Cost Allowance for Machinery	*	0.107
FIFO=1 and LIFO=0	0	1

where * denotes that this parameter is not used in the calculations. In most cases, the values in the table are those applicable for Pakistan. The present tax value of accumulated capital cost allowance for buildings and machinery has been calculated assuming a 50 percent allowance in the first year and declining depreciation from the next year. The same values of taxes (e.g., those levied in Pakistan) are assumed to apply to both the domestic and the foreign (U.S.) investor.

Non-tax parameters are given in Box Table II:

Box Table II: Non-tax Parameters (in percent)

Non-tax Parameter	U.S.	Pakistan
Expected Inflation Rate	2.40	4.57
Expected Real Interest Rate	3.1	6.0
Cost of Equity	6.89	6.89
Debt to Assets Ratio		
Debt Raised Abroad to Home Capital	40	40
Debt to Asset Ratio in Home Country	40	40

Rate of Economic Depreciation

Building	*	2
Machinery	*	5

The first stage in the calculation of the METR for an industry is the computation of the real cost of financing. Using standard formulae, we calculate the real cost of financing for domestic and foreign investors, respectively. These calculations give 2.3 percent and 3.6 percent, respectively.

The second stage in the calculation is the computation of the net-of-tax rate of return. Again using standard formulae, for domestic and foreign investors as before, we calculate the net-of-tax rate of return on capital for each category of assets (building, machinery, inventory, and land). See Box Table III.

The third stage in the calculation is the computation of the gross-of-tax rate of return on capital; these are calculated separately for domestic and foreign investors. Given the assumed values above, the net-of-tax and gross-of-tax rates of return are in Box Table III:

Box Table III: Rate of Return on Capital (percent)

Rate of Return on Capital	U.S.	Pakistan
Net-of-tax Return	4.61	3.83
Gross-of-tax Return		
Building	6.60	4.73
Machinery	8.04	6.20
Inventory	6.24	6.93
Land	6.06	4.00

In the final stage, it is straightforward to calculate the marginal effective tax rate for each type of asset using the two rates of return as: $METR = (r_g - r_n)/r_g$.

Based on the above assumptions and calculations, the results for industry X are in Box Table IV. The total METR for industry X is the weighted average of the METR by asset type, where we assume that the value of each asset type in the industry is: building 30 percent; machinery 50 percent; inventory 10 percent; and land 10 percent.

Box Table IV: METRs (percent)

METR	U.S.	Pakistan
Building	30	19
Machinery	43	38
Inventory	26	44
Land	24	4
Industry X	36	32

Effects on Investment: Intersectoral Allocation Effects – AETRs

A first indication of the distorting effects of taxation on the allocation of resources between sectors is given in Table 3, which shows the average effective tax rate (AETR) paid by corporations that filed tax returns in 2006-07 for the main economic sectors in Pakistan. These AETRs equal taxes actually paid divided by gross income, and are based on the actual returns filed by corporations in

2006-07. Taxes paid include income and profit taxes, of which the main taxes are advance tax and withholding taxes (WHT); separate calculations are made that include and exclude WHT. The most important withholding schemes in terms of revenues are withholding on contracts, on imports, on salaries, on exports, and on interest; other withholding taxes include those on dividends and securities, technical fees, indenting, rentals, prizes, petroleum products, cash withdrawn from banks, commissions, stock exchanges, transport, electricity bills, and telephone. In total, the presence of WHT obviously increases the tax burden on firms. Only those returns that showed gross income of Rs.1 million and above and that paid taxes are included in Table 3. Note that the statutory corporate tax rates in this tax year were 39 percent for banking and financial institutions, 37 percent for private companies, 35 percent for public companies, and 20 percent for “small” companies.

The overall average tax rate (including WHT) is 34.3 percent, or very close to the statutory tax rate of 35 percent. However, there is enormous variation in AETRs across sectors, ranging from a high of nearly 46 percent for beverages to a low of 14 percent for cement. The existence of some AETRs in excess of the top statutory tax rates for the different firm categories in 2006 is due to the inclusion of WHT; if withholding taxes are excluded from the calculations, then the AETRs are of course significantly lower.

Table 3: AETRs for Tax Year 2006 by Industry (percent)

Industry	AETR with WHT	AETR without WHT
Automobile	34.6	24.3
Beverages	45.7	27.8
Cement	13.9	12.7
Tobacco	31.1	29.5
Fertilizer	24.1	21.3
Iron and Steel	37.2	30.6
Petroleum	34.5	32.0
Sugar	28.6	24.6
Textile	21.3	15.9
Telecom	34.5	33.6
Banking/Financial Institutions	35.4	31.2
Insurance	44.4	33.5
Hotels and Restaurants	39.4	20.6
Transport	17.9	15.1
Gas	34.5	33.4
Pharmaceuticals	38.7	28.4
Chemicals	41.5	20.2

Industry	AETR with WHT	AETR without WHT
Other	37.1	24.8
Total	34.3	30.1

Source: Calculations by authors based on tax return data provided by Pakistan Revenue Automation Ltd. (PRAL) for tax year 2006. Note that only those returns for firms that showed gross income of Rs.1 million and above and that paid taxes are included.

These variations in AETRs reflect the differential treatment of sectors in the Income Tax Ordinance, 2001; given the differential treatment of assets in combination with the different proportions of assets across sectors, the variations in AETRs also reflect the differential treatment of assets in the tax code. For example, the relatively high AETR in banking and financial institutions stems from the (assumed) application of the 10 percent capital gains tax to these firms. The relatively low AETRs on cement firms and on transport firms are attributable to the high depreciation allowances (e.g., the initial allowance) that these firms typically claim; relatedly, insurance companies face a relatively high AETR because the magnitude of depreciation allowances for these firms is relatively low. Sectors that are machinery-intensive also have relatively high AETRs because of the differential application of high customs duties on machinery. Note that many firms incurred losses.⁸

In general, Pakistan's statutory corporate tax rate is relative high compared to EEC countries. The calculated AETR in Pakistan is also relatively high, especially when WHT is included in the calculations.

