



**PRIME Analytical Reports on
Regulation, Taxation and Economic Policy**

Issue: 1, Vol: 1



**Withholding Tax Regime: History,
Consequences for Business and
Implications for Policy**



Restricted Release

August 10, 2015

PRIME INSTITUTE

Suite 714, 7th Floor, Silver Oaks Apartments, 10th Avenue, F-10 Markaz, Islamabad
www.primeinstitute.org | research@primeinstitute.org

Withholding Tax Regime: History, Consequences for Business and Implications for Policy

Summary

The contribution of Withholding Taxes in direct tax revenue has surpassed 75 percent, and it has brought in more than Rs. 860 billion to the government kitty in 2014-15. On the other hand, the number of tax return filers has gone down considerably from 1.8 million in 2006 to 0.85 million in 2014-15. The decision to apply a differentiated rate of Withholding Tax (WHT) on filers and non-filers, while penalizing the later, is seen as government's attempt to bring people back into tax net. However, the unseen and unintended consequences of an increasingly complex WHT regime might be exact opposite. This analytical report discusses the history of WHT in Pakistan, its consequences for businesses and implications for the tax policy as well as tax administration.

What is a WHT?

Withholding tax (WHT) is basically a 'presumptive' tax, based on the notion that an earner with a certain amount of income will presumably keep earning that much (if not less) in the future. Put another way, it's a tax on income in advance. In most of the countries where it is applicable, the basic purpose of introducing such a tax is to discourage informal economic activity and to bring more people into the tax net. In doing so, governments not only try to curtail informal economic activity but also realize a source of income in the form of direct tax revenue. Although it's not a universal practice, but at the end of a given fiscal year, the WHT is refundable and adjustable. Not all governments, though, resort to refunding or adjusting the money earned through WHT.

Pakistan inherited WHT on salary and wages under British Income Tax Ordinance (ITO) 1922. The tax reforms of early 1990s expanded the list of items on which the WHT could be applied. It is estimated that this increase in list of items to be taxed under WHT, and the resulting increase in revenue through it, was the main reason for the sharp rise in direct tax to GDP ratio in the early half of 1990s¹. At present, the number of major categories on which WHT is applicable is 35. A breakup of these major categories into sub-categories (by application of different WHT rates) brings the total instances to roughly 75².

¹ State Bank of Pakistan (SBP) *Annual report 01-02*, CH. 4, p.67.

² The complete list of items to be taxed under the WHT can be found on official website of FBR, under "Withholding tax regime (rates card)".

Objectives of the Policy

These words of Chairman FBR reveal the intended objectives of WHT focused regime:

“The Withholding Taxes collected by Federal Board of Revenue are significant contributors to the national exchequer. The collection of Withholding Taxes has been on rise over the years. However, during the course of interaction with the field officers, it has been observed that visible gaps exist between the actual collection of Withholding Taxes and their true potential in the economy. Besides, one of the Study Groups has identified that 110 % gap exists in collection from Salary and wages alone.”³

However, the unstated and presumable rationale of increasing reliance on WHT is the decreasing number of tax filers in Pakistan. This trend is depicted in Table 1 and the accompanying Graph 1.

Table 1: Number of people filing tax returns

| Fiscal Year | Number of people filing tax return ⁴ |
|-------------|---|
| 99-00 | 970,000 ⁵ |
| 03-04 | 1,030,000 |
| 04-05 | 1,230,000 |
| 05-06 | 1,490,000 |
| 06-07 | 1,810,000 |
| 07-08 | 1,570,000 |
| 08-09 | 1,720,000 |
| 09-10 | 1,600,000 |
| 10-11 | 1,510,000 |
| 11-12 | 1,290,000 |
| 12-13 | 745,000 |
| 13-14 | 850,000 |

