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ICMA Research and Publications Department

Will FBR's proposed restructuring plan improve tax collection and administration?

Institute of Cost and Management Accountants of Pakistan

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Summary

This policy note highlights Pakistan's ongoing fiscal challenges, emphasizing tax-related issues like tax evasion, tax avoidance, low tax to GDP ratio etc. Despite being the sixth most populous nation globally, Pakistan's tax-to-GDP ratio fell to 8.5% in FY23 due to a cumbersome taxation system, large undocumented sector, high dependency on indirect taxes and tax evasion and avoidance. Recommendations from donor agencies like the IMF suggest removing exemptions to align with global VAT standards. However, this reliance has created inequalities in the tax structure. The Federal Board of Revenue (FBR) faces challenges of rent-seeking, tax evasion, and corruption, discouraging taxpayers and resulting in undisclosed wealth. Consequently, Pakistan encounters a significant tax gap, notably in sales tax, income tax, and customs duty collections.

The Federal Board of Revenue (FBR) is set to undergo a substantial restructuring, approved by the Caretaker Federal cabinet, aiming to strengthen the Inland Revenue system and expand the tax net. The incorporation of digital systems within the FBR is intended to combat tax evasion and promote higher tax filer registrations. This initiative concentrates on improving tax revenues and diminishing external debt to foster sustainable economic growth. However, in accordance with the decision of the Election Commission, the implementation of the FBR restructuring plan has been postponed until the next elected government comes into power.

This policy document examines the restructuring plan of the Federal Board of Revenue (FBR), evaluating its potential impact on tax collection and administration. It emphasizes the importance of a clear separation between tax policy-making and administration responsibilities, following a model akin to that of countries like the United States. The document further explores the inclusion of oversight mechanisms, a dedicated Tax Policy Office, and digital initiatives to enhance tax monitoring and reduce information leakage. Additionally, it highlights supplementary measures suggested by the World Bank, including increasing tax revenue from sectors such as real estate and agriculture. ICMA is of the viewpoint that the successful implementation of these reforms has the potential to boost tax revenues and improve tax administration.

Introduction

Since its inception, Pakistan has been beset by persistent fiscal crises that have deepened over time. There is no single reason for this state of affairs; rather, various factors have contributed to its economic challenges. Issues such as low tax revenue collections, a budget deficit, a trade deficit, high debt repayments, diminishing forex reserves, rising inflation, and fluctuating monetary policies have all collectively impacted the economy. Among these factors, taxes play a significant role. When an economy struggles to collect an adequate level of tax revenue, it impacts not only the economy itself but also the government and its people. Pakistan's indebtedness is largely linked to insufficient tax collection, resulting in challenges meeting obligations like debt servicing and defense needs.

Pakistan's intricate tax system hampers economic progress, with a tax-to-GDP ratio at 8.5% in FY23, notably lower than the other neighboring countries such as India's tax-to-GDP ratio was 11.2% FY2022-23. The substantial dependence on indirect taxes, especially Value Added Tax (VAT), constitutes around 60% of the total annual tax collection. The International Monetary Fund (IMF) consistently advocates for the removal of VAT exemptions to align with global standards. However, this heavy reliance on VAT introduces inequality through exemptions in specific sectors. Despite boasting an economy estimated to be twice the size of officially reported Rs1,000 trillion economies, Pakistan only collects approximately 16% in taxes. With a potential revenue of Rs32,000 billion, the current collection stands at Rs9,400 billion, prompting concerns about Pakistan's capacity to gather appropriate taxes from its economic activities.

The Federal Board of Revenue (FBR, comprising over 23,000 employees, faces challenges of widespread rent-seeking behavior and tax evasion, creating a culture of corruption and discouragement for taxpayers. This not only hinders tax collection but also deters both domestic and foreign investment, resulting in a meager recorded amount of $1.34 billion in 2022 (approximately Rs274 billion). Simultaneously, the substantial tax gap cannot be overlooked, with a shortfall of Rs1,289 billion in FY22, representing 26% of the collectible tax. Breakdowns include a Rs519 billion sales tax gap (24%), a Rs730 billion income tax gap (31%), and a Rs40 billion customs duty gap (11%).

