

AN APPRAISAL OF FEDERAL BUDGET

BY

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TABLE OF CONTENTS (1)

- Revenue target
- Industrialisation and Custom Duty
- Guise of WTO Compliance
- Abuse of Afghan Transit Trade
- 'Under Invoicing'
- Smuggling
- Custom Administration
- Federal Excise Duty
- Value Added tax – Perception & Realities
- Conclusions on Indirect Taxes

TABLE OF CONTENTS (2)

- **Direct Taxation (Income Tax)**
- **Level Playing Field for Various Forms Of Business**
- **Tax on Bank Withdrawal**
- **Reintroduction of Tax Credit for BMR**
- **Tax on Capital Gain on Trade in Stock Exchanges**
- **Tax on Oil Exploration Companies**
- **Conclusion on Direct Taxes**

How long will we tell lies?

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چٹی چادر داغ لکھیسی، لوئی داغ نہ کوئی

WE ARE DIFFERENT – A LOT OF SPACE TO COVER (1/3)

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REVENUE TARGET (1)

- In the budget document total revenue collections from Federal taxes has been estimated at Rs 1,667 billion as against the target of Rs 1,380 billion for the year 2009-2010. Actual collection for 2009-2010 is expected to be around Rs 1,350 billion.
- This revenue target will be around 10 per cent of GDP.
- The primary question to be answered is whether or not the measures announced in the budget will improve Tax to GDP ratio and that in a meaningful manner.
- The answer is emphatic negative and I do not expect the same in the short run. I would, however be really worried if the direction is wrong.

REVENUE TARGET (2)

- In the proposed budget the increase in revenue collection over the year is Rs 287 billion [Rs 1667-1380]. Out of the same Rs 200 billion is expected from inflation of around 10 per cent and around 4 per cent from GDP growth.
- Remaining recovery of around 80 billion is expected primarily from increase in tax at import stage from 4 to 5 per cent, increase in minimum tax from 0.5 per cent of turnover to 1 per cent and increase in the sales tax rate from 16 to 17 per cent for the period July 1, 2010 to September 30, 2010 when a new Value Added Tax or General Sales Tax is expected to be implemented.
- This is not a rocket science. It is simple arithmetic. It has to be noticed that these are obsolete and traditional methods of balancing the revenue collection which are not expected to provide vibrancy, efficiency and elasticity earnestly required in our tax collection system.

REVENUE TARGET (3)

ARM Twisting of Genuine Taxpayers

- Another important aspect with regard to tax collection is the recovery made through twisting the arms of the genuine taxpayers.
- Around 50 to 70 billion has been raised through orders and assessments which are not maintainable in the court of law and the recoveries if made against these orders will ultimately be refundable. This is effectively an advance payment of tax. Thus, these are not 'actual collections'. This trend which existed in early 90's had died down with the introduction of the new Income Tax Ordinance, 2001 has again cropped up. In these circumstances, the real recovery of taxes is to be taken at around Rs 1,280 to Rs 1,300 billion for the year 2009-2010.
- Do we have a conducive environment for the recovery of the sum of Rs 1,650 billion?

REVENUE TARGET (4)

- The bigger misfortune is the role of foreign advisors and intellectual and economists in Pakistan. There is a constant pressure of increasing the tax to GDP rate without even properly understanding the ground realities. These advisors and national intellectuals will have to honestly be a part of the national pressure groups in the movement to restore Pakistan's economic survival. In this country, politicians, traders (businessman engaged in trading), tax advisors and above all bureaucracy is benefiting from the present tax system at the cost of common man of Pakistan.

INDUSTRIALISATION AND CUSTOM DUTY POLICY

- Mismanagement of custom duty structure in Pakistan is one of the foremost reasons for the decline in industrial activity in Pakistan.
- There are two aspects for the same. First is the policy issue being a blind adoption of reduction in the duty rates under the shadow of compliance to World Trade Organization [WTO] guidelines [a policy mistake]. The second aspect is administrative in nature; being the curse of Afghan Transit Trade, Under-invoicing and misdeclarations.

GUISE OF WTO COMPLIANCE (1)

- We are constantly told that under the present global economic system, there can not be any protection for the local industry by way of duty structure as we have to be compliant to WTO standards. There is no dispute to the fact that there should not be any 'tariff barriers' for trade. However what is a 'tariff barrier' in a particular case is a subject to very intensive study by technical people. We all are aware that one of the most relevant but toothless organizations in Pakistan is National Tariff Commission [NTC] which is supposed to be an organization to determine the effective duty structure.
- In short what we need to do is to undertake a 'zero-based' study of tariff structures.

