

# **The Impact of Sales Tax on the National Economy of Pakistan**

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## **Abstract**

The Federal Board of Revenue has been collecting sales tax on goods since long. The 18<sup>th</sup> Amendment devolved 'sales tax on services' upon the provinces. Taking the first initiative Sindh build up the capacity of tax collection on services at the provincial level. Value Added Tax (VAT) is a multistage form of collection of sales tax. In Pakistan VAT is being implemented on the principle of destination based tax, charging import and domestic consumption at standard rate and the exports are zero-rated. Self-policing and self-enforcing are its main characteristics. Slow release of refund, weak audit procedure, special treatment and a long list of exemption are its achilles heel. Pakistani economy is mainly undocumented, frequent breakage of supply chain is adversely affecting its performance. Royal orders like frequent SRO's, notifications and rulings cause frustration and non-compliance issues. Statutory flaws needs to be suitably amended to make VAT more compliant and equitable form of taxation.

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## **A brief snapshot of the prevailing system of sales tax in Pakistan**

Presently, the federal sales tax on goods under the Sales Tax Act, 1990 is being collected by the Federal Board of Revenue (FBR) under Entry No. 49 of the Fourth Schedule of the Constitution of Islamic Republic of Pakistan, 1973. After the incorporation of 18<sup>th</sup> Amendment on 10 April 2010 in the constitution, 'sales tax on services' has been separated from the taxes on sales and purchases of goods imported, exported, produced, manufactured or consumed. Previously, the sales tax on services was collected through the machinery of FBR under the various heads of services like the services rendered by hotels, marriage halls, lawn, clubs and caterers, advertisement on T.V and radio, the services conducted by custom agents, ship chandlers, stevedores and the courier services as mentioned in the then Provincial Ordinances (repealed now).

Under the mandate of 18<sup>th</sup> Amendment and in line with sanction of 7<sup>th</sup> National Finance Commission (NFC) Award, it is the province of

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Sindh, which first took the initiative of establishing a provincial collecting authority under the name of Sindh Revenue Board (SRB) with the objective of building the capacity or machinery for the collection of sales tax on services. The province of Sindh has also introduced a provincial enactment under the name of Sindh Sales Tax on Services Act, 2011 for the imposition of the tax on various heads of services. All the remaining provinces followed suit and introduced similar provincial enactments for levying sales tax on services.

The officials of the respective provinces started collecting the tax under the umbrella of their respective provincial collecting agency with full zeal and zest, efficiency and dedication. Since the introduction of the provincial sales tax on services, the provincial competent authorities keep on expanding the heads of services over time, and by imposing tax on the different heads of services under the sun, has substantially broadened the tax base and accordingly the provincial governments became successful in raising significant amount of revenue for their provinces.

The prevailing sales tax system in Pakistan can broadly be categorized as Value Added Tax (VAT) type system, bearing some of the features and characteristics of the universally accepted style of VAT. Conceptually, VAT is structured on a credit-invoice mechanism for its administration. VAT imposes the tax through a multistage process that in effect 'withholds' tax at each stage of the chain of production and distribution preceding the final sales to consumer. VAT is collected on the basis of tax paid on sales minus tax paid on purchases or more precisely stated this tax is output-input adjustment based tax. In Pakistan VAT is based on 'destination principle' which simply implies that imports are taxed and exports are completely free of the tax.

Refund is another important feature of VAT which is issued by the revenue authority on the basis of excess input credit claimed by the registered person. In Pakistan, Section 10 of Sales Tax Act, 1990 implies that 'If the input tax paid by a registered person on taxable purchases exceeds the output tax on account of zero rated local supplies or export made during the tax period, the excess amount of input tax shall be refunded to the registered person not later than forty-five days of filing of refund claim.' The claim of refund ought to be based upon the genuine amount of excess input credit (after deduction of output tax minus input tax credit) paid to the exchequer, therefore, the scrutiny and cross matching of output input adjustment is very important step before release of the refund claim to the registered person. The FBR sometimes withheld even the genuine claims of the refund amount in order to inflate the figures of state collection or to meet the revenue target set by the

government. However, the slow release of refund claims may have adverse effects on the recycling of the money for the business men. The refund claims of about PRK 200 billion of the registered persons are pending with FBR up to the year 2016.