Effects on Investment: Intersectoral Allocation Effects – METRs

Calculation of marginal effective tax rates (METRs) by sector also illustrates the sectoral distortions generated by the entire system of corporate taxation. Tables 4 and 5 show calculations of METRs for the manufacturing sector, under various assumptions about the type of investor (e.g., the

⁸ The distribution of corporate filers for tax year 2006 is:

Category of Filers	Number of Returns
Gross Income of Rs. 1 million and above	1882
Gross Income below Rs. 1 million and greater than zero	2673
Gross Income of Rs. 0	6196
Negative Gross Income	3295
Total	13,946

Source: Calculations by authors based on income tax returns for tax year 2006 provided by Pakistan Revenue Automation Ltd. (PRAL). Note that 1561 companies recorded losses of less than Rs. 1 million (in absolute terms).

country of residence); the calculations in Table 4 are for a statutory corporate tax rate of 35 percent, and those in Table 5 are for the preferential tax rate of 20 percent. These calculations are made in part to illustrate the effects of a general reduction in the corporate tax rate on the distortions of the tax system and also in part to indicate the distorting effects of the differential treatment of “large” versus “small” firms (e.g., the 35 percent rate versus the 20 percent tax rate). (Note that it is possible to calculate METRs by asset type, or for buildings, machinery, inventory, and land. METRs by asset type are discussed in the following subsection.)

Table 4: METRs by Sector at 35 Percent Corporate Tax Rate (percent)

Industry	Foreign Investors from U.S.	Investors from Pakistan
Automobiles	34	35
Beverages	39	37
Cigarettes	36	32
Cement	34	34
Fertilizer	29	29
Iron and Steel	31	27
Petroleum (Offshore)	30	28
Petroleum (Underground)	7	6
Sugar	36	32
Textile	37	35
Chemicals	35	38
Telecommunications	40	36
Banking/Financial Institutions	55	50
Insurance	26	16
Hotels and Restaurants	29	23
Transport	30	23
Gas	41	38
Power Generation	19	20

Source: Calculations by authors. Note that power generation companies are exempt from the corporate income tax.

Table 5: METRs by Sector at 20 Percent Corporate Tax Rate (percent)

Industry	Foreign Investors from U.S.	Investors from Pakistan
Automobiles	21	26
Beverages	25	28
Cigarettes	22	24
Cement	21	25
Fertilizer	17	21
Iron and Steel	18	21
Petroleum (Offshore)	18	21
Petroleum (Underground)	5	6
Sugar	22	24
Textile	23	26
Chemicals	22	28
Telecommunications	26	28

Insurance	15	14
Hotels and Restaurants	17	19
Transport	18	18
Gas	27	29

Source: Calculations by authors.

The METRs in Tables 4 and 5 illustrate that the marginal effective taxation of different businesses differ quite significantly depending on the type of investor (e.g., U.S. versus Pakistan). The main tax factors contributing to intersectoral tax distortions include the level of various tax rates and the variance in tax rates and tax allowances across sectors.⁹ Higher statutory corporate tax rates increase METRs, as demonstrated by the always-higher METRs in Table 4 (at 35 percent) versus Table 5 (at 20 percent). More generally, METRs tend to increase in a fairly linear way with the statutory corporate tax rate. Consider, for example, automobiles. An increase in the tax rate in 5 percentage point increments from a 0 percent corporate income tax rate to a 50 percent rate increases the METR for investors from Pakistan from 20 percent to 40 percent, or by roughly 2 METR percentage points for every 5 percentage points in the corporate rate. METRs for other sectors differ in their exact responses to corporate tax rate increases, but the general tendency is unaffected. Note that the wider the gap in METRs between sectors the higher are the intersectoral tax distortions.

Many of the same factors that generated large differences in AETRs across sectors are of course present here. For example, the high METR in banking and financial institutions is due largely to the 10 percent capital gains tax that is assumed to apply to these firms. Also, the relatively low METR on petroleum (underground) firms arises because of the use of 100 percent expensing of capital purchases in this sector, and the relatively low METR on petroleum (offshore) firms is due to the partial expensing of machinery purchases. Similarly, firms in the power generation sector face a lower METR because these firms are assumed to be exempt from several taxes (e.g., the tax on profits) that

⁹ Non-tax factors such as the inflation rate, the interest rate, the financing structure, and the capital structure also affect the intersectoral tax distortion. For example, with a higher (lower) discount rate, as determined by the inflation rate, the interest rate, and the financing structure, a given depreciable asset will be taxed at a higher rate since the present value of its tax depreciation allowance will be worth less (more). When such a higher (lower) taxed asset accounts for a larger share of a capital used by a given sector, it contributes to a higher (lower) METR in this sector compared to other sectors.

apply to most other sectors. Sectors that are especially machinery-intensive tend to have higher METRs because of the differential application of high customs duties on machinery; this tendency may be partially offset for sectors with large purchases of capital (e.g., fertilizer, iron and steel, transport, power generation), thereby generating lower METRs, in part because of the high initial allowance that these firms are allowed. Relatedly, sectors that are especially inventory-intensive tend also to have higher METRs because these sectors are differentially and negatively affected by the sales tax.

