

Implementation of VAT: Pakistan's Experience Mr. Shahid Ahmed Member (Sales Tax and Central Excise) Central Board of Revenue, Islamabad

The emergence of the consumption based Value-Added Tax (VAT) and its unprecedented success in the developed world, motivated largely by its greater efficiency and buoyancy, encouraged the developing countries to adopt VAT during the decades of the eighties and nineties. However, with the exception of a few, many countries faced multiple difficulties in the adoption and implementation of VAT. Pakistan, undeterred by the concerns generally expressed in the developing countries, decided to take a bold initiative and move forward with the introduction of VAT in the country, the goal being to develop it into a major national tax. The move launched more than a decade ago was initially confronted with resistance from some of the stakeholders but owing to the efforts to promote public awareness about the progressive and futuristic dimensions of the tax and political recognition of its significance, the desired support eventually came. The confidence-building measures introduced over the period helped to further improve the operational environment with the result that VAT is now an accepted part of the country's fiscal system. The efforts to address the issues spurred by its introduction, whether concerning the legislative side or the operational elements, remain a part of the continuous reform process.

This paper briefly traces the development of VAT in Pakistan. Starting from its historical context, the paper briefly discusses the issues of taxpayers' registration, adoption of basic threshold, structure of tax rate, audit and refund payments. It also encompasses the contentious areas where the tax administration and taxpayers are trying to develop uniform solutions consistent with the overall philosophy of VAT. These areas include selection of audit including investigative audit and improvement in the tax compliance.

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Historical Context:

In 1947, when Pakistan attained independence, the sales tax was a provincial levy covering a limited area of commercial activity. With its conversion to a federal tax in 1951, its scope was extended to imports and domestic sale of goods by manufacturers and licensed wholesaler. The enactment of the Sales Tax Act, 1990 introduced its value added version renamed as General Sales Tax (GST). This was levied on goods only (with many exemptions) and that too at the manufacturing and import stages. A major leap forward was taken in 1995 - 96 when GST was converted into a full-fledged VAT mode tax with all its basic features; self-assessment, functional distribution, input tax credit facility and audit based procedures. To further increase its base, its coverage was extended to importers in 1997 and wholesalers and retailers in 1998. Following the trend observed in many less developed economies where documentation was limited, Pakistan also embarked on the levy of GST on goods rather than services. With the expansion of the service sector in 1990s, the anomaly was removed and the scope of GST was extended to certain services in 2000.

The effort mounted by tax administration in Pakistan during the last fifteen years supported by the extension of tax base wholesaler and retailer has led to significant improvement in the VAT collection in the country. VAT revenues (domestic plus import stage) jumped significantly during this period. Absolute terms, the collection increased from

US \$ 806 millions only in the early 1990's to US \$ 2.67 billion during 2000 - 2005 remarkable performance of V AT can also be judged from the growth in the revenue during the last five decades (Table 1).

The terms V AT and GST or sales at~ have been used interchangeably in this paper implying the same meaning.

Table 1: Collection and Growth of Sales Tax

Years	Average Annual Collection ⁽¹⁾	Average Annual Growth ⁽²⁾
1950s	3	12.2
1960s	8	8.9
1970s	20	18.5
1980s	120	24.0
1990s	806	21.8
2000 - 2005	2668	20.0

1 Collection in millions (converted into US \$ at the current exchange rate Pak Rs. 60= US \$1)

2 Growth in percent

It is interesting to note that the share of VAT in federal tax receipts has increased from about 20% during the 1990's to over 40% in the percent decade (Table 2). Similarly, V AT to GDP ratio has risen from 2.2 % to 44 % during the same period. Among the dev eloping countries of Asia, the Pacific region and South America which have adopted V AT, Pakistan's performance has been better than many.

Table 2: VAT Share

Years	Share of ST in Indirect Taxes	Share of ST in Federal Taxes	Share of S ^t in GDP
1950s	24.3	18.6	Na
1960s	26.0	20.2	1.8
1970s	10.7	8.9	0.9
1980s	12.9	10.7	1.2
1990s	27.6	19.7	2.2
2000s	60.5	4.20	4.4

Note: (1) Share in percent; (2) Na means data not available on some components.

