REFORMING SALES TAX ON SERVICES IN KHYBER PAKHTUNKHWA

Sustainable Energy and Economic Development Programme

Improved Economic and Urban Planning in Khyber Pakhtunkhwa

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About the work

This work has been done for Foreign, Commonwealth and Development Office's Sustainable Energy and Economic Development Programme in Khyber Pakhtunkhwa, commissioned to Consortium for Development Policy Research through Adam Smith International.

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Message from Chief Minister, Government of Khyber Pakhtunkhwa

Provincial own source revenue is a pivotal component of Khyber Pakhtunkhwa's total receipts and enables the government to provide services to the citizenry and undertake public investments. Sales tax on services has emerged to be the largest single source of provincial revenues and has exhibited a phenomenal growth during the year 2019-20. It goes without saying that Khyber Pakhtunkhwa Revenue Authority (KPRA), which has the sole mandate of collecting Sales Tax on Services, lies at the heart of the government. We, at Khyber Pakhtunkhwa, envision KPRA to be a premium revenue collecting entity capable of undertaking data analytics, system-supported detection of new taxpayers and smart enforcement.

Mahmood Khan

I would like to compliment KPRA for the reform agenda it has embarked upon and the achievements it has accomplished. It gives me immense satisfaction seeing KPRA supporting economic activities during the COVID-19 pandemic through rationalization of tax rates and taking steps to increase ease of doing business in the province. While we consolidate the earlier reforms, our journey does not stop here but we will embark on new initiatives that improve revenue collection in the service sector.

We are committed to taking all measures that will help us optimize our revenue collections so that we can serve the province and the country in a befitting manner. This policy note highlights areas where KPRA can initiate steps and adapt others to further enhance the quality and quantity of Sales tax on Services collection.

Message from Finance Minister, Government of Khyber Pakhtunkhwa

Taimur Jhagra

Tax policy is an important tool of fiscal policy which has a direct bearing on the revenues of the government of Khyber Pakhtunkhwa. A forward-looking tax policy which takes into consideration the context and dynamics of the economy can prove to have far reaching consequences for revenue generation. Sales tax on services is an increasingly important source of Khyber Pakhtunkhwa's tax revenues. The year 2019-20 has been historical in the collection of Sales Tax on Services as collections increased by a historic proportion of 64% over the preceding year. Had it been for business-as-usual policy, this would have been hard to realize. But some bold policy and tax administration reforms were initiated that catalyzed the revenue growth under the constrained economic conditions. Rationalization of sales tax rates on services, generally provided by small and medium enterprises, helped capture the tax base of the semi-formal sector; tax collectors incentives were aligned with performance targets with setting up of meaningful performance indicators and a strong oversight and monitoring mechanism was put in place. My heartiest facilitations to KPRA for its achievements and forward-looking efforts for strengthening the system of sales tax on services in the province.

However, the path to reforms does not end here. In a continuum, the first generation reforms pave the way for refinement and lead to second generation reforms. It is our priority to make Sales tax on Services a buoyant tax, stimulate voluntary compliance and re-calibrate the organizational structure of KPRA to make it a 'well-functioning' tax administration. I envision for KPRA to gain the capability of informing integrated tax policy; be on the cutting edge of data analytics; have improved audit, processes and tools and be run by professionals whose motivation does not falter. This policy note complements our government's vision and highlights not only key reform areas, but also gives instances of where some of the reforms have worked.

Message from Secretary Finance, Government of Khyber Pakhtunkhwa

Atif Rehman

Primarily, Finance Department has a regulatory role for resource management. However, it has a limited role in revenue generation in as much as policy setting where sales tax on services is concerned. KPRA, being an attached department of the Finance Department has two-fold significance; it helps the department in better revenue forecast; and it serves as a repository of technical information and advises the department on technical aspects of the services' sales tax regime. In this latter role, the Finance Department leverages on the services' sales tax proposals for feeding into the annual budget.

Government of Khyber Pakhtunkhwa has initiated a tax reform process that gives salience to businesses and taxpayers but at the same time, is revenue augmenting. While a number of initiatives have already been undertaken by the provincial government like reduction in services' sales tax rates and rationalization of taxes within services sector as well as other sectors, more efforts will be required to further strengthen the policy and tax administration functions of KPRA. A tax system that is buoyant to capitalize on economic growth will be able to ensure flow of revenues that are stable and long lasting. Applying a systems approach for improving enforcement capacities, simplification and automation of business processes and payments, integrating the tax databases and building a high-performance organization can have a persistent impact on revenue generation of KPRA. The policy note highlights these issues and provides key recommendations for the government of Khyber Pakhtunkhwa to reinforce its sales tax on services' reforms agenda.

Message from Director General, Khyber Pakhtunkhwa Revenue Authority, Government of Khyber Pakhtunkhwa

Syed Fayyaz Ali Shah

KPRA is cognizant of the pivotal role it can play in providing a basis for the socio-economic uplift and prosperity of the province. It goes without saying that KPRA has been fast aligning its administration strategy characterized with taxpayers' persuasive facilitation, soft enforcement measures, efficient settlement of disputes and consistent engagement with trade associations using their platform to persuade and motivate businesses towards conformity of sale tax obligations. Measures have been initiated including efficient compliance-aimed handling of non-filers, late-filers or short-filers, selection of food outlets for the purpose of installation of RIMS, rationalization of regional jurisdictions, expansion in registration base by using available third party data, formalization of audit plan and monitoring of its implementation, and introducing measurable key performance indicators for each important activity. The shift in administration paradigm coupled with policy reforms has been instrumental in KPRA achieving a record revenue of PKR 17 Billion during FY20.

Reflecting on my experience of handling the reforms at KPRA, I am of the view that KPRA is at a stage where each additional reform measure can have increasing returns to scale. I do believe that reforms that encourage voluntary compliance, improve enforcement capabilities and builds taxpayers' trust in the tax system can have lasting impact on revenues. This policy note provides an objective assessment of KPRA's current functioning and suggests ways and means to improve it.