Table 1: Summary of Tax Gap Estimates (Rs. Billion)

	Year	Tax Collectable	Tax Collection	Tax Gap	Tax Gap (% of tax collectable)
Sales Tax	FY2020	2,209	1,690	519	24
Income Tax	FY2019/20	2,385	1,655	730	31
Customs Duty	FY2019	358	318	40	11
Total		**4,952**	**3,663**	**1,289**	**26**

Source: Ministry of Finance

Therefore, to prevent the misuse of taxation as a tool to fill revenue shortfalls, there is a need to have separate tax policy-making from tax administration responsibilities. This entails dividing the roles of tax policy formulation and tax collection within the FBR, following a model akin to countries like the United States. In the United States, the Internal Revenue Service (IRS) is entrusted with the responsibility of tax collection while the Department of the Treasury formulates tax policy. Even India, which had a Central Board of Revenue until 1963, recognized the impracticality of reforming a single entity and split their revenue administration into two distinct boards.

At present, the restructuring of FBR has obtained approval, with the caretaker government emphasizing that the ultimate decision rests with the new incoming government. The restructuring aims to bolster administrative operations within FBR, encompassing the expansion of the tax base, rectifying under-documentation issues, improving tax administration, and augmenting the capabilities of officials for more proficient audits. Additional enhancements are anticipated in technical realms such as internal audit, judicial representation, and other pertinent areas. Therefore, it is imperative to perceive these structural alterations as potential game-changers, poised to significantly influence FBR reforms, particularly in the mobilization of domestic resources, addressing immediate revenue imperatives, and fostering economic growth. This approach is essential for instilling trust in the transformative process.

Key Components of the Restructuring Plan

- The plan includes measures to enhance the capacity and efficiency of tax authorities, such as training programs for tax officials and the adoption of advanced technology for tax monitoring and enforcement.
- Efforts will be made to bring more individuals and businesses into the tax net through better identification and registration processes, as well as targeted outreach campaigns.
- The plan seeks to streamline tax filing and payment procedures to make compliance easier for taxpayers, thereby reducing tax evasion and avoidance.
- Measures will be implemented to ensure equitable taxation and reduce the burden on certain segments of the population while enhancing compliance among high-income earners and large corporations.

FBR initiatives to broaden Tax Base

“It is imperative to address the tax gap, as the deficiency in tax collection results in a lapse in tax compliance.”

According to FBR reports, the income tax collected for the tax year a notable decrease from the Rs 5.5 million collected in the tax year To enhance tax compliance, FBR has issued e-notices to approximately 8.195 million individuals who are included in the tax roll but did not file tax returns for the tax year 2022-2023. E-notice statistics reveal that 2.498 million non-filers were identified in FY22, with this number increasing to 5.696 million in FY23. Furthermore, tax authorities emphasized that approximately 839,856 individuals were not registered in the tax records. In a bid to broaden the tax base, notices were sent to all these individuals, urging them to submit their tax returns.

Conversely, it is imperative to address the tax gap, as the deficiency in tax collection results in a lapse in tax compliance. As per FBR records, the comprehensive tax gap for FY22 reached Rs1,289 billion, constituting 26% of the collectable tax. Specifically, the sales tax gap stood at Rs519 billion, equivalent to 24%, while the income tax gap amounted to Rs730 billion, representing 31% of the collectable tax. Additionally, the customs duty gap was recorded at Rs40 billion, constituting 11% of the collectable customs duty (refer Table 1).

IMF Assessment of Tax Gap

According to the IMF, Pakistan faces a tax gap of around Rs3 trillion. In contrast to common beliefs, the IMF’s assessment indicates that the federal tax gap is relatively modest at 2.9% of GDP, or Rs3000 billion annually. The IMF suggests a set of short-to-medium-term strategies, anticipating an additional 2% of GDP in tax revenues. This involves reforms in tax administration, the implementation of anti-avoidance rules, and the use of effective enforcement tools. Furthermore, the IMF highlights areas for improvement in income tax, personal income tax, and general sales tax, with the potential to generate additional revenues.