GUISE OF WTO COMPLIANCE (2)

Defeatist Attitude

- It is very unfortunate that a case for reduction in duty compliance to WTO is made with a defeatist attitude. There is a public acceptance by the government officials that corruption in the nature of misdeclaration, smuggling, and abuse of ATT can only be avoided by keeping the duty at lowest level. This attitude is not acceptable and if we continue with the same, then this country will face huge trade deficit and unemployment. If this contention is correct then why do we need the custom department and the army of officials for this duty.

ABUSE OF AFGHAN TRANSIT TRADE (1)

- Afghanistan is one of twenty two land locked countries of the world. However, our trade agreement for Afghanistan is unique in the sense that there is neither any 'Quantitative Restriction' nor there is any refund of duty paid upfront. This 'free for all' system has effectively crippled our economy.
- We have seen the case where around 50,000 tons of 'Black Tea' has been imported for Afghanistan whereas as per information not a single cup of black tea is used in Afghanistan. This is only an example. This issue is so serious that effectively all our past measures for management of custom duty have failed. One of the most glaring examples was the imposition of regulatory duty in 2008 for 450 luxury items.

ABUSE OF AFGHAN TRANSIT TRADE (2)

- The solution is:
 - placing 'Quantitative Restrictions' on Afghan imports; and
 - levy of duty and the refund for the same on transit out of Pakistan.

- This issue has to be taken as a first priority in our trade policy. The Finance Minister has referred to strong lobbies which counter proper implementation of economic policies. Let me warn the Finance Minister that the most important lobby in this whole field will be those involved in abuse of ATT. We would have to build up a national consensus for the same for our survival.

UNDER INVOICING (1)

- Pakistan is one of those unfortunate countries which suffered heavily due to non-cooperation of her friendly states. We have a flourishing business of under-invoicing that is promoted due to non-cooperation of two of our friendly states. China is the primary source of under-invoiced products and Dubai is used as a conduit in settling the payments through 'hawala' and other organized means. Let us admit that it is a reality that these two countries need not be blamed for our own follies.

UNDER INVOICING (2)

- In case if the people in general are knowledgeable, that the 'Spark Plugs' which they buy at Montgomery Road in Lahore or Plaza Area in Karachi are sold at ten times of the price at which such products are imported, then there would be a pressure against such misdeclarations. This simple action is not done primarily to promote corruption or the fear of mafia involved in these trades.

UNDER INVOICING (3)

Free Flow of Exchange and Tax Amnesty

- The other tragedy of the matter is abuse of the free flow under our so called 'foreign exchange reform'. We have a parallel foreign exchange system which provide mechanism through which payments can be made in US\$ to the importer from which the under-invoiced products have been imported.
- We are hesitant to abolish FE 25 [being a circular that allows Pakistani residents to maintain foreign currency accounts in Pakistan] and exemption under 111(4) of the Income Tax Ordinance, 2001 which are the legal means to promote such businesses. If someone asks which are the biggest errors of Pakistani economic policy, then I would refer to implementation and continuation of these two provisions.

UNDER INVOICING (4)

Have we taken correct remedies?

- We would have to seriously examine the foreign exchange systems and tilt towards the promotion of trade. Notwithstanding the merits of free trade, this population of 180 million needs 'jobs', not a support form Benazir Income Support Program (BISP) or food from Sailani Welfare Organisation. These direct interventions are short term solutions but not the end. This is equal to prescribing 'aspirin' for a cancer patient. What we need is a major surgery.

SMUGGLING

- In our society availability of smuggled goods has been accepted as a norm. There is continuous inflow of smuggled goods across the borders. Containers flow from Karachi port as well as from 'Sust' borders in the Northern areas. Reduction in the duty rate or giving extra-ordinary powers to the custom official is shown as a solution to this problem. I totally disagree with the same. There is a need for a national anti-smuggling drive with political consensus for people to discourage and disassociate from purchase, sale and trade in smuggled goods.

CUSTOM ADMINISTRATION (1)

- There are two stages of automation in customs viz:
 - ▣ automation of process for clearance; avoiding human intervention; and
 - ▣ automation, if possible, for applicable duty rate and valuation process.
- For various ulterior motives, including lack of proper understanding both these aspects have unnecessarily been mixed up and inter-related.