Message from Team Leader, Sustainable Energy and Economic Development Programme

Hasaan Khawar

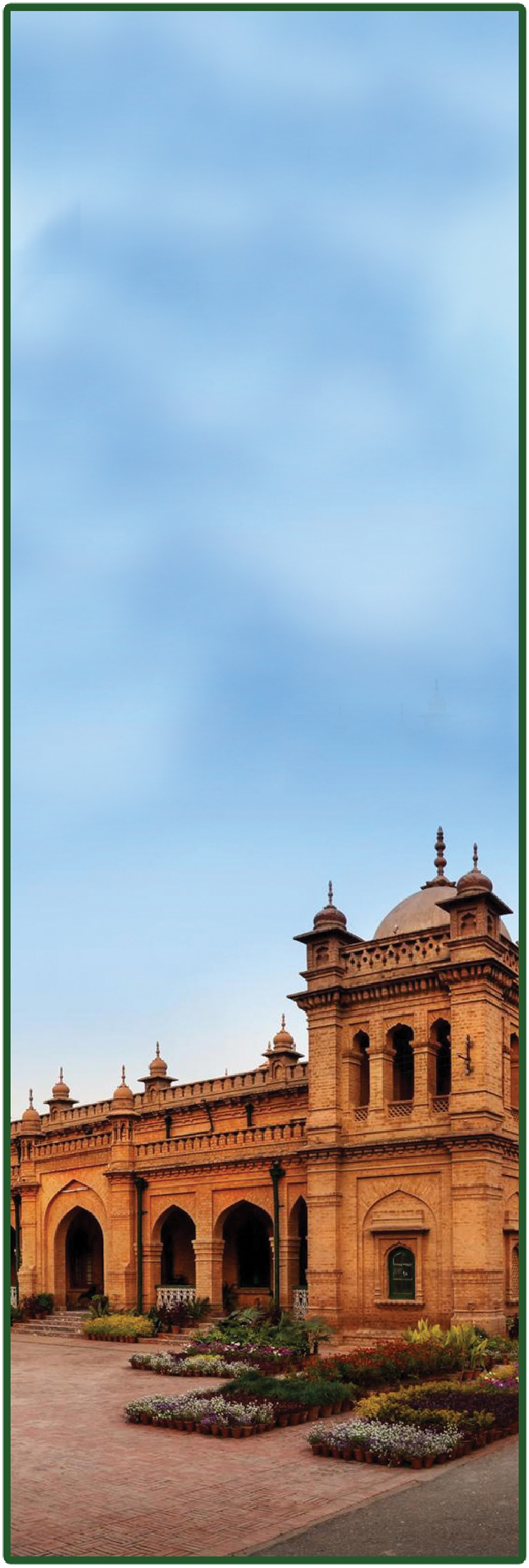
Sustainable Energy and Economic Development (SEED) Programme, funded by UK's Foreign, Commonwealth & Development Office (FCDO), is aimed at generating higher levels of public and private investments. In the post-COVID scenario, there is an even more pressing need for greater public investment, but the fiscal space is now highly restricted. This means that if public investment has to increase, SEED will have to work with the government to increase the available fiscal space. This in turn is dependent upon helping government in optimizing its revenues but the revenue mobilization effort should not lose sight of the private sector development and improved urban planning goalposts.

The provincial government presently relies heavily on federal transfers, while KP's own source revenues remain limited. In this context, the Sales tax on Services (STS) constitutes over 50 per cent of the total provincial tax collection. In recent years, KPRA has been working relentlessly to expand the tax net, simplify the procedures and increase the tax returns' filing ratio. But there is a realization in the government that if KPRA has to keep the momentum going and excel further, it needs to improve its organizational structure, enhance quality of its human resources, refine regulatory regime and most importantly make full use of IT systems and solutions. SEED remains committed to supporting the Government of Khyber Pakhtunkwa and KPRA in this journey towards excellence.

SEED has collaborated with the Consortium for Development Policy Research (CDPR) and the International Growth Center (IGC) to produce this policy note on STS. This note acts as a policy guide for the provincial government to carve out a framework for future reform to improve the performance of sales tax on services in KP.

I hope that SEED will be able to help the Government of Khyber Pakhtunkhwa in reforming the sales tax on services regime, leading to increased public investment, ultimately contributing to achieving the growth and prosperity agenda of the province.

Executive Summary



Sales tax on services is an indirect tax on supply services. Sales tax on services has undergone a major transformation since FY11 which was the last year in which the tax was collected by the Federal Bureau of Revenue (FBR) on behalf of all provinces. An amount of PKR 65.98 billion, equivalent to 0.36% of GDP was transferred to provincial governments on account of sales tax on services in FY11. This had increased to PKR 223.9 billion or 0.65% of GDP in FY18 after establishment of provincial tax collection agencies.

Each province in Pakistan has promulgated its own legislation for sales tax on services whereas sales tax on goods, which is a federal levy, is administered by the FBR. There are differences among provinces on the basic principle for levy of the tax. The Sindh Government uses the origin principle which implies that sales tax on services is the right of the province where services originate. Other provinces primarily argue for use of destination principle, implying that sales tax on services is the right of the province where their final consumption takes place. Different tax rates are used by provincial governments which creates difficulties in input tax adjustments. Similarly, there are a number of disputes over classification of goods and services between FBR and provincial revenue authorities. Taxpayers are required to file multiple returns which also imposes additional compliance costs. quite clearly, fragmentation of sales tax in Pakistan seems to be resulting in significant production inefficiencies for businesses.