The IMF also notes a compliance gap of 6.9% of GDP, amounting to Rs7000 billion, underscoring the challenges Pakistan faces due to its lower tax capacity compared to other nations. The organization underscores the importance of concerted efforts to enhance tax capacity, foster a stronger relationship between citizens and the government, and improve governance across government agencies. In comparison with other countries, Pakistan’s tax-to-GDP ratio currently stands at approximately 10%, with the potential to increase to 12.9% of GDP.

Increasing Tax Expenditure

“In fiscal year 2021-2022, the tax revenue loss represents around 3.36% of the total GDP, compared to 2.69% in fiscal year 2020-2021.”

During the fiscal year 2021-2022, the loss in tax revenue accounts for approximately 3.36% of the total GDP, an increase from the 2.69% recorded in the fiscal year 2020-2021. The data presented in table 2 reveals a rise in tax expenditure across categories such as income tax, sales tax, and customs duty compared to preceding years. This escalation has resulted in the shortfall of collected taxes, failing to meet the requirements and expectations of diverse stakeholders within the economy.

However, in fiscal year 2021-2022, the tax revenue loss represents around 3.36% of the total GDP, compared to 2.69% in fiscal year 2020-2021. The figures shown in table 2 indicates that the tax expenditure in categories like income tax, sales tax and customs duty have increased comparative to previous years. Due to which the collected taxes do not met the needs and demands of various stakeholders within the economy.

Table 2- Summary of Tax Expenditure Estimates (Rs. In Billion)

Tax Heads	FY2020-21	FY2021-22	Increase/ Decrease (%)
Income Tax	416.51	423.89	1.77
Sales Tax	739.77	1,294.04	74.92
Customs Duty	342.89	521.7	52.15
Total	**1,499.17**	**2,239.63**	**49.39**

ANALYSIS AND FINDINGS

ICMA is of the view that segregating the tax collection agency from tax policy formulation offers clear advantages in promoting efficiency and revenue growth as well as improving tax collection and administration. A dedicated tax policy authority can specialize in formulating fair and transparent tax policies tailored to economic conditions. Simultaneously, a separate tax collection agency, free from policy-making responsibilities, can focus on optimizing operations, reducing tax evasion, and ensuring compliance. This separation would help minimize conflicts of interest, enhance transparency, and build public trust. The model also provides flexibility for policy adjustments in response to economic changes, promoting stability in enforcement operations. Adherence to international best practices reinforces a country's credibility on the global stage. Effective communication and coordination between the two entities are vital for the successful implementation of this streamlined approach.

On the opposing end of the spectrum, a heated discourse surrounds the issue of restructuring the FBR, particularly in light of apprehensions regarding potential complications stemming from this decision. Spearheaded by the Caretaker Finance Minister, Dr. Shamshad Akhtar, the proposed reform encountered resistance from a faction within the FBR, and its implementation faced a legal halt by the Judiciary. The contention was based on the argument that the interim Government lacked the mandate to make such a significant decision involving the restructuring of a government organization.