Implementation:

Pakistan has reached a stage where V AT has been accepted by taxpayers. The journey up to the present stage has not been easy. Thanks to the gradual introduction of various measures and reengineering of the business processes, the implementation of VAT has been possible in its present manner. Some of the issues and the way they were dealt with are discussed below.

Threshold:

At the outset, a system of multiple thresholds was designed to cater to the needs of all categories and levels of taxpayers. In this system, four different kinds of threshold levels for manufacturers and retailers were offered. A lower threshold level Rs. 0.5 million was fixed for manufacturers and Rs. 1 million for retailers. The enrolled persons under this category were required to pay turnover tax at the rate of 2% of their annual turnover. Similarly, a higher threshold level of Rs. 5 million was fixed for manufacturers and retailers, respectively, making it mandatory for them to pay sales tax at the rate of 15% of their total turnover.

This layered system brought into focus difficulties of various dimensions. On the one hand, it prompted taxpayers to register under wrong categories to avoid tax payment at the standard rate of 15% and on the other hand it encouraged short-life' taxpayers given the registration for supplies to the government departments. In this case, supplies would register with the tax department when they were required to show sales tax registration number only to disappear soon, after thereby increasing the infructuous tax base. To overcome this problem, the government has recently done away with the system of multiple thresholds and instead set a single threshold for manufacturers and retailers at Rs. 5 million. Although this move alone has shrunk the VAT base by about 26%, the revenue sacrifice implicit by this action has been nominal as the contribution of the 'delisted' taxpayers was already fairly insignificant. There has been, nonetheless, a substantial gain in terms of reduced cost of tax administration, as the department has to deal with a smaller yet more compliant tax base. It is further hoped that this provision would serve as a reasonable safeguard against excessive taxation of small businesses.

Registration:

Since its inception, registration for V A T was done by the local sales tax offices after a thorough investigation. The intending tax registrant was required to submit a large number of documents such as national tax number, income tax returns for the last two years, rent or ownership details of the business premises, utility bills pertaining to the business to the business premises and physical verification of the business premises and manufacturing machinery. There were repeated complaints from taxpayers of unnecessary delays and harassment by the staff of the V A T department deputed for physical verification. In July 2004, a new system of centralized registration was put in place at the Central Board of Revenue, Islamabad, using automated Risk Based Registration Module to overcome the registration problems and broaden the tax base. The registration form has also been simplified and requirement of documentation has been minimized. Most of the necessary verifications are done through data from other sources. Thus, registration that used to take more than a month is now completed in three to four days and registration certificate is delivered directly to the taxpayer. The new mechanism has also significantly improved the maintenance of comprehensive database of all VAT registered persons. It is anticipated that the redesigned system will minimize contact between the tax department and the prospective registrants, helping to reduce the complaints emanating from the interaction between the two.

Multiple Tax Rates:

Vat in its present form was introduced in Pakistan at the standard rate of 12.5% in 1992. With an ever-increasing need for additional revenue to reduce budget deficit (one of the conditionalities of the Structural Adjustment program of the IMF), the VAT rate was raised to 18 % in 1995 with a reduced rate of 2 % introduced to bring the small businessmen into the tax net. **In** response to the taxpayers' pressure, the rate was cut to 15 % in 1998, though a higher rate of 29 % was introduced on range of industrial raw materials. Further, a penalty system was introduced in 1999 whereby an additional tax at the rate of 3 % was levied on the supplies made by the registered persons to unregistered persons. Introduced with the intention of encouraging documentation in the economy, the move nonetheless complicated the situation by introducing a system of multiple tax rates.

Thus, by 2004 VAT was administrated at five different rates i.e., 2 %, 15 %, 18 %, 20 % and 23 %. Besides creating administrative difficulties, it also increased the cost of compliance for registered persons. The complications trigged by the multiplicity of these inconsistent measures finally led to the levy of VAT at the uniform rate of 15 % introduced from July 2004.