At the same time sales tax on services is extremely important for provincial revenue generation in Pakistan as it contributes more than 50% of the total provincial tax collection. Reforms to sales tax on services are, therefore, extremely important for provincial governments with a view to generate more resources at a time when provicial governments are feeling a resource crunch due to slow-down in FBR collection and resultantly lower Federal Divisible Pool Transfers. At the same time businesses need to be protected from impact of COVID-19.

Pakistan inherited the Government of India Act, 1935 which assigned collection of sales tax on goods and services to the provincial government. Soon after independence, the power to levy sales tax on goods was assigned to the federation. However, the power to levy the tax on supply of services still remained with the provinces. Exercising its powers, the Federal Government promulgated sales tax acts in 1948 and 1951. Up till 1990s, sales tax was a minor and unimportant tax in Pakistan. It started with a narrow base, and between 1996 and 1999 the scope was expanded sequentially to include all economic activities except services, because services were in provincial domain. The Federal Government got provinces on board and all four provinces levied tax on supply of services through respective sales tax ordinances and delegated the power to collect it to FBR. This arrangement meant that Pakistan had a broad base of sales tax and only one revenue authority was collecting it.

This arrangement was, however, changed after 7th National Finance Commission (NFC) Award and 18th Constitutional Amendment as the provinces were allowed to collect sales tax on services themselves, if they desired so. The major shift was the result of the demand of the Sindh government. The government was apparently aggrieved by the population-based distribution of the sales tax on services between provinces and also the taxation of some major services as part of the Excise Duty by the Federal Government. Thereafter, provinces passed new sales tax legislations and established their own tax collection authorities in the light of decisions made by 7th NFC. Pakistan moved from an integrated system of sales tax to a fragmented system where a number of authorities are levying and administering this tax.

Sales Tax on Services in KP

Under the KP Sales Tax on Services Ordinance, 2000, only thirteen services were liable to pay the tax. By FY19, the number of taxable services increased to 94. Khyber Pakhtunkhwa Revenue Authority (KPRA)'s collection has been increasing steadily. The collection had touched PKR 17.0 billion in FY20 which translates into an increase of approximately 64% over the previous financial year. This growth rate could have been around 35% if the collection in FY19 had not restricted due the Supreme Court of Pakistan's decision to suspend collection of sales tax on telecom services. Sales tax on services collected by KPRA is important for Government of KP as it constitutes over 50% of the total provincial tax collection. KPRA has also done well by reducing its dependence on telecom services. Their share in total sales tax collection decreased from approximately 92% in FY14 to almost 40% (excluding FY19 when the share of telecom services was only 24%). KPRA is also working hard to increase its filing ratio and take it above 90%. KPRA had a total of only 37 personnel in FY19 but the authority is increasing its HR capacity through fresh recruitments. With stronger ownership of KPRA by the Finance Department, the government's support for its accelerated strengthening of KPRA has visibly increased.

Key Reform Ideas

A. Expansion in scope of sales tax on services

The Government of Khyber Pakhtunkhwa has done well by bringing a total of 46 services within the scope of sales tax on services. The number of taxable services in KP in FY19 was 94. However, during FY20, the Schedule of taxable services was revamped, and classification of services was reorganized in light of international practices. Still there are many services that remain outside the tax domain.

B. Study to assess tax gap

KPRA's revenue growth has been impressive in the last financial year. There is a plausible need to undertake a tax potential study covering the potential from the entire services sector. Punjab Government, with the assistance of the World Bank and FCDO (Ex-DFID), UK, undertook a tax gap study which revealed a tax gap of 70%. A similar study for KP will tie in very nicely with the move to negative list. The study would not be a mere diagnostic as it will identify areas with major untapped potential/ tax gaps and lead the authority's efforts to develop a strategy to plug the tax gap.

C. Organizational development/ restructuring of Khyber Pakhtunkhwa Revenue Authority

There are a number of areas of organization development/restructuring where KPRA can benefit from the experience of other revenue authorities in Pakistan. KPRA was initially established in the Directorate of Excise & Taxation. KPRA has recently moved from the administrative control of Excise Department and assigned to the Finance Department. After this move, KPRA has started to use functional roles and needs undergo a functional review to be organized on functional basis in future.

Several measures have been undertaken on HR and incentives within KPRA to boost collections. Tax collectors' incentives are now aligned with performance targets moving towards more meaningful performance indicators. In FY19 KPRA's manpower was also enhanced from 37 to 79. At the strategic management level KPRA is moving towards creating in-house capacity for tax policy formulation and tax audit administration.

However, lack of capacity of tax collectors is a major challenge for KPRA. KPRA like other provincial authorities has been relying, to a great extent, on officers of In-land Revenue Service working at these authorities on deputation, causing serious capacity constraints for revenue authorities. KPRA must recruit young, qualified officers of its own and build their capacity over time to fill important positions through targeting training. In addition to exposing the trainees to conceptual dimensions of the tax regime, training content needs to include practical dimensions of tax collection and administration. These trainings could be imparted by establishing KPRA's own training facility (as done in Punjab) or by collaborating with major academic institutions in the country.

D. Use of Information Technology

Use of information technology is vital for taxpayer facilitation, effective administration of sales tax and audit of taxpayers' returns. Provincial revenue authorities are ahead of other provincial tax collection agencies/departments in the sense that their tax collection systems are fully automated. Process of registration, filing of return, generation of tax challan etc. are performed electronically. In Punjab, the E-Pay system is also functional for ten taxes which includes sales tax on services. So, taxpayers can also make payment of sales tax on services using E-Pay. Government of KP is also in the process of automating process of payment of taxes by the taxpayers. KPRA has undertaken a number of initiatives to make use of information technology systems for collection of sales tax on services. These initiatives include Restaurant Invoice Monitoring System (RIMS), e-courts and a system to develop pre-populated returns of taxpayers.

KPRA has also joined e-Strive system of FBR which will help with improvements to the system of input tax adjustments with FBR.