Basically, the VAT system is based on a principle of self-policing and self-enforcing mechanism of taxation. And, an audit is a tool at the hands of the revenue machinery to keep a watching eye over the business activities after having access to business record and other related documents in order to forestall any tax law violation or detect any tax evasion. By virtue of Section 25 of Sales Tax Act, 1990, it has been empowered that 'A Commissioner or officer of the Inland Revenue authorized by the Commissioner were empowered to ask any tax payer to produce record or documents which were in his possession or control for the purpose to produce record or documents which were in his possession or control for the purpose of conducting audit'. The audit report is nothing more than part of charge sheet which needs to be established through the process of adjudication.<sup>1</sup> Any person aggrieved by the process of adjudication may approach the departmental hierarchy of revenue authority or court of law in order to redress his grievance.

In Pakistan, although the federal sales tax was introduced in 1990, however, since then has been facing fierce opposition from the business circle for its enforcement. The apprehension of the business community is twofold: On the one hand, the record keeping requirement of a VAT is quite cumbersome for uneducated business class and on the other hand, there is every likelihood of harassment and corruption at the hands of the tax officials on account of non-maintenance of the required record. VAT supporters viewed undocumented economy is the main reason of failure of VAT system and without formal economy, VAT is tantamount to allowing the tax evasion with impunity as the system fails to plug in the breaches. Under the prevailing circumstance, and in order to cope with the situation for the time being, a single stage retail tax has also been retained side by side with formal VAT system.<sup>2</sup>

There is a plethora of taxation issues including narrow tax bases, generous tax concessions, special treatment and exemptions, weak and fragmented revenue administration and defective structural features of

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<sup>1</sup> Tariq Najib (ed.), *Pakistan Tax and Corporate Laws (PTCL) 2004 Case Law* (Lahore: Tariq Najib, 2004), p.84.

<sup>2</sup> Wayne Thirsk, 'A Review of Major Taxes' in *A Role of Taxation in Pakistan's Revival*, Jorge Martinez-Vazquez and Musharraf Rasool Cyan (eds.) (London: Oxford University Press, 2015), p.105.

the economy, which are not allowing the collection agencies to realize an optimal level tax collection from the total tax potential revenue.<sup>3</sup>

Admittedly, the Pakistani economy is not fully documented and there is a big segment of informal sector which has been spoiling every single step taken in right direction since the inception of Federal Sales Tax Act, 1990. The frequent breakage of supply chain of production-distribution has caused unwarranted load of tax upon the registered person. The sales tax at federal level has been hovering around 17% which is slightly on the higher side rate on the registered person especially in the social milieu or in Pakistani context when the buyer is unwilling to pay his tax liabilities voluntarily. The supplier has to pay either from his own pocket, as an additional cost of doing business or lose the buyer straightaway. In any way, the choice is not an easy one either, rather quite detrimental for the promotion of business. Fixing of joint and several liabilities upon both the persons of making or receiving the supply may have secured revenue for the federal government but it has confused the very concept of fixation of liability upon the defaulting party only.

The success of VAT lies in its complete chain of supply without any disruption or breakage. To achieve this end, there must be very few exempted items on the list of exemption and VAT must be confined to a very few essential items of household. 'In the United Kingdom, the VAT is progressive mainly because of zero-rating for food, housing and children's clothing. However, while the zero-rating achieves progressivity, it does so at the cost of a great erosion of the tax base, large amounts of revenue forgone, and extraordinarily poor targeting of those groups supposed to be helped'.<sup>4</sup>

In Pakistan, a long list of exemptions has been provided in the Sixth Schedule and a number of zero rating provisions have been incorporated in the Fifth Schedule of the Sales Tax Act, 1990. This special treatment has been creating a bad faith among the genuine tax payers who question the rationale of this discriminatory treatment and exclusion of a big segment of society from the scope of charging provisions of the sales tax. The discriminatory treatment with various articles, items and industries smacks of favoritism and cronyism. This

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<sup>3</sup> Serhan Cevik 'Unblocking Pakistan's Revenue' 2016. Available at <https://www.imf.org/external/pubs/ft/wp/2016/wp16182.pdf>

<sup>4</sup> Alan A. Tait, *Value Added Tax: International Practice and Problems*, (Chapter 11) 'Effects of VAT on the Economy' (Washington D.C.: International Monetary Fund, 2001), p.216.

concessional treatment is being regulated through issuance of various Statutory Regulatory Orders (SRO) issued by federal government at its own discretion without any formal policy. This extensive concession has caused frustration and disappointment among the genuine taxpayers and business circle. This state of affairs has been causing uncertainty about tax legislation and adversely affecting consistency in policy.