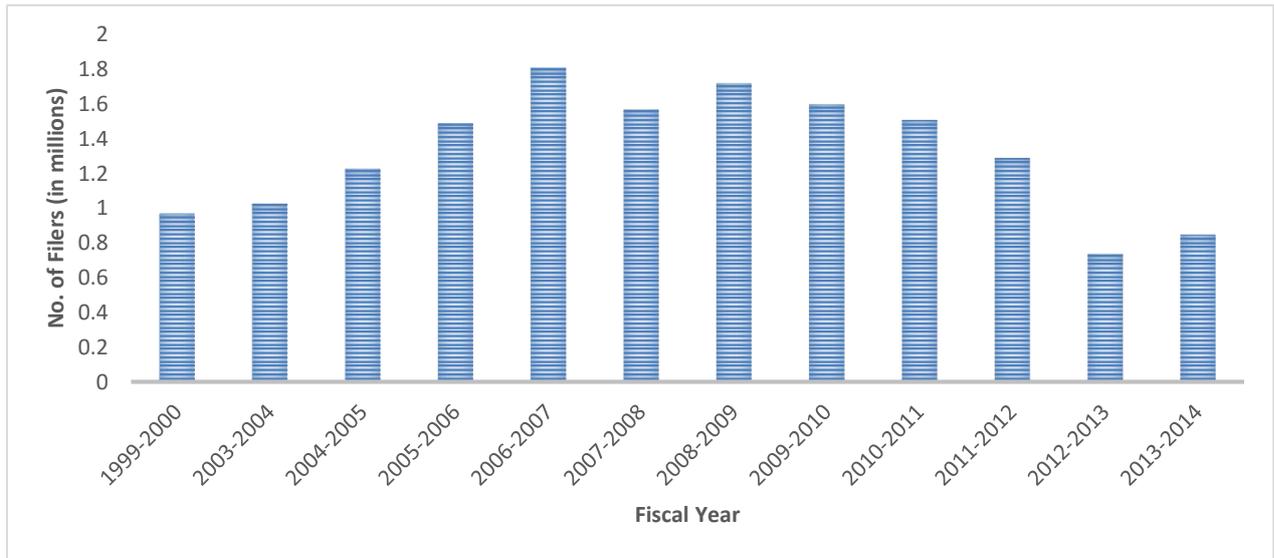
Source: FBR, Dr. Ikram ul Haq, Mubarik Zeb Khan and IMF Reports

³ Remarks by Sohail Ahmed, Chairman FBR in “Standard operating procedures for monitoring of withholding taxes”, FBR (July 2011), page iv.

⁴ These numbers have been rounded off because in some years, figures were provided only in million.

⁵ See IMF (2004) “Pakistan: Selected issues and Statistical Appendix”, p.50 for FY 99-00 and 03-04 numbers for those who filled tax returns.

Graph 1: Number of Tax Return Filers



This has prompted the government to take steps towards stemming this decline any further and to compel people towards filing their returns. The imposition of higher WHT tax rates on non-filers as introduced in 2014-15 is a major legislation in this regard.⁶



Clearly, the number of people filing their returns has gone down drastically. From a high of 1.81 million in FY 06-07, the present figure stands at a dismal 0.85 million.



Besides the objective of bringing more people into the tax net, it is also clear that the WHT holds significant importance as far as government revenue prospects are concerned. While relative share of withholding taxes in gross direct tax revenue has increased steadily, its absolute collection has increased significantly. As pointed above, officials in government circles (especially in the FBR) view it as the most promising tax in terms of earning revenue. This aspect, along with the need to document economic activity (that will bring in more revenue) assumes even more importance given the severe pressure on the treasury to meet burgeoning and ever increasing fiscal demands. The following table that depicts tax earnings through WHT and its percentage wise contribution to direct tax earnings will make it clear why WHT holds such importance for government.

⁶ The official notification proclaiming differential application of taxes on filers and non-filers is FBR's Circular No. 2 of 2014 (Income Tax), dated 17th July 2014. The relevant point in the document is number 5. This is the first time that an official document makes clear the distinction between a filer and a non-filer.



From Rs. 71 billion in 2000, [WHT] present contribution stands at a staggering Rs. 865 billion, now contributing more than 75 percent in direct taxes.