KPRA can further benefit from reviewing the use of information technology in other provinces and experiences to date. PRA, for example, has developed a number of systems to facilitate taxpayers and directly collect information of transactions involving service provision. These include development of PRA Mirror and PRA eye (for efficient monitoring of staff), e-courts, Restaurant Invoice Monitoring System (RIMS), e-IMS (system that captures real time information of invoices generated by target sectors), pre-populated return, e-proceeding module, and database integration and data scraping (for identification of new taxpayers).

E. Mass Audit

The officers recruited in the audit and compliance unit of PRA have been trained on tax laws in Punjab. Using the compliance requirements set in the tax legislation and rules, the officers have developed risk criteria to review tax returns submitted by taxpayers. This can be done electronically.

KPRA is aware of the PRA's experience on establishment of this unit and has started to undertake mass audit of taxpayers. Development of this area can help overcome tax evasion.

F. Taxpayer Awareness/ Communication Strategy

Non-compliance of tax laws/rules, in many cases, is an outcome of lack of awareness of taxpayers especially the small and medium level businesses. The experience in other provinces has shown that taxpayer awareness campaigns can help increase voluntary tax compliance.

G. Harmonization of Sales Tax

Lack of harmonization of sales tax between Governments in Pakistan is causing major production inefficiencies and costs for businesses/taxpayers. The Federal Government has agreed with the International Monetary Fund (IMF) to create a National Tax Council to harmonize and integrate sales tax on services. The provincial Government / KPRA may start to work on integration by working with Sindh Revenue Board, Balochistan Revenue Authority, PRA and FBR. This can perhaps be the biggest reform in the system of sales tax in Pakistan. If there is consensus among the provincial and federal government, the remaining work could be completed quite quickly.

Concluding Remarks

KPRA has made significant progress on developing a system of collection of sales tax on services in KP. In order to further develop its tax collection systems, KPRA needs to improve its organizational structure, quality of human resources and its audit policies/plans. Effective use of IT can also go a long way towards improving quality of tax administration in KP. Further, efforts towards harmonization of sales taxation in Pakistan remains the most important area of reform.

1. Introduction

What is sales tax on services and what is the context of its evolution over time?

Sales tax on services is an indirect tax on supply of services. As per the Constitution of Islamic Republic of Pakistan, 1973 provincial governments have the power to levy and collect this tax.[1] Accordingly, provincial governments in Pakistan have established their respective revenue authorities/boards to collect this tax whereas Federal Board of Revenue (FBR) is collecting this tax in the federal territories.

Introduction

Sales tax on services has undergone a major transformation since FY11[2] which was the last year in which the tax was collected by the FBR on behalf of all provinces. Thereafter, Sindh Revenue Board (SRB) was established in 2011, Punjab Revenue Authority (PRA) in 2012, Khyber Pakhtunkhwa Revenue Authority (KPRA) in 2013 and Baluchistan Revenue Authority (BRA) in 2015. In this fashion provincial authorities gradually took over collection from FBR. An amount of PKR 65.985 billion, equivalent to 0.36% of GDP was transferred to provincial governments on account of sales tax on services in FY11[3]. The collection from sales tax on services had grown to PKR 223.9 billion or 0.65% of GDP in FY18. The collection, however, dropped to PKR 202.9 billion (0.52% of GDP) in FY19 as collection of this tax from telecommunication companies was suspended by a decision of Supreme Court of Pakistan. The suspension was vacated in April 2019.

Each province in Pakistan has promulgated its own legislation for sales tax on services. The legislations have resulted in differences in scope of the tax, multiplicity of tax rates and even differences in principles (origin principle vs. destination principle) for levy of the tax. The matter is further complicated by the fact that sales tax on goods, which is a federal levy, is administered by the FBR. The Sindh Government uses the origin principle to levy sales tax on services which implies that sales tax on services is the right of the province where services originate. Other provinces primarily argue for use of destination principle, implying that sales tax on services is the right of the province where the final consumption takes place. Similarly, there are a number of disputes over classification of goods and services between FBR and provincial revenue authorities. Revenue authorities have also been unable to come up with a fail-safe system of input tax adjustments. Businesses do not get input tax adjustments for transactions relating to more than one tax collection authority. Multiplicity of tax rates also renders it difficult to allow input tax adjustments. Quite clearly, fragmentation of sales tax in Pakistan seems to be resulting in significant production inefficiencies for businesses. Further, businesses operating across the country are required to file monthly tax returns to all tax authorities which also adds considerably to cost of doing business in the country.

Sales tax on services is extremely important for provincial revenue generation in Pakistan as it contributes more than 50% of the total provincial tax collection. Reforms to sales tax on services are, therefore, extremely important for provincial governments with a view to generate more resources at a time when provincial governments are feeling a resource crunch due to slow-down in FBR collection and resultantly lower Federal Divisible Pool (FDP) Transfers. At the same time, in the post COVID-19 scenario, it is very important to protect businesses and provide stimulus for greater economic activity. Therefore, the provincial governments in Pakistan including the Government of Khyber Pakhtunkhwa are trying to reform sales tax on services in a way that it generates optimum amount of revenue, without adversely affecting economic activity in the country.