Other tax factors that affect the magnitude of the METR calculations include mainly the assumed rate of tax depreciation and the various taxes that may be imposed on firms, especially the statutory corporate tax rate, the tax on the transfer of property, and the tax on capital gains. An increase in the tax depreciation rate always lowers the METR, but often by a relatively small amount.¹⁰ Also, note again that there are large differences in METRs in Tables 4 (statutory corporate rate of 35 percent) and Table 5 (statutory rate of 20 percent). Further, if the capital gains tax rate is assumed in Table 4 to be zero rather than 10 percent (and all other parameters are unchanged), then the METR on Pakistan investors in banking and financial institutions falls from 50 percent to 14 percent; even a smaller reduction in the capital gains tax rate from 10 percent to 5 percent lowers the METR for these investors from 50 percent to 38 percent. If the capital gains tax is applied to other sectors, then the obvious effect is to increase METRs, typically by large amounts.¹¹ An increase in the property transfer tax increases the METR in the affected sectors, but the impact is generally small.¹²

¹⁰ For example, the assumed rate of tax depreciation on buildings for the automobile sector is 10 percent. As the tax depreciation rate for buildings varies from 0 percent to 10 percent, the METR falls in total by only 2 percentage points. Changes in the tax depreciation rate for machinery have similar effects. These impacts also depend on the relative importance of buildings or machinery in the overall capital stock of the sector.

¹¹ Imposing a 5 percent (10 percent) capital gains tax on beverages increases the METR on Pakistan investors in Table 4 from 37 percent to 61 percent (73 percent); for offshore petroleum, the comparable increase in the METR from a 5 percent (10 percent) capital gains tax rate is 23 percent (37 percent); and for automobiles the METR at a 5 percent (10 percent) capital gains tax rate is 51 percent (63 percent).

¹² For the automobile sector, a doubling of the transfer tax rate from 5 percent to 10 percent increases the METR by 3 percentage points for investors from Pakistan facing a 35 percent corporate income tax rate; an increase in the transfer tax to 15 percent increases the METR by another 3 percentage points.

Non-tax parameters can also affect the METR calculations. Other things equal, an increase in the (assumed) rate of economic depreciation increases the METR, generally by roughly 5 percentage points for each 1 percentage point increase in the rate of economic depreciation.¹³ An increase in the assumed debt to asset ratio decreases the METR in all sectors, although the effect is not large. An increase (decrease) in the assumed rate of inflation tends to increase (decrease) the METR because many features of the corporate tax system (e.g., depreciation allowances, capital gains) are not indexed for inflation; however, the effect is non-linear because higher inflation also reduces the real cost of debt finance. Changes in the cost of equity also have a complicated impact on METRs because the cost of equity affects both the gross-of-tax return required by the firm and the net-of-tax return required by the investor. Most other non-tax (and tax) parameters tend to have relatively small impacts on METRs.

Effects on Investment: Asset-type Effects – METRs

Similar calculation of METRs by asset type clearly shows that assets are treated quite differently by the various features of the tax system (Tables 6 and 7). Again, these large variations in METRs distort marginal investment decisions across assets, and thereby generate efficiency losses. These differences are driven by the same features of the tax code as those discussed earlier. Some recent international comparisons by the EEC (2001) and by Mintz et al. (2005), using somewhat different methodologies, give the consistent result that the METRs in Pakistan are often higher than in several other countries, though not always dramatically so. It is important to note that the METRs for these international comparisons do not reflect the reductions in statutory corporate tax rates in many of

¹³ For example, in banking/financial institutions the assumed rate of economic depreciation for buildings is 2 percent. An increase to 3 percent (4 percent) increases the METR for Pakistan investors facing a 35 percent corporate income tax rate to 56 percent (62 percent); a decrease to 1 percent (0 percent) decreases the METR to 45 percent (39 percent). For automobiles, the effects are similar if slightly smaller; for each 1 percentage point increase in the economic depreciation rate for buildings, the METR increases by 4 percentage points. Roughly similar impacts are found in other sectors.

these countries in the most recent years, so the differences between Pakistan and other countries is now likely to be considerably higher.¹⁴

Treatment of “Small Businesses”: The “Notch” Problem

Recall that a “small business” is taxed on its income at a reduced rate of 20 percent, rather than the standard rate of 35 percent. This large difference in tax rates creates an enormous incentive for a company to be classified as a “small business”, even if it does not in fact meet the criteria of having paid up capital plus undistributed reserves not exceeding Rs. 25 million, of having employees not exceeding 250 any time during the year, of having annual turnover not exceeding Rs. 250 million, and of not being formed by the splitting up or the reconstituting of a business already in existence.

Aside from the strong incentive to opt for the small business classification (whether legally justified or not), the system further distorts incentives facing companies in several significant ways. First, firms at the threshold have an incentive to fragment their operations in order to meet the requirements; the law specifies that these types of fragmentation disqualify a firm from the “small business” designation, but monitoring these splits is quite difficult. Such purely tax-driven fragmentation is economically inefficient. Second, there is a major “notch” problem facing taxpayers. Consider a legal entity with turnover of exactly Rs. 250 million (or exactly 250 employees). An increase of 1 unit in either turnover or employees would in principle generate an enormous increase in tax liability, as the company must legally move into the regular corporate tax system; the company would also now also be subject to withholding requirements. These disincentives for growth in turnover or in employment are economically inefficient. There may be sound reasons for preferential taxation of small business, such as more difficult access to credit markets or higher (proportionate) compliance costs for small firms. Even so, preferential treatment is typically given by taxing an initial

¹⁴ Again, the exact methodologies differ somewhat across the various studies. The concept of the marginal effective tax rate is identical across all studies; that is, the METR is the difference between the pre-tax rate of return on a marginal investment and the required post-tax rate of return, expressed as a percentage of pre-tax rate of return. However, specific assumptions (e.g., interest rates, depreciation allowances, type of investor) can differ across the studies, thereby generating different METRs.

slab of income at a lower concessionary rate and then by taxing any income in excess of that ceiling at a higher rate, rather than by taxing all turnover exceeding the small business threshold at the higher corporate rate of 35 percent, as is the case of Pakistan.