Furthermore, the persons who are sitting outside the registered regime enjoy a complete tax-free regime under their own time-tested notion of 'wait and see, nothing will happen'. This rule of thumb is valid and is still holding the field and is not going to be shattered in a short span of time. The collusion of tax evaders with that of the tax administrators has fortified this perverse view point. Under this non-compliance tax environment, the tax evaders cannot be convinced to join the formal tax regime and accordingly the tax base remains as small as ever before. The tax evaders violate the tax provisions without any fear of penal consequences. Instead of taking the tax evaders to task, the government keeps on extending concessions and favors by way of amnesty schemes without letting them learn any lessons of their default.

In Pakistan the tax effort on the part of tax collectors is also at its lowest ebb and, therefore, a big amount of tax revenue remains uncollected. The tax administrators have restricted their role to the extent of collecting the taxes which are 'easy to collect' administratively, leaving aside a big chunk of taxes uncollected, considering them as 'hard to collect' from the potential taxpayers. This easy approach of tax collection has excluded a number of articles, items and industries from the scope of charging provisions of the tax and left a big source of revenue untapped.

The government keeps on introducing such 'royal orders' by way of various amnesty schemes, SROs, instructions, rulings, and notifications from time to time, creating uncertainty about tax enforcement. This anti-tax conduct has been dissuading the potential taxpayers to join the mainstream of the tax base in the hope of special treatment to their industries as well. The frequent issuance of such notifications conveys the negative message to the potential taxpayers that the FBR has a final word on the enforcement, implementation and interpretation of sales tax. It is the general perception of the public that FBR can take a U-turn any time so the tax payers have to see tax laws through the lens of FBR or more precisely: 'Continuous tinkering with, and tweaking of, the tax laws through a steady barrage of SROs over time causes the legislation to lose shape and focus, not to mention

undermining the efforts of taxpayers to comply with the laws that are in force at any point in time'.<sup>5</sup>

There is another psychological reason for lack of incentives in the public for the compliance of tax laws. It is an old grievance of the general public that the social spending of the state is neither adequate nor as per the legitimate expectation of the masses. It may be true that the ameliorative role of the state has been relegated to a bare minimum level. The general perception is that there must be a *quid pro quo* against the payment of taxes. The public complains that there is hardly any rudimentary social security system in place for the disadvantaged group.

The masses has been facing non-availability or less availability of basic infrastructure, like roads, railway, transport and other means of communication in most of the backward areas of the country. Similarly, an easy-to-do business environment, safe law and order situation, and adequate facilities of education, health, transport and universal entitlements like clean drinking water, electricity, transport and accommodation etc. are not easily available to the have-nots segment of the society. The ultra-rich class has managed themselves the facilities like better healthcare and quality education by opting out the foreign sources, however the less privileged class is groping in the dark and expect that there may be a positive change in any foreseeable future. For the time being, the common man has been managing or arranging such essential things of life, social security and business as far as possible at his own risk, cost and consequences.

When these social indicators are below the minimum mark, there is less motivation and urge for tax compliance, when payment and non-payment is not a point of distinction socially, or social persuasion is totally missing, then tax evasion seems an easy option. Consequently, there is a tendency of flouting tax laws than complying with the provisions of tax laws. Although, this wrong tendency of non-payment of taxes cannot be justified on the touchstones of non-availability or less provision of essential social services, however the social milieu is not conducive for tax compliance either. In order to develop a tax culture, there must be some respite or satisfaction for the law abiding citizen of Pakistan.

There is hardly any culture of social recognition for a regular taxpayer. There is no concept of any reward on the part of the state for the tax compliant member, who has opted to deposit his hard-earned money in the national kitty. In U.K, there is a concept of state-pension

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<sup>5</sup> Wayne Thirsk, *op.cit.*, p.129.

for the tax payer people who remained regular in tax payments to the exchequer in their active professional life. After the retiring age, the quantum of the state pension is determined on the basis of all the previous tax payments made by such tax payer. In Pakistan, the concept of pension benefits and provident funds is equally defective. The government servants who have already availed the perks and privileges at the expense of tax payer's money, have been made entitled for pension and provident funds etc. It is the need of the hour that a formal social security system ought to be established so that every tax payer should have a sense of security during his active business life or professional life and may draw the benefits of tax payments by way of drawing pension or other such social security system, otherwise there would be least incentives for tax payment especially when the government has minimum tools to detect such tax evasion.