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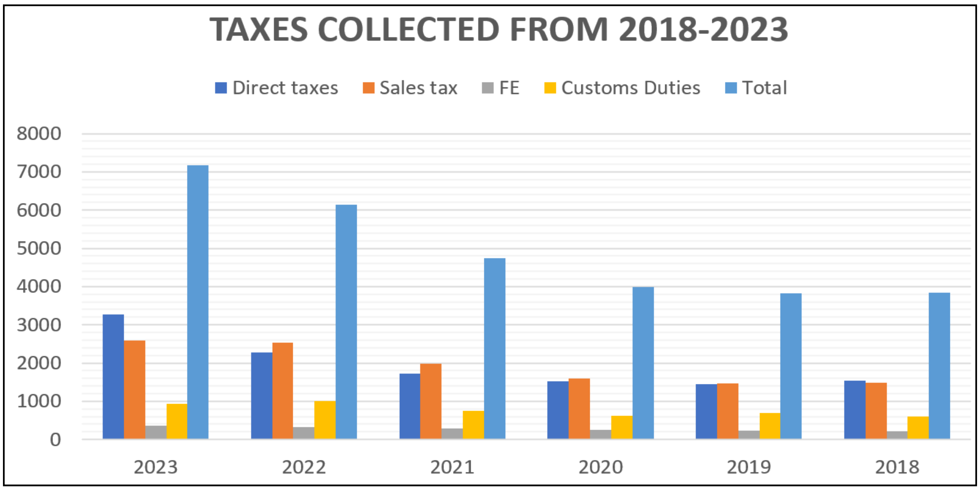
A secondary concern revolves around the potential augmentation of organizational complexity through the proposed restructuring, thereby presenting decision-making challenges for bureaucrats. Similarly, concerning digitalization, critics have pointed out that systems such as POS, track and trace, Iris, and various software and applications, including eFBR, PaySys, Reg Sys, ITMS, RCAPS, MPR, STARR, SMART, VOSS, Edox, HRIS, BTB, WeBOC, TAMPs, SAP Modules, and CSTRO, are regularly utilized in FBR. Over the years, these systems have proven instrumental in assisting FBR in the substantial collection of taxes, as illustrated in Table 3:

Table 3: FBR Tax Collections (in Billion PKR)

	2023	2022	2021	2020	2019	2018
Direct taxes	3,271	2,285	1,726	1,523	1,445	1,536
Sales tax	2,591	2,532	1,981	1,597	1,459	1,491
Federl Excise	370	321	280	250	238	206
Customs Duty	932	1,011	747	626	685	608
Total	7,164	6,149	4,734	3,996	3,827	3,841

Source: Revenue Division Year Books



With the recent assumption of power by the new government under Prime Minister Shehbaz Sharif, there is a hopeful outlook for progress in this matter. While consensus exists on the imperative nature of digitization for enhancing tax administration and efficiency, resistance from FBR employees is anticipated in relation to other initiatives outlined in the restructuring plan. Prime Minister Shehbaz Sharif has recently taken proactive measures to address this scenario, instructing the hiring of a foreign consultant with the aim of modernizing the Federal Board of Revenue.

Why FBR Restructuring is important?

Over the years, there has been a rise in the tax gap and tax expenditure, necessitating a restructuring of current reforms. The proposed FBR restructuring is crucial for eliminating past issues, broadening the tax base, addressing under-reporting, and improving tax administration and auditing efficiency. According to the 2024 IMF report, Pakistan's revenue collection department must be strengthened to align with the FY2024 budget. To achieve this, FBR needs to incorporate 900,000 non-filers into the tax base. Despite utilizing various software and systems for tax collection, there is a lack of monitoring to trace and track the collection. Hence, concerted efforts are required to address the growing shortfall in taxes.

As per the Finance Ministry's Monthly Economic Update for the first half of the fiscal year 2024, there has been a notable 30% increase in FBR's tax collection, reaching Rs5.15 trillion in the initial seven months. However, this rise in revenue is insufficient to cover overall expenditures. The fiscal deficit has concurrently expanded to 2.3% of the GDP in the first half of the fiscal year 2024. In February 2024, FBR provisionally collected Rs681 billion, falling short of the Rs714 billion target, resulting in a significant deficit of Rs33 billion. Likewise, a report by the Sustainable Development Policy Institute (SDPI) indicates a revenue loss of Rs567.34 billion for FBR over the past seven years due to various tax policies, including those related to tobacco taxation and revenue.

Reasons of FBR tax collection deficiency

Although, FBR presently has been utilizing various systems to facilitate individuals to file tax returns and collect taxes from people. But the major root cause of FBR inability to cover the tax deficit solely relies on the following factors:

- Pakistan's tax code is plugged with a range of exemptions
- Under taxation of agricultural income
- Under taxing properties
- Tax exemption on the payable tax by the companies on investment made for the purchase of plant and machinery
- Tax Evasion
- Massive corruption
- Policy gaps
- Misuse of power
- Inadequate number of tax filers

Hence, to eliminate and mitigate the effect of all these factors for sufficient collection of taxes by FBR requires restructuring. The restructuring of FBR intends to be divided into four separate boards. Specifically, there would be two boards dedicated to Customs and Inland Revenue, respectively, each with its own jurisdiction and responsibilities. Additionally, there would be two oversight boards established to monitor and supervise the functions of the Customs and Inland Revenue boards. This component aims to streamline the structure of the FBR, with key elements including:

- Segregation of policy formulation from operational tasks, assigning the former to the Federal Policy Board with a revised composition and responsibilities, while operational functions, particularly tax collection, remain separate.