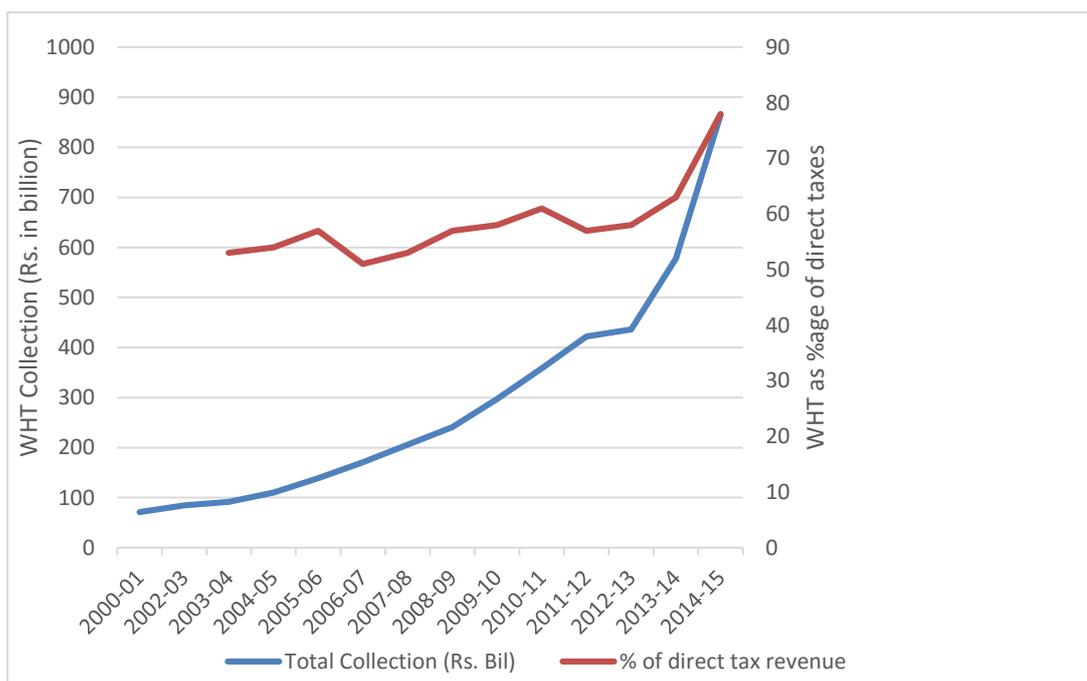


Table 2: A snapshot of WHT over time

| Fiscal Year | Total Collection (Rs. Billion) | % of direct tax revenue | Increase/Decrease |
|-------------|--------------------------------|-------------------------|-------------------|
| 2000-01 | 71 | 50 | |
| 2001-02 | - | - | - |
| 2002-03 | 85 | | |
| 2003-04 | 92 | 53 | |
| 2004-05 | 110 | 54 | |
| 2005-06 | 139 | 57 | |
| 2006-07 | 171 | 51 | 21.58% |
| 2007-08 | 206 | 53 | 21.89% |
| 2008-09 | 241 | 57 | 17.47% |
| 2009-10 | 297 | 58 | 22.72% |
| 2010-11 | 358 | 61 | 20.53% |
| 2011-12 | 422 | 57 | 17.87% |
| 2012-13 | 436 | 58 | 3.31% |
| 2013-14 | 578 | 63 | 32.56% |
| 2014-15 | 865 ⁷ | 78 | 49.65% |

Source: FBR Quarterly Reports (2003-04 to 2013-14), Sherani, Sakib (2015-16)

⁷ This number is calculated by taking into account the total direct tax collection figure of Rs. 1109 billion, as stated in the Budget 2015-16 document (available on Finance Division's website).

Graph 2: A snapshot of WHT over time

Source: FBR Quarterly Reports (2003-04 to 2013-14), Sherani, Sakib (2015-16)

As is clear from the Table 2 and the accompanying graph, the WHT has assumed the position of a major source of revenue over time. From a Rs. 71 billion in 2000, its present contribution stands at a staggering Rs. 865 billion. Moreover, its contribution as a component of direct taxes has now surpassed 75 percent. Therefore, besides the stated aim of efforts to document the economy through filing tax returns, WHT can bring in a lot more revenue once the income and its sources are known. Thus, WHT holds major significance for policymakers since not only it has become a major source of revenue over time, but it is also the most promising one in the future relative to tax revenue.

The real bone of contention between the traders and the government is the increase in tax on non-filers relative to banking transactions. The WHT on banking transactions is relatively new and was limited to cash withdrawals till now. It was introduced through Finance Act 2005⁸ whereby 0.1% charge was levied on cash withdrawals above Rs. 25,000/-. Since then, the rate on cash withdrawals has increased to 0.3%⁹. In its first fiscal year (2005-06), this tax on cash withdrawals brought in Rs. 2.5 billion. In FY 13-14, this particular source brought in Rs. 19.06

⁸ From its imposition in July 2005 to March 2006, it brought in Rs. 1736.6 million in revenue. This prompted FBR's high ups to conclude that "*The collection up to March 2005 under this head has been Rs. 1736.6 million, which is not insignificant to warrant policy reversal*" (FBR Quarterly Journal, Jan-Mar 2006, p.14). It is pertinent to note that there was no mention of filers or non-filers; the main attraction of this tax was the revenue that it brought to government kitty.