### **Certain statutory flaws in the Sales Tax Act 1990:**

Pakistan needs to amend and overhaul its existing sales tax legislation with the objectives to eliminate the arbitrary powers of FBR or to remove distortions in the VAT mode of collection of sales tax. There are certain inherent weaknesses in the provisions of Sales Tax Act, 1990, which are not only contrary to pure concept of the VAT, but also self-conflicting to the overall growth of sales tax. The sections that need to be amended for an effective and coherent sales tax policy are as follows:

*Section 3(B):* It has been provided in this section that any tax which was collected in excess whether collected under misapprehension of any provision of act or otherwise, is liable to be paid to the federal government. This provision of law is not in consonance with the sound principles of law. This windfall collection of sales tax, cannot be treated as an arrear of tax or charge, received on the basis of the omission of the registered person. This undue collection cannot be made part of the national kitty as the same does not belong to the federal government in terms of the charging Section 3 of the Act. Therefore such collection cannot be justified on the touchstone of equity, justice and fair play. The federal government should either give its due adjustment to such person from where it was wrongly collected or completely do away with this section.

*Section 7(A):* Similarly, the government cannot specify or fix any minimum value addition as mentioned in this section. If fixation of minimum value addition is the prerogative of the federal government, then the whole concept of invoice-credit mechanism would become

redundant and superfluous. The federal government has introduced a method of verifying under the name of Sales Tax Real Time Invoice Verification (STRIVe). Through this method, the buyer cannot claim its input till the time supplier has first uploaded the sales invoice entry. After the introduction of cross checking of input credit, this section has lost its rationale (if any). This section needs to be deleted.

*Section 8(1)(b):* In terms of this section, the federal government may decline any input of the registered person. The discretionary power of declining the input of the registered person without providing an opportunity of being heard smacks of an element of arbitrariness. The section ought to be amended by providing the tax payer an opportunity to contest this decline of input.

*Section 8 (2):* According to this section, if a registered person deals in taxable and non-taxable supplies, he can reclaim only such proportion of the input tax as is attributable to taxable supplies in such manner as may be specified by the FBR. The onus of proof of proportion of the input attributable to taxable supply ought to be fixed upon the registered person and the board may not be empowered to fix any specific manner excluding the rest of the manner as unacceptable one.

*Section 8 (1)(ca):* According to this section, the goods or services in respect of which sales tax has not been deposited in the government treasury by the respective supplier, the Finance Act, 2008 has added services for which the registered person became entitled for reclaiming or deducting input paid. The Finance Act, 2016 has excluded provincial sales tax on services for reclaim or deduction purpose. The federal government has restored input provision of the provincial sales tax on services as input in terms of definition of Section 2(14) of Sales Tax Act, 1990. The variation in the rates of federal sales tax and provincial sale tax have been creating difficulties, while claiming the tax credits.

*Section 8 (1)(caa.):* It has been provided in this section that the tax credit is not allowed to such purchases, in respect of which a discrepancy is found as is indicated by means of computerized program for analyzing and cross matching of sales tax returns, which is more precisely referred to as Computerized Risk based Evaluation of Sales Tax (CREST) or input tax of which is not verifiable in the supply chain. The federal government has also introduced a special procedure of verifying sales invoice under the name of Sales Tax Real Time Invoice Verification (STRIVe) for halting the false claims of tax input which states:



With the help of the new regime, all the registered suppliers will submit the data of their sales invoices to the FBR along with monthly tax return. The registered purchasers will claim their input tax from this data. This new kind of technology will verify all the input tax claims.

After the introduction of new system of invoice verification, Section 8 (1) (d) of Sales Tax is suggested to be done away as well. Through this method, the buyer cannot claim its input till the time supplier has first uploaded the sales invoice entry on real time basis by way of Annexure 'C'. The withholding provisions should now be done away between the registered persons and the same should be restricted to unregistered persons only and that too at the time of making payment and not on the accrual basis.

*Section 8B:* According to this section, a registered person shall not be allowed to adjust tax in excess of ninety per cent of the output for that tax period. The restriction of adjustment to the extent of ninety per cent of the output for that tax period is uncalled for and unwarranted. This section has added a proviso to the main section empowering the FBR to exclude any person or class of person from the purview of this restriction. This discretionary power may give an exploitative tool in the hands of the board which is not congenial for the promotion of the business.

*Section 8. (A):* It has been provided in this section that a joint and several liability of registered persons in the supply chain where tax is unpaid. Despite payment on the part of buyer, the person receiving the supply is held equal responsible for non-payment of the person making the supply. The federal government instead of fixing the responsibility about the non-payment of tax has adopted an easy approach and randomly saddled the responsibility upon both the registered persons unjustifiably.