[1]Serial No.49 of Part I of Federal Legislative List, Constitution of Pakistan, 1973
[2]FY11 refers to FY 10-11
[3]Budget in Brief 2011-12, Finance Division, Government of Pakistan, Islamabad (Page 48)

This policy note is an attempt to review the current system of sales tax on services in KPRA and other provincial revenue authorities (particularly Punjab Revenue Authority) with a view to identify if there are lessons that can be learnt for improvements in the system for levy and collection of sales tax on services in KP. This section provides the historical context of sales tax on services in Pakistan with a special focus on the period post 7th National Finance Commission (NFC) Award when provinces started to establish their own revenue collection agencies. Section 2 summarizes the state of collection of sales tax on services in the provinces of Khyber Pakhtunkhwa. Section 3 is the key part of this policy note as it identifies reforms and initiatives that can be implemented by Khyber KPRA for improvements in the system of collection of sales tax on services in the province and emphasizes the need for harmonization / integration of sales tax in Pakistan in order to reduce production inefficiencies and cost of doing business. Section 4 marks the end of the note with concluding remarks

Historical Context

At the time of independence, Pakistan inherited Government of India Act 1935.[4] The Act was based on federal structure, with powers demarcated between federation and provinces. The authority to levy sales tax on supply of goods and services was with the provinces. Soon after independence, Pakistan changed this in the sense that the power to levy sales tax on goods was assigned to the federation. However, the power to levy the tax on supply of services still remained with the provinces. Exercising its powers, the Federal Government promulgated sales tax acts in 1948 and 1951. Up till 1990s, sales tax was a minor and unimportant tax in Pakistan. In 1990, the Government of Pakistan decided to reform it along the lines of Value Added Tax (VAT). However, implementation of these reforms took a long time. It started with a narrow base, and between 1996 and 1999 the scope was expanded sequentially to include all economic activities except services, because services were in the domain of provincial taxation authority. The Federal Government got provinces on board and all four provinces levied tax on supply of services through respective sales tax ordinances and delegated the power to collect it to FBR.[5] The proceeds of this tax were distributed among provincial governments in proportion to their share in population. Most of the major services such as telecom, banking and insurance were being taxed by the Federal Government under Excise Duty. This arrangement meant that Pakistan had a broad base of sales tax and only one revenue authority was collecting it. This arrangement was, however, changed after 7th NFC Award and 18th Constitutional Amendment when power to administer sales tax on services was explicitly devolved to provinces and they were also allowed to collect this tax by establishing their own revenue collection agencies. This major shift was the result of the demand made by the Government of Sindh to 7th NFC to collect its tax through its own authority/board. Sindh Government was apparently aggrieved by the population-based distribution of the proceeds proceeds of sales tax on services between provinces and also the taxation of some major services as part of the Excise Duty by the Federal Government. Provinces passed new sales tax legislations and established their own tax collection authorities in the light of decisions made by 7th NFC and explicit authorization in the Constitution through the 18th Amendment. Thereafter, Sindh Revenue Board (SRB) was established by Government of Sindh in 2011, followed by establishment of other provincial revenue authorities. In this way, provincial

[4] Government of India Act, 1935, General Sales Tax Act, 1948, Sales Tax Act, 1951
[5] NWFP Sales Tax Ordinance 2000.

authorities gradually took over collection of sales tax on services from FBR. Thus, Pakistan moved from an integrated system of sales tax to a fragmented system where a number of authorities are levying and administering this tax.

The collection of sales tax on goods and services by different revenue authorities has its own complications. First, classifying transactions as either purely goods or services is difficult in some economic activities. Second, this affects production efficiency. The production efficiency requires that the tax should not interfere with the production decision of the firm. That is why VAT is so popular around the world as it maintains production efficiency by allowing full adjustment of tax paid on inputs acquired by a firm, for intermediary and raw materials. But when the tax base is fragmented, and multiple tax authorities are collecting taxes then adjustment of taxes is very difficult. This situation requires a transparent accounting mechanism and inter-authority transfer of funds to ensure that no authority loses revenue from its tax base. If this does not happen and authorities disallow input tax adjustments, this results in production inefficiencies for businesses. Similarly, fragmentation of the tax collection results in excessive requirements on firms to file multiple returns.

2. Performance of Sales Tax on Services in KP

How well has sales tax on services performed in KP and what are some of the key challenges?

SALES TAX ON SERVICES IN PAKISTAN

- Pakistan inherited the **tax structure** of **pre-partition India** as per the **Government of India Act**
- Unlike Sales Tax on Goods that was **federalized** in **1948**, Sales Tax on Services **remain a provincial subject**
- **Provinces promulgated** Sales Tax on Services Ordinances in **1999** and assigned collection to the **Federal Board of Revenue (FBR)**
- After the **7th NFC Award (2010)**, provinces created their **own revenue authorities** and **tax legislations** to **collect** Sales Tax on Services

KHYBER PAKHTUNKHWA REVENUE AUTHORITY (KPRA)

- Established in **2013** to **administer and collect sales tax on services** in accordance with the **KP Finance Act, 2013**
- **46 services** are **taxable** under the **Sales Tax on Services Act in KP**

KPRA'S PERFORMANCE IN 2019-2020

64% INCREASE IN **TAX COLLECTION** DESPITE THE IMPACT OF **COVID-19**

Rs. 17 bn*

Total Sales Tax Revenue

Performance of Sales Tax in KP

Khyber Pakhtunkhwa Revenue Authority (KPRA) was established in 2013 to administer and collect sales tax on services in KP. Prior to this, FBR was collecting sales tax on services on behalf of the Government of KP. KP Sales Tax Ordinance, 2000 remained operative till the new law in the form of KP Finance Act, 2013 was enacted. Under the KP Sales Tax Ordinance, 2000, only thirteen services were liable to sales tax. More systematic work to increase the number of taxable services started in 2013 and by FY19, the number of taxable services increased to 96 in 2019 and has now reduced to 46.

Without any increase in the existing taxes and despite a non-conducive environment due to the on-going pandemic, KPRA managed to make a significant increase in its annual revenue collection during the last FY20. In fact, half of the total provincial revenue was collected by KPRA. This was possible due to the smart tax collection system of the authority, its performance-based incentives for employees, its monthly regular review meetings and other reform measures.