The distortions can also be illustrated by the calculation of METRs for otherwise identical corporations facing a corporate income tax rate of 20 percent versus 35 percent. As shown by the earlier calculations, the differential taxation of small versus large companies creates very large differentials in METRs.

VII. Evaluating the Pakistan System of Corporate Taxation

Tax systems are designed to achieve multiple objectives. An obvious purpose is to raise the revenues necessary to finance government expenditures (sometimes termed “adequacy”), and also to ensure that the growth in revenues is adequate to meet expenditure requirements (“elasticity”). Another is to distribute the burden of taxation in a way that meets with a society’s notions of fairness; such “equity” is typically defined in terms of “ability to pay”, such that those with equal ability should pay equal taxes (“horizontal equity”) and those with greater ability should pay greater taxes (“vertical equity”). Taxes can also be used to influence the behavior of those who pay them; in choosing taxes, a common goal is to minimize the interference of taxes in the economic decisions of individuals and firms (“efficiency”). Taxes should be “simple”, both to administer and to comply with because a complicated tax system wastes the resources of tax administrators and taxpayers.

In many – though not all – ways, the basic structure of corporate taxation in Pakistan is sound, in terms of the correspondence between Pakistani practices in the definition of the tax base and in the choice of tax rates versus international practices in these dimensions. There are, however, significant problems in the Pakistan system, problems that relate mainly to the distortions – between sectors and between asset types – that the system of enterprise introduces; there are also significant administrative

limitations in taxation that reduce tax collections. This section discusses the performance of the Pakistan corporate tax system in achieving the various objectives of taxes, and focuses especially on the distorting effects and on administrative issues.

Table 6: METRs by Asset Type at 35 Percent Corporate Tax Rate (percent)

Industry	Foreign Investors from U.S.					Investors from Pakistan				
	Building	Machinery	Inventory	Land	Total	Building	Machinery	Inventory	Land	Total
Automobiles	29	43	24	21	34	19	38	45	4	35
Beverages	29	50	24	21	39	19	48	45	4	37
Cigarettes	30	43	26	24	36	19	38	45	4	32
Cement	29	43	24	21	34	19	38	45	4	34
Fertilizer	29	33	24	21	29	19	26	45	4	29
Iron and Steel	29	38	24	21	31	19	33	45	4	27
Petroleum (Offshore)	29	32	24	21	30	19	25	45	4	28
Petroleum (Underground)	29	-11	24	21	7	19	-31	45	4	6
Sugar	29	43	24	21	36	19	38	45	4	32
Textile	29	43	24	21	37	19	38	45	4	35
Chemicals	29	46	24	21	35	19	43	45	4	38
Telecommunications	29	46	24	21	40	19	43	45	4	36
Banking/Financial Institutions	54	49	75	57	55	50	45	78	51	50
Insurance	29	27	24	21	26	19	17	45	4	16
Hotels and Restaurants	29	50	26	21	29	19	47	45	4	23
Transport	29	33	23	21	30	19	26	45	4	23
Gas	29	53	24	21	41	19	51	46	4	38
Power Generation	14	24	13	10	19	15	26	13	10	20

Source: Calculations by authors. Note that power generation companies are exempted from Income Tax.

Table 7: METRs by Asset Type at 20 Percent Corporate Tax Rate (percent)

Industry	Foreign Investors from U.S.					Investors from Pakistan				
	Building	Machinery	Inventory	Land	Total	Building	Machinery	Inventory	Land	Total
Automobiles	17	29	13	10	21	16	29	31	7	26
Beverages	17	36	13	10	25	16	37	31	7	28
Cigarettes	17	29	13	10	22	16	29	31	7	24
Cement	17	29	12	9	21	16	29	31	7	25
Fertilizer	17	21	13	10	17	16	20	31	7	21
Iron and Steel	17	25	13	10	18	16	25	31	7	21
Petroleum (Offshore)	17	20	13	10	18	16	20	31	7	21
Petroleum (Underground)	17	-3	13	10	5	16	-5	31	7	9
Sugar	17	29	13	10	22	16	29	31	7	24
Textiles	17	29	13	10	23	16	29	31	7	26
Chemicals	17	32	13	10	22	16	33	31	7	28
Telecommunications	17	32	13	10	26	16	33	31	7	28
Insurance	17	16	13	10	15	16	15	31	7	14
Hotels and Restaurants	17	35	13	11	17	17	37	32	8	19
Transport	17	21	21	13	10	16	20	31	7	18
Gas	17	38	13	10	27	16	40	31	7	29

Source: Calculations by authors.

There are Likely to be Large Efficiency Costs.

Perhaps the most serious problem with the system of enterprise taxation relates to the distortions in investment – across sector and across assets – that it generates. A commonly accepted notion about “good” tax policy holds that the tax system should raise revenues with minimal interference in the decisions of consumers and firms. When a tax leads individuals and business to change their decisions solely because of the existence of the tax, the tax is said to impose an efficiency cost, or an “excess burden”.