⁹ Under the Finance Act 2006, the rate was increased from 0.1 to 0.2 percent. This rate again saw an increase from 0.2 to 0.3 percent through Finance Act 2008. It was brought down to 0.2 percent again through Finance Act 2011, and increased again to 0.3 percent through Finance Act 2013. None of these acts made any distinction between filers and non-filers.

billion¹⁰, which means a 660 percent increase in revenue collection from this head within a decade.

In 2014-15, the incumbent federal government introduced a distinction between filers and non-filers through Finance Act 2015.

“One of the principles which formed the basis for Income Tax proposals for Finance Act 2014, is to make the “cost of doing business for non-compliant/non-filers, higher than compliant taxpayers/filers”. In other words, law has been amended to the effect that non-compliant/non-filers will have to pay a higher tax at the time of collection or deduction.”¹¹

Thus the intended purpose of providing a penalty clause to non-filers was to incentivise more people to file returns and become “Active Tax Payers”. This was manifested in different rates of WHT for filers and non-filers applicable in banking transactions, motor vehicle registration and excise payments. Moreover the Finance Act also provided for an assurance of adjustment of WHT for filers in the case of most recent imposition of WHT on all banking transactions.

Consequences for Business and Investment Environment

Widening Trust Deficit

The imposition of WHT on all banking transactions in 2015-16 has led to shutter downs by traders all across the country against this tax hike. More than their actions, these shutter downs are in fact a manifestation of the lack of trust that exists between the traders and the government. Both suspect each other’s intentions. The government is disconsolate over the low number of tax filers from business community and the relatively low revenue (relative to potential revenue) coming from this group. The trader community feels that in the garb of penalizing non-filers through higher tax rates, the real intention of the government is to tax them even more in the future¹², thus squeezing their income flow. The final outcome is likely to be in the form of increased level of mistrust between the government and the traders.



A future implication of this increase in the level of mistrust between the traders and the government may manifest itself in the form of increase in informal economic activity. Already, there are reports that traders (and business community in general) have resorted to informal transactions to avoid formal banking one’s.



¹⁰ Source: FBR’s statistics.

¹¹ “Finance Act 2014- Explanation regarding important amendments made in the Income Tax Ordinance 2001”, Number 5, p.6.

¹² That will be easier to achieve once the sources of income, assets and wealth are known. The filing of tax returns aims to do just that.

Expansion in the Informal Economy

A future implication of this increase in the level of mistrust between the traders and the government may manifest itself in the form of increase in informal economic activity. Already, there are reports that traders (and business community in general) have resorted to informal transactions to avoid formal banking one's. Government, on its part, does not have the intellectual or administrative resources to effectively curtail the spread of these kinds of economic activities¹³. As more transactions go informal due to spread of informal economy, the probability of earning revenue (relative to the real potential) will decrease further¹⁴. Thus, in essence, the increase in the trust deficit could bode ill for future revenue prospects.

Prospects for Investment

The probable future negative effects may not be limited to the domestic economic activity only. The continued mistrust and confrontation between the government and the business community gives a negative signal to prospective foreign investors. One of the most critical aspects that a foreign investor takes into account before making an investment is the level of economic stability and policy predictability in the business environment. The present state of affairs sends a negative message as far as both these criteria are concerned, and should be worrying for the decision makers since level of foreign investment in Pakistan is already very low.

Increase in the cost of doing business

The increase in WHT on banking transactions implies an increase in cost of carrying out day to day business. This is especially true for large scale businesses. Given a further increase in cost of carrying out their business, they will have little option but to turn towards methods that can help them avoid the increase in this cost.

Increased level of insecurity

Carrying out informal activities can bring untoward consequences. For example, though a far-fetched one, to avoid WHT on cash, business community in particular may resort to physically carrying cash around. This is especially true of small scale business establishments where the cash exchanges per day are not substantial. Yet carrying cash around itself presents the spectre of physical attacks. Thus, the increase in such an activity will likely increase the probability of crimes in the form of physical attacks.