Refund Payments:

Another problematic area in the implementation of VAT has been refund payments. Since V A T is primarily a tax based on value addition at source and exports are zero-rated on the destination principle, there is an in-built need for the documentation of transactions involved in the entire supply chain in the export business. However, the system is marred by the element of fake invoices creating difficulties for its smooth functioning. While textiles cater for the major exportable commodities of Pakistan, various intermediary manufacturing and processing activities are largely carried out in the unorganized and undocumented sector. This gap is filled by invoicing malpractices to inflate refund and suppress local supplies. Thus

the refund issue in the textile sector has assumed staggering dimensions posing challenges for the vat administration in Pakistan.

However, with greater automation of the VAT department through be-spoke software, the problem of refund is being dealt with in a systematic Manner. On the basis of data covering supplies and purchases (including imports) of the exporters, all the refund claims are scrutinized centrally by verifying the acquisitions of inputs including imports and exports. The results of such verifications are transmitted to the local sales tax offices for finalization of refund claims have been detected during the last few years. As a result, the VAT refund bill of the government has been curtailed. In the meantime, payments of genuine refunds have been accelerated (from 60 days to 30 days).

To further improve the V A T refund system, introduction of a mechanism for "cross matching" of every input tax invoice used in refund claims, on the model in place in Korea, is already underway. From July 2005 onwards, each registered person shall be required to give an aggregate summary of invoices along with the monthly VAT return and this information shall be use to verify the accuracy of assessments and genuineness of the refund claims across the board.

The government earlier introduced the scheme of Duty & Tax Remission on Export, whereby the taxpayer is entitled to VAT free purchases of export-inputs from the local market or board. Adopted from the Korean V A T model but configured to accommodate the local business practices, another comprehensive scheme for duty free delivery of input goods and services for the production of exportable goods has recently been designed. Initially, this scheme will apply to industrial exporters of textile sector, while covering the vending industry and second stage supplies from the registered sectors. The scheme will be stretched to other export sectors including other segments of textiles. The scheme will be monitored through a tailor-made IT-based infrastructure.

Adjudication:

With the introduction of many appellate fora, the number of appeals has increased considerably in the last couple of years. The time involved in settlement of cases before these institutions not only blocks revenue, but also increases the cost of doing business for the taxpayers, especially the small businesses. In an effort to address this problem, the tax administration has come up with the innovative idea of adopting an alternate Dispute Resolution (**ADR**) mechanism. An independent judicial committee is constructed comprising members from private sector and tax department that deals with cases of disagreements on the outcome of audit or assessment.

Difficulties due to VAT design:

Pakistan has a peculiar background of VAT implementation. New sales tax legislation was introduced in the year 1990 without any major structural shift in the existing framework. Till 1996 sales tax was administered through physical controls and documentation partially analogous to excise tax. Liberal exemptions were available and regulated out of statutory precincts. However, in the budget 1996-97, sales tax legislation was drastically altered by incorporating the heterogeneous exemption regimes within the statutory framework. This allowed automatic adjustment of invoice-based credit replacing traditional sales tax rebate regime with zero rating system and managing absolute exemptions through the concept of deemed exports. Besides, small size enterprises were accommodated by separately fixing lower level thresholds for manufacturing and retail sectors. Commercial importers and wholesaler

were subjected to compulsory registration. Concessions on capital goods were bound with certain procedural compliance in order to encourage voluntary adherence to VAT laws.

Though hitherto several improvements have been made in V AT design as adopted by Pakistan, there are some problems which need to be addressed in future to make the applied design closer to the one ideally desired. Service sector generally is still out of V AT coverage. However, given the constitutional constraints, several services have been brought under V AT net through provincial and central excise legislation. Meanwhile, attempts have been made and are still being made to minimize V AT exemptions and broaden the tax base by curtailing breaks in V AT application on different stages of the supply chain. Fixation of lower threshold has always remained a problem in Pakistan's model. It is believed that VAT design problems of Pakistan will be resolved by sharing experience of V AT implementation in other countries.