The system of corporate taxes in Pakistan almost certainly introduces a wide range of distortions in firm (and individual) behavior, perhaps more than any other tax in the system. These distortions are illustrated most clearly by the large variation in AETRs and in METRs by sector and by asset type. Together with the extensive system of tax incentives and exemptions, the preferential tax rate for small businesses, and the use of the presumptive tax regime for some companies, the corporate tax gives preferential treatment both to different types of investment and to different sectors, thereby leading firms to base their investment decisions mainly on tax considerations rather than on market forces.

There is Widespread Use of Tax Incentives and Exemptions.

One of the major sources of these distortions is the relatively heavy reliance in Pakistan on tax incentives and exemptions. In the case of the income (individual and corporate) tax, the exemptions are contained in the Second Schedule of the Income Tax Ordinance, 2001 (“Exemptions and Tax Concessions”), which contains over 70 pages of items. The exemptions and concessions are from “Total Income” in Part I of the Second Schedule, for “Reduction in Tax Rates” in Part II, for “Reduction in Tax Liability” in Part III, and for “Specific Provisions” in Part IV. Often included in the Second Schedule of the Income Tax Ordinance, 2001 are specific exemptions for named organizations. There are also many investment incentives, as discussed in detail earlier.

What should be the role of these incentives and exemptions, especially in relation to the alternative policy of reducing corporate tax rates? Pakistan has gradually lowered its statutory corporate tax rates over time, and has brought some uniformity in these rates across different types of companies (e.g., public, banking, private); there is also a reduced rate of 20 percent for small businesses. There is currently a debate about whether the corporate rate should be further reduced to 30 percent by the year 2010 (Ali, 2007). A crucial issue here is whether a lower statutory tax rate by itself would attract investment, or whether investment incentives are also necessary. As demonstrated in the calculation of METRs, it is quite possible for a country to have low statutory tax rates but high effective tax rates on capital investment if other provisions of the tax law impose burdens. In Pakistan, there is a fairly widespread view that lower corporate tax rates alone will not work but must be supplemented with such incentives as investment tax credits, investment allowances, and accelerated capital consumption allowances. In fact, Pakistan has been generous in providing broad-based corporate tax incentives to attract foreign direct investment (FDI). However, the actual effect of incentives on FDI (and on investment more broadly) in Pakistan and elsewhere is a hotly contested empirical issue that remains controversial and unresolved.

Tax incentives are widely used in most all countries, usually in the form of special provisions that favor investment. According to Zee, Stotsky, and Ley (2002), 22 percent of the foreign affiliates of U.S. companies operating abroad received some form of tax concessions, and nearly all countries offer tax concessions. These concessions are designed to encourage two kinds of investments: from investors in foreign countries and from domestic investors.

Regarding domestic investors, the general principle is that domestic investors should be treated equally regardless of the sector or the asset in which they are investing (unless there are special considerations favoring certain specific investments), in order to avoid efficiency losses; domestic investors should also be treated equally relative to foreign investors. Regarding foreign investors, the general principle here is that capital imports should occur as long as their contribution to the domestic

economy (or the “marginal product of capital”) exceeds the cost to the economy. Now a small open economy like Pakistan must compete with investment opportunities in other countries, so it must offer the foreign investor the going after-tax rate of return. In general, this means that the country should not tax capital imports, because doing so reduces the rate of return received by foreign investors and thereby discourages capital imports.¹⁵

This suggests that a small capital-importing country like Pakistan should aim for tax rates that are close to – neither higher nor lower – than the tax rates of the countries from which capital imports can be expected. This result also follows when it is recognized, as it must be, that countries compete with one another for capital. If one country lowers its taxes on capital (or gives incentives), then other countries may respond in kind. The result is that no country may be able to gain a tax advantage against its rivals, and all that occurs is that the countries in the aggregate lose tax revenues, either to capital-exporting countries or to the multinational enterprises.

In general, there are several major types of incentives, most of which depend upon the existence of positive profits and most of which are targeted to specific types of assets (e.g., plant or machinery) or to certain types of industries (e.g., manufacturing) that the country wishes to encourage: investment tax credits and deductions; accelerated depreciation; tax holidays; investment grants; and various miscellaneous incentives (e.g., reduced corporate income tax rates, reduced tax rates on some activities, exempt purchases). In all cases, the exact magnitude of the benefit to the enterprise depends upon the specific features of the incentive: the period in which the incentive applies, the magnitude of the incentive, the tax rates in the corporate income tax (both in the country itself as well as in the home country of the enterprise, if relevant), the assets and sectors to which the incentive applies, the amount

¹⁵ An important exception to this rule-of-thumb is when a capital-exporting country taxes multinational companies on their world-wide income but allows a credit against home-country corporate income taxes of taxes paid in foreign countries. The failure by a capital-importing country (say, Pakistan) to impose its own corporate income tax on profits earned within Pakistan simply means that the capital-exporting home country of the enterprise (say, the U.S.) collects the taxes on income earned by the company in Pakistan. Failure to impose the tax therefore transfers taxes from the capital-importing country (Pakistan) to the treasury of the capital-exporting country (the U.S.).

and time profile of the expected profits of the enterprise, and so on. Evidence from Gugl and Zodrow (2005) and others suggests that the most popular type of investment incentive is the tax holiday (based on a somewhat small sample of countries). This is followed by accelerated depreciation, investment tax credits, and import duty exemptions. Nearly all countries use several incentive schemes.

It is in fact possible to quantify the magnitude of these incentives, using a variety of fairly complicated formulae; the calculation of METRs is one standard approach here. However, many countries do not seem to undertake such analyses. When the formulae have been applied (Thirsk, 1991; Rider, 2004; Russo, 2004), the analysis has typically shown that tax holidays and investment tax credits lower the marginal effective tax rate more than other incentives and that the interaction of different incentive schemes is crucial in determining their overall impact.