¹³ This is at least what the history of economic activity in Pakistan informs us. Research suggests that the informal economy is a substantial part of Pakistan's economy, and constitutes at least 30 percent of the total economic activity. Reference in this regard may be made to SBP's research paper No. 33 (May 2010) titled "*The size of informal economy in Pakistan*"; A.W. Qasim (2011), "*Relation between inflation and tax evasion: A case study of Pakistan*"; and M. Ali Kemal (2007), "*A Fresh Assessment of the Underground Economy and Tax Evasion in Pakistan: Causes, consequences and Linkages with Formal Economy*". All of these studies (and others like it) indirectly point to the fact that government does not have the capacity to stop the spread of informal activities.

¹⁴ In fact, SBP also voiced its concern that such a move may lead to more informal transactions. Reference may be made to "*SBP critical of proposed WHT on LCs*", Business Recorder, May 12 2015.

Policy Implications

Loss of Tax Payers

If there indeed turns out to be more informal economic activity in the future, then the straightforward implication is loss of tax payers as permanent sources of potential revenue for the government. As is clear from figures presented in Table 1, the number of tax filers over last one decade has gone down as the WHT collection has increased. If the imposition of higher rates of WHT leads to further tax filers slipping out the tax register, it could be devastating to the national exchequer as more tax filers can opt out of the system under severe pressure from different sides. There is little (if any) fiscal space, and government can ill afford to lose any more of it¹⁵.

Seigniorage Taxation

The further loss of fiscal space, in turn, may prompt government to take the less popular (and inefficient) route of printing more money to meet its ever increasing expenses. This, in turn, will increase inflation which will be an unwelcome development. Inflation in Pakistan, affected by international factors like lower oil prices, has only started to come down in the last fiscal year. For government and for the people, this is a welcome reprieve from the higher inflation levels of the last decade. Yet all this could be undone if government resorts to



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printing more money to meet its expenses. The increased reliance on borrowing and printing money will ultimately end up in the form of higher borrowing costs, higher inflation and crowding out of private sector from taking up loans through formal channels. The non-availability of loans will, in return, have negative effects upon private sector business development and its participation in overall economic activity.

As official credit lines contract, so will the circulation of money within the economy which is so crucial for daily economic activities. Unless the contraction of official channels of borrowing is matched by the provision of same amount of required credit through unofficial channels, there is surely going to be a negative effect. This negative effect will also bear upon on overall growth numbers, whereby economic growth will also be negatively affected. If things start to

¹⁵ Even now, government finds itself in a difficult position as far as fiscal operations are concerned. The heavy reliance on borrowing continues as government now intends to borrow Rs. 1.5 trillion more from banks. See Shahid Iqbal, "Government plans to borrow Rs. 1.5 trillion", daily DAWN, August 5 2015.

take a negative turn, it will also prompt government to think about policy reversal. This itself constitutes another negative aspect since different groups (both local and international) will come to presume this policy instability as a pressure tactic. In essence, the end-result of all this may very well be the further erosion of government's authority and standing. Future governments will find it difficult to implement their authority in lieu of this loss of confidence in government's commitment towards sticking with a particular policy.

Wither FBR?

Withholding taxes now account for 78% of direct tax revenues. If this trend continues, which is likely, the utility of FBR as a tax collecting authority and as a reliable enforcing regime will be highly questionable. If the state will depend primarily on the withholding agents for tax collection with increasing penalty for them for non-compliance, in addition to already reliance on the indirect taxes, one can easily question the utility of 35,000 strong FBR, with a coterie of 1,500 plus officers.



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Indirect Consequences

The above two sections discussed repercussions or probable fallout from the policy of increasing the WHT, specifically with respect to business community and the government policymaking. There are, though, other affects that may come into play that may be termed as the 'indirect' effects of this policy. Some of them are as follows.

Assets Diversification and Debt Level

Instead of cash finding way into the overall circulation of money, it may end up in the form of buying alternative assets. Two of the most favoured one's are gold and the dollar. There are already indications that the demand for dollars has seen a sudden jump in the wake of the tax on banking transactions. In the open market, the dollar is trading at Rs. 103¹⁶. This is above the Rs. 100 exchange rate sanctioned by the government. To realize the implications of this increase, consider the fact that every decline of rupee by 1 unit increases our total debt by more than Rs. 80 billion. Thus, going by the present open market trading price of dollar against

¹⁶ As on 7th August 2015.

the rupee, we have already piled on another Rs. 240 billion in terms of additional debt since the confrontation between the traders and the government began.