Lingering Concerns:

However, despite this improvement in implementing V AT, there are various aspects of policy and administration where more efforts are required. Some of these areas are discussed below.

Audit and Penalties:

For V AT to be successful, high and fair probability of detection (audit) and strict application of penalties is important. In Pakistan we are actively engaged to base audit on the principle of risk management and selection of criterion on input/output analysis. It is likely to take some time before implementation. Currently, our audit programs have lower yield - below 1 %, which is far less than the average in the OECD countries. Similarly, the strict application of penalties is not forthcoming. A legal system that allows long delays in the application of penalties tends to contribute towards the blockage of government revenues and as a result diminishes the system's effectiveness.

It is therefore essential to develop an audit program that lays emphasis on key areas such as audit coverage, selection, methods, staff training and monitoring. Efforts are being made to have cost effective audit by relying more on short, issue-oriented audits of a limited period of activity, covering a broad range of taxpayers. Desk and investigative audit facilities are also being strengthened to supplement the overall audit mechanism. With automation under contemplation, it would be easier to develop and enforce sectoral approaches as well as linkage with other tax systems in order to make audit more effective. Nonetheless, given the critical significance of audit to the success of VAT system, abundant care is being taken to ensure that the program being developed embodies fairness and integrity.

Tax Compliance:

Another area of great concern to the V AT administration is tax compliance. Tax compliance is fairly low in Pakistan. About 70 % of registered persons and businesses file monthly tax returns. Realizing that an adversarial relationship between taxpayers and tax administration is the major cause of this compliance, a new taxpayer education and facilitation strategy has been designed. Many initiatives have been introduced to make the system more simple. For example voluntary disclosure (before commencing of audit) does not attract penalties. To facilitate taxpayers, separate returns for different taxpayers have been designed. It is also being considered to introduce electronic filing returns.

It is expected that continuous with the trade and business communities, greater moves towards education and facilitation of taxpayers, constant improvement in rules and procedures, design of forms and invoices, publication of self help leaflets on VAT provisions, rules and procedures media campaigns, automation of tax administration and addressing taxpayers' queries in a meaningful way would help in evolving an environment where voluntary compliance would be encouraged.

Future Direction:

V AT in Pakistan is a recent phenomenon. Nonetheless, its growth has been faster than that of the any direct tax, which reflects its buoyancy. In order to tap the potential that it holds for the future financial landscape of the country, it is important that the systems are developed in a manner, which respond to future needs and assures easily workable methodologies, while embodying appropriate safeguards. Integration and automation will replace the present footless and, in certain areas, segmented approach. That being the goal, Pakistan will soon invite expression of interest from international firms on supply, Customization and implementation of Off-the-Shelf (COTS) Sales Tax Application Software Solution. The project seeks the designing, development and implementation of an end-to-end web-based sales tax system with simplified procedures aimed at providing speedy and reliable services to taxpayers while minimizing their contacts with the tax officials. The new system will be based on functional and technical requirements and will also involve the training of selected end users. In less than two years, Pakistan expects to have in place a fully modernized and automated V AT system that will be geared towards serving future needs.

Conclusion:

The implementation of V AT in Pakistan in terms of tax collection and basic principles has been encouraging. While adverse elements in its introduction have been effectively dealt with, some concerns do remain. Issues of compliance, effective audit and strict application of penalties are being studied to further strengthen the system and root out areas of concern. While effective solutions to such problems will form part of the up coming reform projects, intern measures are underway to address them in way that are taxpayer friendly and in line with the overall V AT scheme. In this constant pursuit of seeking improvement, Pakistan has learnt from the trail of developments and the elements of progression experienced by some of the countries that have achieved phenomenal success in terms of V AT. The UK and Korean models contain components concerning the key areas of V AT activity that are akin to our requirements and operational environment. Their further relevance to the indigenous environment will be studied and it is likely that they will be adopted in the up coming reforms. It will only be fair if the cooperation of these countries in sharing their experiences with us is acknowledged. The support extended by the IMF, the World Bank and other international institutions has also been highly instrumental in the progress that Pakistan has made in adopting V AT so far and in undertaking its further reform.