Overall increase in collection: During FY18, KPRA collected PKR 10.91 billion, whereas for FY19 a target of PKR 15 billion was fixed but the authority could only collect an amount of PKR 10.1 billion primarily due to suspension of collection from telecom sector. The authority, however, collected an amount of PKR 17.0 billion in FY20 from sales tax on services[6] which translates into an increase of approximately 64% over previous financial year – the best in the country. This growth rate would have been around 35% even if the collection in FY19 had not been truncated due to a decision by the Supreme Court of Pakistan to suspend collection of sales tax on telecom services.

Diversifying its tax base: Sales tax on services is extremely important for KPRA as it constitutes over 50% of the total provincial tax collection. KPRA has also done well by reducing its dependence on telecom services by reducing its share in total sales tax collection from approximately 92% in FY14 to almost 40%, if we exclude FY19 when the share of telecom services had plummeted to only 24% because of the suspension of the tax on telecom. GDP growth patterns indicate that there is also potential for generating sales tax revenue from other services sectors such as transport, storage, travel, wholesale and retail.

Increase in registered taxpayers: The number of registered taxpayers of KPRA from FY14 to FY19 is shown below. Overall, it shows that the registrations in FY19 are 12 times what the authority inherited from FBR.

Financial Year	Number of Taxpayers Registered During The Year	Cumulative Number of Taxpayers	% Increase in Number of Taxpayers During The Year
2014	323	323	
2015	326	649	50
2016	525	1,174	45
2017	851	2,025	42
2018	1,774	3,799	47
2019	3,890	7,689	51

Registrations have increased significantly due to inclusion of new services in the tax net. The total filing of tax returns in FY19 was 10,144 with an increase of 17% from the previous year. KPRA has made a programme for thorough cleansing of its registration database in near future, increasing the filing ratio to more than 90%.

[6]Annual Budget Statement 2020-21, Finance Department, Government of Khyber Pakhtunkhwa

Increased capacity: In FY19 KPRA's manpower was limited to 37 personnel only. Approval from Policy Making Council (PMC) led to the creation of 79 more vacancies including 8 assistant collectors, 1 assistant director accounts, 10 senior auditors, 5 inspectors, 7 computer operators, 1 reader, 3 receptionists, and 42 class IV officials. At the strategic management level KPRA felt a strong need to create in house capacity for tax policy formulation and tax audit administration. Approval from PMC allowed one tax expert and one audit expert as KPRA's Advisors on extendable contracts.

Increasing reliance on technology: KPRA has a full-fledged inhouse IT Directorate to provide strategic advantage by using innovative technology to achieve KPRA's objectives. A new website has been developed for exclusive service to KPRA's domain with the latest web technology and inbuilt capacity for updating. An SMS portal has been set up for dispersal of messages to the taxpayers for reminding them about their time specific tasks of return filing and tax payment.

Automation of Sales Tax on Services in KP:

KPRA's has established an IT Directorate to lead on automation of sales tax on services. The Directorate has taken a number of important initiatives. Some of these have been summarized below:

1. **SMS portal:** An SMS portal has been set up for tax communications including registration campaigns, enforcement of returns, reminders for tax returns and payments.
2. **Restaurant Invoice Monitoring System (RIMS):** KPRA has also developed a RIMS in order to electronically receive invoices from the restaurants on real time basis. The system will be deployed to restaurants and beauty parlors.
3. **Decision support system (DSS):** A DSS has been developed in conjunction with an existing database of Pakistan Revenue Automation Limited (PRAL). The system has started generating tax analytics to support management decisions on various aspects of tax collection including registration, payment reports, invalid invoices and cash payment receipts etc.
4. **Enforcement management system:** Automation of notices' generation, issuance and management is crucial for efficient enforcement of tax laws. KPRA has developed notice automation system initially from registration side of the tax compliance enforcement.
5. **E-Payment:** KPRA is also in the process of implementing E-Payment system through State Bank of Pakistan. Through this system, taxpayers will be able to perform banking transactions through ATM POS/Multi-functional Kiosks, contact the bank's Call Center for any inquiry, access the digital Interactive Voice Response (IVR), perform transactions through Internet Banking, and even on smartphones through mobile banking.

In addition, there are a number of initiatives e.g. use of web scrapping for identification of new taxpayers, establishment of Enterprise Resource Planning (ERP) system for the authority and automation of adjudication system which are also being planned for implementation in near future.

Audit plans underway: During the last quarter of FY19, the first ever tax audit plan was developed by KPRA. However, no major audits have been undertaken as yet. KPRA would like to consult with other provincial sales tax administrations and FBR for the possibility of joint audit before embarking on audit of any major revenue spinning regime for e.g. telcom or banking.

Pegging of sales tax collection with traditional excise and taxation management environment created problems for institutional development of KPRA as a futuristic modern tax administration.[7] Although most sales tax compliance processes are automated to facilitate tax compliance for businesses, its enforcement and audit regimes require properly trained and skilled personnel and various physical resources including logistics and office equipment. With KPRA now being attached with the Finance Department, the government's support for its accelerated strengthening has visibly increased. With a better recovery strategy, KPRA will be able to meet its fiscal targets even in the wake of COVID-19.

How are other provinces faring – a case of Punjab:

PRA is a similar tax collection agency for Punjab province. PRA was established by the Government of Punjab through Punjab Revenue Authority Act, 2012 as a semi-autonomous organization for collecting and enforcing sales tax on services in Punjab. It started collecting sales tax on services in Punjab w.e.f. July 01, 2012. PRA has registered more than 82,295 taxpayers up to June 30, 2020 compared with only 615 registrations transferred to it in 2012 from FBR. Similarly, PRA has expanded its scope of taxable services from 12 services in FY12 to 69 services at present. Accordingly, as per the revised estimate for FY19, PRA collected an amount of PKR 101.1 billion as sales tax on services. It is important to mention that the Punjab Government received a straight transfer of PKR 26.8 billion in FY12 from the Federal Government on account of sales tax on services from Punjab. This implies that Punjab's sales tax on services has grown at an annual rate of approximately 20% since creation of the authority.