*Section 10 (1):* According to this section that if the input tax paid by a registered person on taxable purchases made during a tax period exceeds the output tax on account of zero rated local supplies or export made during that tax period, the excess amount of input tax shall be refunded to the registered person not later than forty-five days of filing of refund claim in such a manner and subject to such conditions as the FBR may, by notification in the official Gazette specify. The refund provisions are the most ineffective and neglected provisions of law in the hands of the board, warranting to payback to the business men. The VAT cannot achieve its desired results unless the claim of refund are not swiftly

processed and finalized and the refund amount are released to the business men for recycling the money, held up with the FBR. The slow release of refunds and weak system of cross-matching of input credit may adversely affect the implementation of VAT in any working revenue administration or negative effects on the tax morale of the taxpayers.

*Section 13:* According to this provision, the supply of goods or import of goods specified in the Sixth Schedule is too long lengthy and unwarranted. The list should be restricted to essential food items only.

*Section 45-B:* According to this section, any person, other than the Sales Tax Department, aggrieved by any decision passed under Section 10, 11, 25, 36 or 66, by an officer of Inland Revenue may, within thirty days prefer an appeal to the Commissioner Inland Revenue (Appeals). The Commissioner (Appeals) works under the administrative control of member judicial of the FBR. The Commissioner (Appeals) cannot afford to go against the revenue interests of FBR, especially when he is supposed to join back the board's administrative hierarchy. This constraint is not conducive for complete justice especially where big revenue amount is involved and may focus on departmental expedience, compromising on the fundamental principle of justice, equity and good conscience. When the appellate forum does not meet the end of justice, it results in further cause of litigation, creating bad faith between the aggrieved person and the appellate forum, overburdening the overworked judicial system and finally slowing down the recovery process.

The judicial hierarchy needs to be suitably modified and the administrative branch of FBR be separated from the judicial functions of FBR. Similarly the Appellate Tribunal be made subordinate to the Supreme Court of Pakistan instead of the Ministry of Law and Justice. Any officer of FBR who has joined the judicial or adjudication assignments cannot be allowed to join back the administrative branch of the board. A proviso has been added to Section 72 of the Sales Tax, 1990 that 'no such orders, instructions or directions shall be given so as to interfere with the direction of Officers of sales tax in the exercise of their quasi-judicial functions'. It states that 'The Collector (Appeals) and other adjudicating functionaries were not required to follow the instructions of Federal Board of Revenue'.<sup>6</sup> Similarly, it is said that 'the ruling issued

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<sup>6</sup> Tariq Najib (ed.), *op.cit.*, p.28.

by Law Ministry cannot interfere the quasi judicial work. Law Ministry is not a Court of Law. In fact, it is not even an administrative authority in revenue authority'.<sup>7</sup> Unfortunately, FBR as well as the Ministry of Law, holding the dominating position in terms of the service matters for the officers of the FBR, can wield influence on such officers who are discharging the quasi judicial functions for the time being, especially when they expect to join back the administrative posts of FBR.

*Section 65:* It has been provided that any tax not levied or short levied in relation to any supply on account of general practice or as a result of inadvertent practice is exempted from making any tax payment. This exemption may be justified at the time of initial stage or teething stage of Sales Tax Act, 1990, however such provision of law cannot be justified after the mature age of 26 years of the statute. This arbitrary power of the federal government may be misused by influential business men and create uncertainty for the effective implementation of tax law.

Many of the sections of Sales Tax Act, 1990 begin with a clause or word like 'notwithstanding', recalling the origin of the word itself when the crown was empowered to dispense with any laws at its discretion, although this discretionary power of the crown was abolished by the Bill of Rights. FBR, however, is not willing to dispense with the discretion vested in the various parts of the entire statute. This overriding effect of this power of the FBR needs to be modified or qualified in order to give certainty to the tax code and such provisions of the Sales Tax Act that 'whatever may be the content of the section, it may be overturned at any time by a decision of the FBR' needs to be revisited.<sup>8</sup>

Pakistan needs to embrace substantial changes in tax policy aimed at increasing the buoyancy of the tax system, broadening the tax bases, reducing distortion and phasing out exemption. Although some of the distortions may be intentional, the real consequences of the distortions is that investment decisions are not guided by tax considerations as opposed to economic considerations.<sup>9</sup> Pakistan may emulate the sales tax legislation found in other countries, such as New Zealand and Australia, suitably adjusting according to our specific economic circumstances.

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<sup>7</sup> *Ibid.*

<sup>8</sup> Wayne Thirsk, *op.cit.*

<sup>9</sup> *Ibid.*, Chapter 9.