CUSTOM ADMINISTRATION (2)

- It is to be appreciated that 'Customs' and 'Inland Revenue' are two different subjects. 'Customs' is effectively a subject of trade regulation. In countries like us, it should effectively be used as an aid for promotion of local industry and facilitation. Thus as an out of box thinking, a separate Board for 'Custom' like in India and many other countries can be explored. Furthermore, since almost all the activities are effectively undertaken at ports located in the south, therefore the new board may be headquartered in Karachi.

FEDERAL EXCISE DUTY

Abuse and Provincial autonomy

- Federal Excise Duty structure is to be fundamentally revamped with the introduction of the proposed Value Added Tax. There had been serious intrusion by the federation in the right of taxation of the provinces through this tax for 'Services' specially in the nature of telecommunication, travel, banking and insurance.
- In fact the present unsettled issue between the Province of Sindh and the Federation on Value Added Tax's implementation primarily relates to this subject only.
- At the first stage, it has to be settled that Federal Excise Duty is effectively not leviable on 'services' which is a provincial subject.

VALUE ADDED TAX (1)

Why are we so confused?

- There are in principle, five (5) issues with reference to VAT:
 - Is it a new 'Tax'?
 - What is the issue between the Federation and Provinces (specially Sindh) with reference to Services?
 - Would the same result in increase tax incidence and resultantly 'inflation'?
 - Is the wholesale or retail trade sufficiently documented to implement this tax?
 - Whether or not 'zero rating' for exports continue to remain applicable to export oriented sector through which local consumption of such industries also remain outside the tax ambit?

VALUE ADDED TAX (2)

Rationale for Implementation of VAT

- It is essential to understand that the rationale for introduction of VAT is based on the premise that:
 - contribution of services sector in overall tax base is to be improved. At present consumption tax is effectively restricted to goods;
 - local consumption of export oriented sector be brought into tax net; Zero-rating for products rather than whole sector; and
 - all segments of business being wholesaler, distributors and big retailers be brought into tax net. This extension of documentation will ultimately lead to improvement in direct tax collection. Indirect taxes are in any way being recovered.

VALUE ADDED TAX (3)

Is VAT a new TAX?

- Sales Tax on 'Value Added Tax Mode' and the present VAT Bill are the two names of the same product. When we study the proposed VAT, it is revealed that it is almost similar to 'puristic' General Sales Tax as was introduced in 1996. Sales Tax system (in the VAT mode) has been defaced specially with reference to zero-rating, exemptions and mode of collection of tax at retail prices at manufacturing stage for certain products (Third Schedule basis of taxation]. It is reiterated that VAT in the proposed form is a legislation better than that prevalent at present. This justifies the introduction of the new law. Accordingly, the impression that it is a new tax has to be dispelled with.

VALUE ADDED TAX (4)

Provinces' Right of Taxation

- Constitutionally, there is no dispute that consumption tax on services is the right of the provinces. In the past, there has been intrusion in the right of provinces through FED on services as referred earlier. Furthermore, provinces can opt not to surrender their right of taxation of services to federation. We all should 'honour' this provincial right. In my view, this matter is being unnecessarily complicated. There is no ideal system of VAT and every country on account of its constitutional provisions may implement consumption tax according to its own basis of distribution of taxes between Federation and the provinces. Thus, if the province of Sindh requires separate 'accounting' for tax on certain services that should be honoured and accepted.

VALUE ADDED TAX (5)

Increase in Tax Incidence - Inflation

- VAT implementation is being linked to increase in over all inflation levels. VAT per se will not result in any increase in prices as the present rate of 16 per cent and certain higher rates as applicable are being reduced to 15 per cent across the board. Nevertheless, the issue of inflation is directly related to following two factors:
 - whether or not withdrawal of exemptions will increase the price levels for the reason that many products are not subjected to tax at present; and
 - whether or not multiple stage taxation for wholesale and retailer would effectively be implementable specially on account of substitution of Third Schedule [Tax at retail price is charged from the manufacturer].

VALUE ADDED TAX (6)

Is Wholesale and Retail Trade ready? (1)

- This is an important subject as at present, our trade sector is filled with products being:
 - imports through ATT;
 - under invoiced products; and
 - products originating from unorganised undocumented manufacturing sector.
- There have to be serious simultaneous actions on all such matters if any incremental improvement is required for implementation of multiple stage VAT.