Although PRA still relies heavily on FBR's borrowed capacity, it has been able to achieve certain milestones with regards to sales tax on services and can offer important lessons for other revenue collecting authorities.

Sales Tax on Services Collection in Punjab[8]

	FY18	FY19
Telecommunication	28.2	16.3
Withholding Agents	26.5	20.6
Banking/Non-Banking/Insurance	10.8	14.3
Franchise Services	3.1	7.5
Contractual Execution of Work	3.2	4.7
Courier Services	1.9	2.6
Manpower Recruitment Agents	2.1	2.5
Restaurants	2.3	2.9
Construction Services	1.9	4.1
Security Agency	2.0	2.2
Information Technology-Based Services	1.4	1.6
Transport of goods other than water, through pipeline, conduit or any other medium	2.4	1.8
Technical Scientific & Engeeniring Consultant	2.6	2.2
Hotels	1.9	1.9
Mining of Minerals Oil & Gas	1.1	1.7
Other Services	1.5	14.2
	93.1	**101.1**

7 Anunual Report of KPRA, 2018-19
8 White Paper on Budget 2019-20, Finance Department, Government of The Punjab

Overall Challenges

Despite efforts to reform the sales tax on services regime, the federal and provincial governments have encountered several challenges in both tax policy design and implementation.

1. Lack of Harmonization of Sales Tax: There is lack of harmonization of sales tax between the federal and provincial governments in Pakistan, as identified by KPRA and other provincial authorities. This has led to production inefficiencies due to denial of input tax adjustments, higher compliance costs for businesses/taxpayers who have to file for multiple tax returns, and adverse effects on Pakistan's ranking on World Bank's 'Cost of Doing Business' index. Hence, there is an urgent need to create a platform to help develop consensus among revenue collection agencies i.e. FBR, Sindh Revenue Board (SRB), PRA, KPRA and Balochistan Revenue Authority (BRA) on different aspects of the harmonization principle of taxation, tax rates, single return and tax coverage.

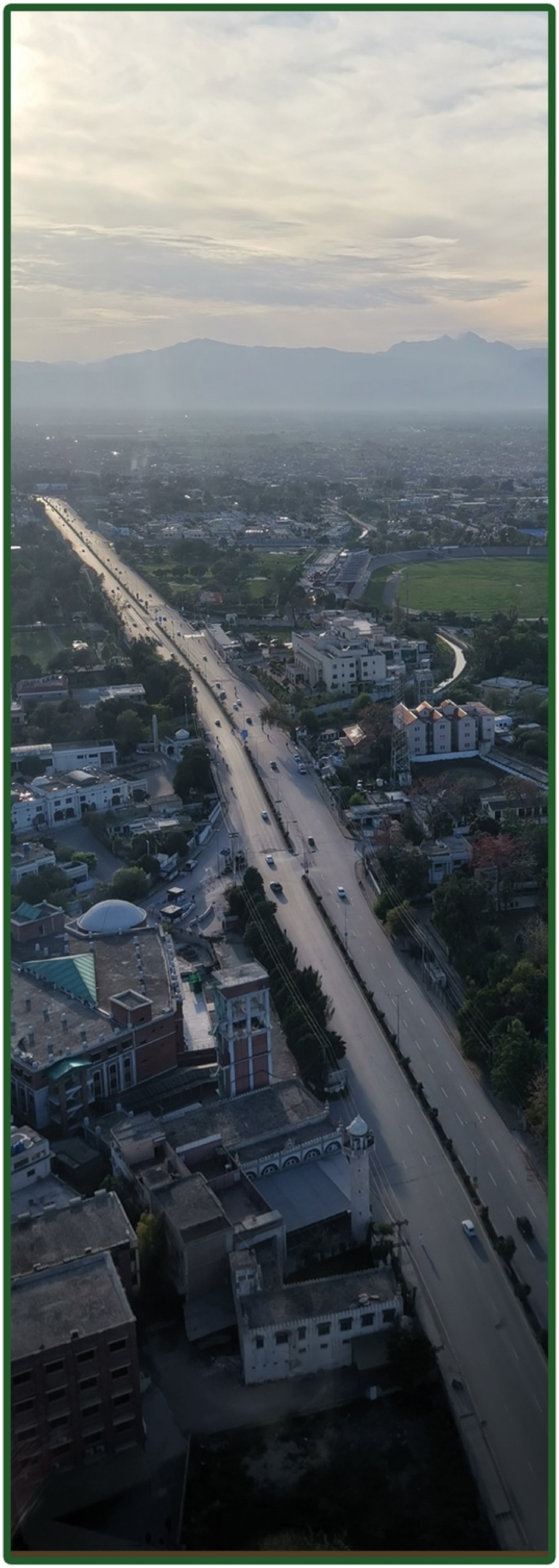
2. Limited Coverage of Services in the Tax Net: The existing Sales Tax on Services Act does not have a clear and comprehensive definition of services, and this leaves services open to interpretations by the FBR. Consequently, a tax gap is created due to limited coverage of services – the yield of sales tax on services is only equal to 0.6% of Pakistan's GDP, although services contribute approximately 56% to its GDP. Hence, the existing system incentivizes service providers to resort to litigation and evade taxes by claiming that the services they are supplying are slightly different from the schedule of taxable services under the law.

3. Reliance on Telecom Taxes: Traditionally, the telecom sector has had the largest share in sales tax collected from services. As this sector consists of well-structured, large corporates, it is comparatively easier to collect taxes from them. In Punjab, for instance, the generation of telecom sector revenue was around 78% to begin with, however, over the years it has been reduced to around 20-25%. This setback in services tax revenue has largely been due to the Supreme Court's decision to suspend telecom services tax in 2018. Nevertheless, GDP growth patterns indicate that there is also potential for generating sales tax revenue from other services sectors such as transport, storage, travel, wholesale and retail.