Lower Aggregate Demand

The dampened macroeconomic activity may be another effect of this policy. As already touched upon in the above section, trade and overall business activity is likely to be affected negatively. As the business activity is affected, other sectors will also feel the pinch in lieu of the decline in daily business. One of ways that can happen is the lower availability of cash for private investment in lieu of lower growth of deposits. If this happens, then macroeconomic activity (and hence economic growth) will likely remain low. Lower economic growth means lower revenue, and lower revenue means more pressure on government's fiscal operations. Pressure to fulfil government obligations usually forces the government to cut the size of the Public Sector Development Projects (PSDP), which affects the socioeconomic indicators. Thus, a cycle of effects and further effects may be the final outcome. This kind of effect due to a withholding tax on macroeconomic activity has been well documented over time¹⁷.

Increased Reliance of Banks on Government Deposits

If the business community, and traders in general, shun the official financial channels and withdraw their deposits (or decline to deposit cash), it will induce the financial industry to find alternatives to meet their depositary requirements. One of the favoured one's is through opening government's institutional accounts. At the start of every fiscal year, government earmarks billions of rupees to ministries/divisions and its other institutions. These are then deposited in bank accounts. There is intense competition and lobbying between banks to get those deposits opened in one of their branches. In the face of lower deposits, there will be an increasing likelihood that banks will be ever more reliant on these kinds of accounts. Fairness may be at stake as it is a well-known fact that government officials ask for favours in return for opening such accounts in a certain bank (for example, getting loans written off or financing consumer durables on reduced rates). Thus, a negative consequence of the tax hike may appear in the form of banks doling out more favours to higher officials for getting their desired accounts.

More jobs for Tax consultants

Last, but not the least, there is concern that multiplicity and expansion of the WHT regime only lead to more complex and hard to understand tax procedures. Resultantly, even those who want to file a tax return may desist from doing so. The increasing complexity of the tax system will serve as a boon for tax consultants, who may advise clients not to fill out tax returns out of pure self-interest.

Scenario Analysis

Based on the ensuing discussions, we can forecast best case, pragmatic and worst case scenarios.

¹⁷ For example, see Joel Slemrod and Matthew Shapiro (1993), "Consumer response to the timing of income: Evidence from a change in tax withholding", NBER paper No. 4344.

The best case scenario forecasts a substantial increase in the number of tax payers and tax filers as a result of penalty rate for non-filers. As the number of taxpayers and tax filers increases substantially, so will the government revenue. With the increase in government revenue will come the easing of fiscal pressures, which will help government to allot more to development purposes and economic growth. The uncertainty regarding decision making will be taken care of to a large extent, foreign investment will start coming in, overall economic growth will increase and informal economy will shrink substantially.

The pragmatic scenario is relatively less rosy. There will be a policy of 'give and take' from both sides. Traders will agree to file returns but only if they are modified according to their suggestions. Government, seeking a way out of the present morass, will agree to certain changes and proposals and modify the income return forms. Thus, there will be some sort of mutual compromise from both sides. But the air of suspicion will still linger, especially on side of traders and business community in general. This kind of suspicion will ensure that there is interest in informal channels and ways of carrying out day to day activities, which in turn will ensure that the size of informal economy more or less remains the same. Even if the trust deficit between the two sides is repaired, it will take a long time. Economic activity and



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economic growth in general will pick up pace again once a compromise is reached between the two sides. There will be an increase in overall collection of revenue through the WHT, but it is likely to remain below the potential.

The worst case scenario includes the possibility that tax filers and tax payer numbers will see a further decline. Compliance with taxation and tax payments will be shunned, and there will be an increase in the overall tense atmosphere between the opposing sides. In lieu of declining revenues and increasing fiscal obligations, government will resort to more borrowing and increase in printing of money. This will usher in substantial increase in inflation and even more limited fiscal space. If lenders (international and domestic) refuse to lend to the government, then the government may reach on the verge of default. Economic activity will be severely curtailed, resulting in lower economic growth rate and worsening socioeconomic indicators. A failure to cope with all these problems may even force the government to quit or to look at external sources of cash once again.

For Feedback: research@primeinstitute.org