Still, the crucial issue is: Why give these incentives? The main reason appears to be that many small countries believe that they must have the incentives to compete with rival countries, especially when the country has little in the way of market size or resource endowment to attract foreign investors. Put differently, the introduction of a tax incentive by one country leads to strategic responses by other, rival countries. A related reason is that the introduction of tax incentives stems from the power of large domestic firms, who pressure the government to take measures that favor their enterprises. In both cases the result is the same: the incentives have little impact on investment because other countries have similar incentives, but the incentives distort investment decisions and have a large and negative impact on the aggregate tax collections of all countries, simply transferring revenues to large enterprises. There is little question that in Pakistan incentives (and the resulting preferential tax treatments) have created a misallocation of investments and that they have been a significant fiscal drain on the budget.

Few countries have undertaken a rigorous analysis of the benefits (e.g., increases in investment, gains from industrialization, job creation, transfer of technology and training, increased tax revenues) and the costs (e.g., revenue losses, distortions, complexity, political discord and corruption) of

incentives. Pakistan certainly has not, and a full assessment of the desirability of the system of incentives requires that such a benefit-cost analysis be undertaken. Indeed, there is now some evidence that the best way to encourage investment is simply to lower the tax rate in the corporate income tax, not to offer targeted incentives. There is also increasing evidence that the main effect of tax incentives is on the transfer of income across jurisdictions (via such mechanisms as transfer pricing and financial policies) rather than on the location of real activity across jurisdictions (Grubert and Slemrod, 1998; Zee, Stotsky, and Ley, 2002; Desai and Hines, 2004; Hines, 2004; Morisset and Pirnia, 2004). The main messages of this research are several. Tax incentives can stimulate investment. However, a country's overall economic characteristics are much more important for the success or the failure of industries than any tax incentives package. Further, even if tax incentives stimulate investment, they are not generally cost-effective.

Again, all of this is not to deny that tax incentives can affect the movement of "capital", broadly defined. It is to question whether any such movement represents a transfer of "real" economic activity as opposed to simply a transfer of "paper" transactions that reduce a firm's tax liabilities without generating any real economic activity. It is also to question whether the benefit-cost ratio of any such incentives is greater than one.

However, it should be acknowledged that this work remains controversial and unresolved. As emphasized by Devereux and Griffith (2005) and Klemm (2009) in recent reviews, the existing empirical work does not provide much in the way of policy-relevant insights.

There are Large Amounts of Tax Evasion.

As noted earlier, the corporate tax base is very small. Out of 2.2 million National Tax Number (NTN) holders in 2006, only 28,756 (or 1.4 percent) are in the corporate sector; of these only 13,946 filed a tax return. These numbers suggest a very low level of voluntary compliance with the corporate income tax.

Even aside from the very low filing rate of corporations there is much speculation and anecdotal evidence that companies are able to evade their true tax liabilities by taking advantage of poor administration of tax rules. Different businesses in Pakistan are subject to different tax regimes with different tax rates, and companies may be able to take advantage of these differences in tax rules by shifting income from higher to lower tax regimes.

One method is the use of over-invoicing. For example, taxes on transportation services are a fixed amount per passenger seat or per unit of vehicle weight. If a company supplying these services to a corporation over-invoices the value of these services, then it will not raise its own taxes but it will save taxes for its customers. Similarly, a presumptive tax on a firm of 3.5 percent on gross sales encourages over-invoicing by that firm in its sales to corporations. If a presumptively taxed firm over-invoices its corporate client by Rs. 100, then it will pay Rs. 3.5 in additional tax but it will save its client Rs. 35 in corporate tax, a net gain of Rs. 31.5 that the two parties can split by prior agreement. Over-invoicing of imported capital goods, in order to secure a larger investment allowance, is another method.

The FBR has the legal mandate that would allow it to control these forms of transfer pricing, and Chapter 8 of the Income Tax Ordinance, 2001 contains anti-avoidance measures available to the FBR that would allow the Commissioner to re-characterize income and deductions and to impose arms length values on transactions. However, the actual administrative capability of the FBR to monitor these types of transfer pricing activities is quite limited. Indeed, tax administrations in most other countries are often powerless to enforce arms-length transfer pricing rules.

There is a Narrow Tax Base.

Related to the heavy use of incentives, the tax base in Pakistan is a narrow one. It has been narrowed in at least two important ways. As just noted, one stems from administrative failures (especially enforcement problems) that allow the existence of enormous amounts of tax evasion. The second is legal and takes the form of exemptions or preferential treatment (e.g., “tax expenditures”).

To our knowledge, there is no comprehensive and systematic listing of the tax expenditures in the Pakistan tax system.

One result of a narrow (and likely falling) tax base is that the government by necessity must emphasize collection of taxes from those “tax handles” that are more readily available. More visible taxpayers (such as larger corporations and wage earners) end up bearing increasing amounts of the tax burden.