VALUE ADDED TAX (6)

29

Is Wholesale and Retail Trade ready? (2)

Further Tax [Not required]

- There is another issue of 'Equalisation' of tax incidence. This refers to the disparity which arises on account of sale to persons being retailers below the threshold limit. This is particularly important in our economy as bulk of retailers fall outside the ambit of tax.
- In order to resolve issue of equalisation, a proposal of a 'further tax' of 3 per cent is being considered. In my opinion, this action is not recommended. This would result in a perception, which in that case would become a reality, that tax rate is effectively being increased to 18 per cent.

VALUE ADDED TAX (7)

Zero-Rated Sector (1) - Accept Past Failures

- The biggest distortion in the VAT system as introduced in 1996 is zero-rating for Export Oriented sector. As explained earlier, we have zero-rated the export oriented sector as against exports. This reflects a defeatist attitude and is equal to action which was taken due on account of complete failure in managing the refund mechanism. I fully acknowledge for fact that I was a member of this team that worked out the excess refund paid on export sector in 2005 [around Rs 40 billion of refunds were issued whereas collection was around Rs 20 billion only].

VALUE ADDED TAX (7)

Zero-Rated Sector (2) – Refund Management

- Total export of Pakistan are estimated to be around US\$ 20 billion. This would mean that around Rs 252 billion [US\$ 20 x 15% x Rs 84] will be collected and would have to be refunded. The question is whether or not we have established an adequate system managing such refunds. In case of any mismanagement, genuine exporters will suffer giving boost to fictitious export etc. There is financial impact of the subject also. It has to be ascertained whether or not export industry, at this stage, would be able to bear the finance cost for the timing differences.
- In these circumstances, a prudent approach that would cover both the risks would be to introduce VAT on export oriented sector at a lower rate ranging from 2.5 to 5 per cent.

VALUE ADDED TAX (7)

Zero-Rated Sector (3) – VAT or no VAT?

- To conclude this matter it is my view that implementation of a broad based integrated consumption tax is a step in right direction. This correct step from national benefit needs to be handled carefully, diligently in the forthcoming quarter with national consensus.

VALUE ADDED TAX (8)

Interim Arrangement in Sales Tax

- General rate of sales tax, till the introduction of VAT as proposed, has been increased from 16 to 17 per cent. This appears to be only a tax collection measure. There is a case for reduction of rate as being envisioned in the proposed VAT therefore the present action becomes totally unjustifiable.

CONCLUSIONS ON INDIRECT TAXES

- To sum up the budget recommendations with respect to indirect taxation, it can be concluded that:
 - The present major issue of protection to local industry by tariff regime has not been taken into account;
 - Issues of Afghan Transit Trade, Under Invoicing and smuggling have not been taken up seriously;
 - Increase in Sales Tax Rate is not justified being 'inflationary' in character;
 - Proper 'Road map' for implementation of VAT is missing; and
 - there is no policy change being a reflection that bureaucracy is looking for easier choices for tax collection even at the cost of disturbing economic fundamentals.

We have no choice except to love this country

میں کیوں کر جاواں کعبے نوں
 دل لوچے تخت ہزارے نوں
 لوکیں سجدہ کعبے نوں کر دے، ساڈا سجدہ پار پیارے نوں

DIRECT TAXATION (INCOME TAX)

Primary Policy Error

- Window for whitening of untaxed money by way of remittance from abroad which is the biggest ill for taxation system [as briefly explained earlier] has not been plugged. There seems to be strong vested interest for the same; and
- The tilt towards presumptive taxation has not been removed. The budget does not seem to provide any road map or will towards the elimination of indirect taxation in the guise of direct taxation. At present, presumptive tax covers almost all the major activities of Pakistan businesses being exports and all kinds of trade. If these major segments are taken out from taxation on net income basis then no meaningful improvement can happen for direct tax regime.

LEVEL PLAYING FIELD FOR VARIOUS FORMS OF BUSINESS

37

- Pakistan's fiscal policy has been designed in a very strange way whereby, by design or implication, it encourages business in non-corporate sectors for the reason that:
 - Lower tax rates for individuals and partnership (Association of persons) in business;
 - Exemption from withholding for Individuals and AOP in business; and
 - No minimum tax on Individuals or AOP in business.

TAX ON BANK WITHDRAWAL

- I have the honour or dishonour of recommending the introduction of the provisions relating to withholding tax on cash withdrawals. I have no regret for the same however I reiterate that the purpose of recommending this provision was not tax collection but to unearth the person dealing in cash which are not within the tax ambit. The tragedy is that the tax department has not used this effective measure to identify and then penalize and prosecute the persons dealing in cash not within the tax net. This shows clear lack of conviction and enforcement by the tax department. It has to be admitted that this provision does not meet the test of good legislation.