- Establishment of distinct Customs and Inland Revenue bodies led by Directors-General from respective service backgrounds, reflecting the diverse tax functions they manage.

- Reinforcement of governance within the FBR structure through the introduction of new oversight mechanisms specific to Customs and Inland Revenue. These oversight boards will be accountable for ensuring high standards of performance and service delivery, aligned with policies set by the Federal Policy Board.

- The Federal Policy Board, chaired by the finance minister, will include academic professionals nominated based on predetermined criteria to avoid conflicts of interest, ensuring government approval.

- Creation of a Tax Policy Office within the Revenue Division tasked with conducting thorough research and providing data-driven analysis on taxation issues, recommending policy adjustments and evaluating revenue projections from sectors currently underrepresented.

- With these structural reforms and initiatives to broaden the tax base, integrate data enhancement and technology, and transform Pakistan Revenue Automation Limited (PRAL) into a leading technology company with NADRA's support, there is an expectation to raise the tax-to-GDP ratio to 18% within five years (by 2029).

This restructuring plan aims to potentially improve the efficiency and effectiveness of the FBR's operations by dividing responsibilities more clearly and enhancing oversight mechanisms.

Digitization of the tax operations

The FBR restructuring plan underscores the importance of digitization, aiming to reduce information leakage and facilitate accurate documentation for verifying the number of tax avoiders. Despite facing criticism, the proposal for the digitization plan is integral to the digital transformation of the Tax authority, encompassing several key components:

- Introduction of mandatory digital documentation for organizations, requiring them to share data about assets, transactions, and income with the Federal Board of Revenue (FBR) through a digital platform.

- Implementation of digital invoicing to capture sales and purchase transactions across the entire supply chain, aiming to address the current lack of documentation in these processes.

- Utilization of technology from the National Database and Registration Authority (NADRA), collaboration with Karandaaz, and support from the Bill and Melinda Gates Foundation to digitize tax collection and foster IT integration across different organizations over time.

- Digitization of withholding tax collection to address compliance gaps and detect violations and malpractices that may occur in the manual and outdated process.

- Introduction of a new and simplified scheme for untaxed sectors, based on a technology platform, to minimize human interaction between small businesses and tax officials, thereby reducing complaints and malpractices.

Taxing the Real Estate and Agriculture sector

Furthermore, in addition to these reforms, various other measures require implementation. According to the World Bank's proposal, Pakistan has the capacity to augment tax revenue by 3% of the GDP through more effective tax collection from the real estate and agriculture sectors. However, constitutional constraints hinder the federal government from taxing agriculture, as it falls within the purview of provincial jurisdiction.

The monthly revenue could be enhanced through the adoption of the following reforms:

- Increase the GST rate for tier-1 textiles and leathers from the reduced rate of 15 percent to the standard rate of 18 percent, with an expected monthly collection of Rs 1 billion.
- Implement a Federal Excise Duty (FED) of Rs 5 per kilogram on sugar, anticipating a monthly collection of Rs 8 billion.
- Raise advance income tax on the import of machinery by 1 percentage point, aiming for a monthly collection of Rs 2 billion.
- Raise advance income tax on the import of raw materials by industrial undertakings by 0.5 percentage points, with an expected monthly collection of Rs 2 billion.

“It is crucial to expand the taxpayer base through a door-to-door campaign in major cities, aiming to register non-filing retailers and simplify their tax filing process.”