There are few estimates of the revenue loss from these tax expenditures, and the estimates that exist show significant differences in the magnitudes. The *Pakistan Economic Survey 2006-07* estimates that the tax expenditures in the income tax, the sales tax, central excise taxes, and customs duties totaled Rs. 46.75 billion in 2005-06, and increased dramatically to Rs. 184.90 billion in 2006-2007. By far the dominant factor generating the increase was the exemption of capital gains in 2006-2007, which increased the tax expenditures on capital gains from Rs. 0.95 billion to Rs. 112.45 billion. Tax expenditures from the income tax include those stemming from: pensions; allowances; income from funds; donations and contributions to charitable organizations; independent power producers; income from certain trusts, welfare/charitable organizations, and nonprofit organizations; profits on debt/interest from government securities and certain foreign currency accounts and profits on debt earned by certain nonresident individuals and institutions; NSS interest income; export of information technology; other interest income; capital gains; and other sector and enterprise specific exemptions. Only a few of these are related to the corporate income tax and its various provisions. Aside from capital gains, the estimated tax expenditures from these items in 2006-07 were only Rs. 9.43 billion, and again only a few of these latter items are related to the corporate income tax and its various provisions. Of course, companies benefit from exemptions in the sales tax, in central excise taxes, and in customs duties. The estimated revenue losses in 2006-07 from these items were Rs. 12.00 billion, Rs. 50.52 billion, and Rs. 0.450 billion, respectively.

Note, however, that Ahmad and Rider (2008) have recently estimated that the tax gap for 2004-05 for direct taxes was Rs. 263 billion, and that the tax gap for indirect taxes was Rs. 147 billion. In total, these estimates indicate a revenue gap of well over Rs. 410 billion, or roughly 6 percent of GDP.

Note that agriculture is often seen as an inviting target for federal government income taxation (despite the constitutional limitations on federal taxation of agriculture). However, the revenue potential of taxing agriculture at the federal level is uncertain, because there are very few “large” farms and because most of the remaining “small” farms would probably fall below any threshold of income taxation.¹⁶ It should also be noted that provincial taxation of agriculture is allowed via the Agriculture Income Tax, but that this tax is a very unproductive source of revenues for provinces (Bahl, Wallace, and Cyan, 2008).

There is an Apparent – and Largely Undocumented – Belief That Taxes Can Be Used to Generate Greater Economic Growth.

Closely related to the issue of tax incentives is the notion that the tax system can be used to encourage economic growth, and indeed is an essential component of any growth strategy via its use of incentives. There is a large literature that attempts to demonstrate the possible linkage between taxation and economic growth. Much of this literature focuses upon the experience of U.S. states, and examines the possible connection between state tax policies and economic growth (Yu, Wallace, and Nardinelli, 1991; Mendoza, Milesi-Ferretti, and Asea, 1997). This literature is somewhat inconclusive, but recent work by Alm and Rogers (2008) that examines the effects of measurement error and estimation technique demonstrates that there are some connections between state government policy variables and state economic growth but also demonstrates that these results are not very robust. For example, in some regression results it is possible to show that higher state tax revenues are associated with lower growth rates; however, this connection is fairly weak and is not present in all regressions and in all time periods. Alm and Rogers (2008) also find weak evidence that the mix of taxes (e.g., a

¹⁶ We are grateful to Mr. Syed Shabbar Zaidi for these observations. He estimates that the revenue potential from taxing agricultural income may only be Rs. 3 billion.

heavier reliance on income taxes or on sales taxes) affects state economic growth; in particular, they find fairly consistent results that greater use of sales taxes is associated with higher economic growth. As for state expenditure policy, Alm and Rogers (2008) find that higher welfare expenditures are correlated with lower economic growth, as expected, but greater spending on education and highways tends to be negatively associated with state economic growth. In short, there is some connection between various policy variables and economic growth, but the connection is very tenuous and is not very robust across all time periods, estimation methods, or specifications. There is also a growing literature that uses the World Tables to examine the determinants of country economic growth (Barro, 2000), and, as demonstrated by Levine and Renelt (1993), many of the results in this literature are also quite fragile.

In sum, this literature suggests that Pakistan should be cautious in manipulating tax policies (including investments incentives) to increase economic growth. There are few concrete examples from international experience that such efforts have been successful.

The Tax System is Excessively Complex.

Limitations in tax administration are magnified by the overly complex tax system. Over time, the tax system has been adjusted to raise revenue, or to respond to requests for more favorable tax treatment, or to promote specific activities, or to redistribute income, or to protect the poor. Each of these changes complicates the tax system. Complexity in turn leads to higher administrative costs, more arbitrariness in administration, and an increasing erosion of confidence in the fairness and effectiveness of the tax system. Taxpayers are not inclined to pay a tax that they do not understand, that imposes high compliance costs, and that is administered by a tax administration that is viewed by many as arbitrary, corrupt, and ineffective.

There are numerous elements that complicate the tax system. The corporate income tax itself is necessarily complex. Further, complexity is sometimes a by-product of well-intentioned adjustments

to the tax structure (e.g., the exemption of the purchases of items consumed by lower income individuals).

Still, there are areas where the system is needlessly complex. Clearly this is true for tax incentives. It is also true for capital allowances. Much effort goes into the calculation of depreciation. Many countries have elected to avoid such complicated schemes by grouping assets into broad categories.

It is difficult to quantify the costs of administration and compliance across countries. However, there is some work that has calculated these costs, using a variety of methods (Sandford, 1995; Slemrod and Blumenthal, 1996; Chattopadhyay and Das-Gupta, 2002). These studies demonstrate that there is substantial variation in the compliance and administrative costs across taxes and countries. Income taxes appear to be especially high in terms of administrative costs per dollar of revenue collected, with the more complicated the system the higher the cost. Broader-based taxes may be less costly to administer; capital gains taxes are notoriously difficult to administer.

The structure of the corporate income tax in Pakistan is complex, and there is extensive use of tax incentives and exemptions. These factors imply higher compliance and administrative costs than would be the case for a less complicated system.