REINTRODUCTION OF TAX CREDIT FOR BMR

- After a very long time an effective measure has been introduced for the promotion of industrial sector. This provision effectively means that government will finance 10 percent of the cost of plant and machinery by way of tax credit for BMR. This is a need of the time. This issue is, however, required to be read with reference to the matter of presumptive taxation on exports. On account of being subject to presumptive tax regime the biggest and most vital sector of our economy, those engaged in exports would effectively not be able to avail the benefit of this productive measure. This would be a tragedy. It is therefore suggested as above, that exports income should be taken out of presumptive tax regime and be zero-rated. This would promote documentation and allow the exporter to avail the benefit of an industrial promotion scheme of the government.

TAX ON CAPITAL GAIN ON TRADE IN STOCK EXCHANGES (1)

40

Permanent Exemption for Long Term Capital Gains

- Through an amendment introduced on this subject a very reasonable step has been undertaken whereby long term capital gains on sale of shares of listed companies have been exempted from tax for ever. Such time bound exemption which was provided by way a clause in the Second Schedule has now been incorporated in the law. Now we can emphatically state and plan that long term capital gains on sale of shares are exempt from tax in Pakistan for ever. In my view this would encourage people to distinguish between short and long term gains and discourage the tendencies to trade in shares.

TAX ON CAPITAL GAIN ON TRADE IN STOCK EXCHANGES (2) –

Indexation for Foreign Investors

41

- There is a need to further refine the system for non-residents who invest in foreign currencies to the effect that there is indexation of the cost of shares in foreign currencies so that effective taxation is for the gain on sale of shares and not the effective notional amount of exchange difference arising due to the change in exchange rate parity for Pakistani rupee.

TAXATION OF BANKING COMPANIES (1)

Positive Correction

- Seventh Schedule of the Income Tax Ordinance, 2001 is one of the product not properly understood by many stakeholders. This is a model whereby the role of regulator being State Bank of Pakistan has been accepted and protracted litigation and subjectivity with reference to charge for irrecoverable advances has been removed. Under the Seventh Schedule provisions for irrecoverable advances are allowable as per the amount so certified under the Prudential Regulation of the State Bank of Pakistan.
- This year the ceiling of 1 per cent has been enhanced to 5 per cent of advances for consumer loans and loans to Small & Medium size entities. This is a correct step.

TAXATION OF BANKING COMPANIES (2)

Remedy to Avoid Litigation

43

- Another good step which was suggested earlier was the introduction of similar mode of allowability of irrecoverable advances for years prior to the introduction of the Seventh Schedule. Numerous litigations are pending at various levels on this matter and the only workable solution for future is the allowability of the charge for earlier years on the similar basis. Enabling provisions to this effect have to be introduced.

TAX ON OIL EXPLORATION COMPANIES (1)

Implementation of MOU with PPEPCA

44

- There are three major issues in dispute between the oil exploration companies and the Federal Board of Revenue. In order to settle the matter a very reasonable document was exchanged between Pakistan Petroleum Exploration & Production Companies Association [PPEPCA] and FBR in the form of a Memorandum of Understanding. In that MOU a manner of settlement of all the disputes was laid down.
- The implementation of MOU was delayed apparently on account of the fact that legality of the matter could have been challenged in the court of law. This is not a correct notion. I totally disagree with this contention, however, even if that contention is taken to be true the right approach is to incorporate the understanding exchanged in the MOU by way of 'explanation' or 'amendment' in the Ordinance.

TAX ON OIL EXPLORATION COMPANIES (2)

MOU with PPEPCA

- To sum up the issues relating to direct taxation it can be concluded that there is no policy direction for improvement, except taxability of trading capital gains. There are certain specific positive actions, however, on overall basis these measures proposed would fail to:
 - broaden the tax base;
 - disincentives trading business against manufacturing and to curtail the process of whitening of untaxed income; and
 - abolition of the cruse of presumptive taxation.

CONCLUSION ON DIRECT TAXES

- On an overall basis, it appears that the proposal in the budget 2010-2011 from the receipt side is a 'Non-Event'. This is a status quo position. We would have to sit down again to decide whether or not we have the 'space' for this status quo. In my view, time is short and we would have to take some strong, non-traditional actions. We would require a national political consensus for the such revolutionary incremental approach.

کہ اب تک! پاؤں ننگے ہیں بے نظیروں کے



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چلے چلو کہ منزل ابھی نہیں آئی



**This country is beautiful. Its real beauty is yet to
be known.**

Thank you