- Increase advance income tax on the import of raw materials by commercial importers by 1 percentage point, projecting a monthly collection of Rs 1 billion.
- Heighten withholding tax on supplies by 1 percentage point, forecasting a monthly collection of Rs 1 billion.
- Increase withholding tax on services by 1 percentage point, expecting a monthly collection of Rs 1.5 billion.
- Raise withholding tax on contracts by 1 percentage point, anticipating a monthly collection of Rs 1.5 billion.

It is crucial to expand the taxpayer base through a door-to-door campaign in major cities, aiming to register non-filing retailers and simplify their tax filing process. This initiative will use electricity meter data for cross-referencing and conducting audits to identify tax evasion.

Rigorous supervision, including random audits, will ensure accuracy in assessments. The scheme aims to launch with limited discretion for field offices to modify valuations, safeguarding potential revenue.

To prevent double taxation, monthly advance tax payments will offset final income tax liabilities, with no refunds issued. The commitment includes providing the IMF timely monthly data on agreed performance indicators.

FBR Restructuring Plan will boost revenues and improve tax administration

The FBR Restructuring Plan is a key strategy designed to improve revenue generation and enhance tax administration efficiency. This initiative aims to implement digital solutions, broaden the taxpayer base, and ensure robust supervision for accurate assessments.

By addressing existing challenges, the plan is poised to create a more effective and modernized framework within the Federal Board of Revenue. This comprehensive approach is anticipated to boost revenues while establishing a stronger foundation for effective tax management.

Policy Recommendations

While the proposed restructuring plan holds promise for improving tax collection, its success will depend on effective implementation and overcoming various challenges. Key factors influencing its impact on tax revenues include:

- ICMA is of the view that by implementing various measures such as raising GST rates, introducing new taxes, and improving tax collection mechanisms, the government may witness a boost in tax revenue. This additional revenue can be used for public services, infrastructure development, and reducing budget deficits.

- Initiatives like the door-to-door campaign and cross-referencing tax filings with electricity meter data can help in identifying tax evasion more effectively. This could lead to a reduction in tax evasion and an increase in compliance among taxpayers.

- Streamlining tax filing processes for non-filing retailers can make it easier for them to fulfill their tax obligations. Simplified procedures can encourage more businesses to register and comply with tax regulations.

- Strengthening oversight mechanisms, such as introducing new oversight boards and implementing strict supervision through random audits, can enhance governance and transparency within the tax administration. This can help in reducing corruption and ensuring fair treatment of taxpayers.

- Increased tax revenue and improved governance can contribute to overall economic growth and development. The government can allocate resources more efficiently towards key sectors such as healthcare, education, and infrastructure, which are essential for sustainable development.

- While these reforms aim to improve tax compliance, there may be challenges in implementation, especially regarding resistance from non-compliant taxpayers and administrative hurdles. Efforts to address these challenges will be crucial for the success of the reforms.

- Changes in tax rates and regulations can have implications for businesses, affecting their operations, costs, and competitiveness. It's essential for policymakers to consider the potential impact on the business environment and take measures to mitigate any adverse effects.

- ICMA suggests the establishment of a specialized Tax Planning Unit within the Ministry of Finance, staffed with experts, including cost and management accountants. This unit will exclusively concentrate on developing and implementing effective tax policies which should align with economic growth goals as well as enhance tax administration.

- ICMA proposes to establish a highly competent FBR board comprising individuals with expertise in economics, law, finance, and related fields. This board will play a pivotal role in making strategic decisions to enhance tax administration and policy.

- ICMA recommends the development of a unified national tax policy to streamline tax collection efforts across Pakistan. This policy will harmonize tax regulations and procedures, ensuring consistency and simplicity in tax collection throughout the country under a centralized tax agency.

- ICMA proposes adopting Pakistan's version of Australia's Taxation Data Matching system to cross-reference taxpayer data with third-party information, like bank transactions and property sales. This aims to detect discrepancies, combat tax evasion, and improve tax compliance, enhancing transparency and revenue collection.

- ICMA suggests tax reforms to ease the burden on the poor and middle class, while ensuring fair contributions from the wealthy. The aim is to spur economic growth and create jobs, especially for youth, through productive investments.

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