Many countries in fact use simplified, or presumptive, methods of taxation in order to reduce complexity for some types of taxpayers. Pakistan is no exception. Typical “Best Practices” in presumptive methods of taxation include: ensuring that the tax burdens under a simplified tax system and under the regular tax system are comparable, reevaluating turnover thresholds, so as to ensure that only “small” taxpayers are eligible; regularly adjusting the thresholds for inflation and other changing economic circumstances; and improving enforcement of a simplified system, to ensure that firms who participate are in fact eligible (Alm, 2006).

There are Horizontal and Vertical Inequities in Corporate Taxation.

There is little question that the practice of enterprise taxation in Pakistan introduces significant vertical and horizontal inequities. If a tax system is fair, equally-situated companies (and individuals) will face the same tax obligations. When this is not the case – when the tax system is horizontally inequitable – some companies will bear a heavier burden than others who have roughly comparable means. This weakens confidence in the system, and may encourage some companies to look for avenues of nonpayment that will have negative consequences for revenues. It also may lead companies to make different economic choices in order to capture tax advantages, which in turn leads to losses in economic efficiency.

Indeed, there are many sources of horizontal inequities in the Pakistan enterprise tax system:

- The corporate income tax discriminates among firms, largely because of the existence of tax preferences that are available to some firms and sectors and not to others, including the preferential tax rate for small businesses.
- In addition to the formal provisions for tax relief, there is discretionary relief on a case-by-case basis.
- The opportunities for tax evasion differ considerably between firms in the formal and the informal sectors, between “large” and “small” firms, and between domestic and multinational firms (due to differences in transfer pricing capabilities).

These features also create vertical inequities. For example, larger firms may in fact receive more favorable treatment than smaller firms (as measured by profits or turnover or employees) if the larger firms are successful in being taxed inappropriately under the 20 percent statutory regime and the smaller firms is not. Larger firms that qualify for investment incentives may also be receive more favorable tax treatment than smaller firms that do not receive such incentives.¹⁷

There are Significant Limitations in Tax Administration.

¹⁷ Of partial relevance here is the overall incidence of the corporate income tax. See Wahid and Wallace (2008) for a detailed analysis of the incidence of taxes in Pakistan, including the incidence of the corporate income tax. They find that the corporate income tax imposes tax rates that increase with income, so that its impact on the distribution of income is progressive.

A dominant theme in most assessments of the Pakistan tax system is the absence of effective tax administration. If taxes cannot be administered efficiently and equitably, then the goals of any tax system, or of any tax reform, will not be achieved (Goode, 1981; Bird, 1989).

One indicator of administrative efficiency is the extent of tax evasion. As discussed earlier, there are apparently large amounts of evasion in Pakistan, with a wide range of negative effects. Evasion reduces the revenue and the elasticity of the tax system. It necessarily undermines the horizontal and vertical equity of the tax system, since equals are no longer taxed equally and the well-to-do are generally more successful in exploiting opportunities for evasion. The actual allocative effects of the tax system are likely to differ significantly from those implied by the statutes. In short, poor tax administration frustrates the achievement of virtually all goals of the tax system.

Other problems with the tax administration stem from the tax structure: the tax base has been narrowed by preferences, the system is overly complex, especially in its use of tax incentives, and over time the rate and base structures have become more and more complex. The structural and administrative problems are clearly related. Complexity in the rate and base structure makes administration more difficult and also reduces the compliance rate.

VIII. Reforming the Pakistan Enterprise Tax System

Reforms of the current system of corporate income taxation in Pakistan should be in the direction of reducing its distortions and improving its administration. Specifically, reforms should focus upon:

- Reducing the statutory tax rate of the corporate income tax. Such reductions would reduce significantly the distorting effects of the corporate tax. Recall also that the world-wide trend in corporate taxation is clearly for reductions in statutory tax rates.
- Reducing the widespread use of withholding taxes (WHT); if some of the WHT are to be retained, they should be made adjustable rather than final. The withholding taxes clearly increase the effective tax rate on companies; in many cases, they also have become final taxes in themselves. Indeed, in most cases WHT have very little to do with income taxation, and instead they resemble discriminatory taxes, as is the case with many of the withholding taxes

on imports and exports. Consideration should be given to elimination of these taxes, especially those that generate trivial amounts of revenues. Further, as a general rule withholding taxes should be adjustable as a pre-payment on the final tax liability of taxpayers, and should not be the final tax liability.

- Expanding the base of the corporate income tax, mainly by reducing, and where appropriate rationalizing, the use of tax incentives and exemptions. Conversations with business executives indicated in most cases a strong willingness to trade off reductions in tax incentives and exemptions for compensating reductions in corporate tax rates. In this regard, a complete examination of the benefits and costs of tax incentives and exemptions should be performed.
- Simplifying the tax system, especially in the ways in which tax incentives and exemptions are used. Reducing the use of tax incentives and exemptions would obviously help in this regard.
- Re-examining the thresholds for the “small business” classification, in order to ensure that only truly “small businesses” qualify.
- Re-examining the widespread use of the PTR.
- Continuing to improve tax administration, with a special focus on improving tax compliance. The re-introduction of the National Audit Plan is a helpful step in this direction. In this regard:
 - More stringent penalties need to be imposed in the event of non-filing, perhaps buttressed by the option of third-party intercepts if the penalty goes unpaid.
 - The use of field audits needs to be expanded. Again, it is important that non-filing companies be targeted given the apparently low rate of filing.
 - Non-filers should be assessed best judgment presumptions of liability, with the proviso that, while the presumption is potentially rebuttable and appealable, the assessment must be paid in advance of any attempt to rebut or appeal it.

There are tradeoffs in any reform, and the government must recognize these tradeoffs and set priorities. It is hoped that this chapter will help in the process of identifying the tradeoffs and of highlighting the ways in which the Government of Pakistan can address them.

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