4. Need for Improved Documentation: In addition to increasing the sales tax base, it is also important to make much needed efforts in other areas, such as documentation and tax administration. Although relief measures are introduced to make the regulatory environment friendlier for small businesses and increase the ease of doing business during COVID-19, businesses operating across provinces still have to undergo long and complicated procedures to file returns. Even though KP has launched initiatives to improve documentation, it has become increasingly important to move beyond an understanding of services sales tax within provincial silos but view it more dynamically at the national level.

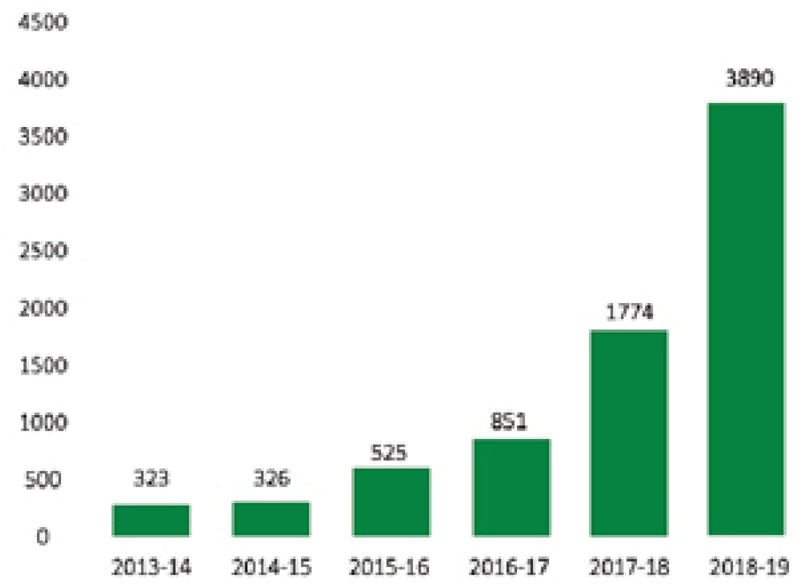
3. Reforming Sales Tax on Services

What lessons can be learnt from provincial experiences and what steps can be taken to improve the performance of sales tax on services specifically in Khyber Pakhtunkhwa?

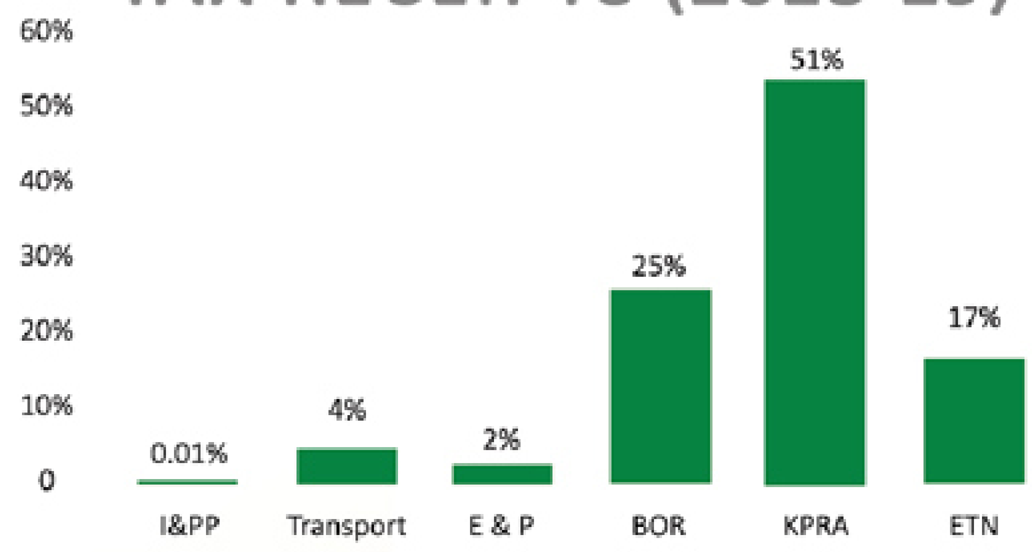


KPRA'S PERFORMANCE

KPRA SALES TAX REGISTRY



KPRA's CONTRIBUTION IN PROVINCIAL TAX RECEIPTS (2018-19)



HIGHLIGHTS OF BUDGET 2020-21

- No new tax or increase in rate of tax
- Rate of sales tax on services reduced for 27 services
- Hotels on active taxpayers list of KPRA exempted from Hotel Tax
- Professionals on active taxpayer list of KPRA exempted from Professional Tax

BUT CHALLENGES REMAIN

POLICY CHALLENGES

- Overall **service sector** contributes **56% to GDP**, yet sales tax collected from services is just **0.6% of GDP**
- Fragmented **tax base** and **disconnect** between **federal** and **provinces tax collection authorities**

Large number of **services** still **outside** the **tax net**

- **Limited sectors** in the **tax base** with **Telecom** being the largest **contributor** to **revenue** from **Sales Tax on services**

ADMINISTRATIVE CHALLENGES

- Sales tax **collection** uses a **traditional organisational structure** of the Directorate of **Excise & Taxation**
- **Inadequate documentation** of the economy, especially **small** and **medium scale** businesses in the **informal sector**
- Greater use of IT required for **effective tax administration**

Since inception, provincial revenue authorities across Pakistan have taken a number of reforms and initiatives to improve tax collection. Some of these reforms/initiatives can provide useful lessons for KPRA as discussed in the section below.

A good way to benchmark the performance of KPRA is to see how other provinces have evolved this form of tax and what challenges and opportunities they faced and continue to face and whether we can draw any lessons for KP. Given the scope of work, access to information and familiarity with the subject, the note provides some references to Punjab. However, other provinces such as Sindh have also implemented several reforms around this tax demonstrating success in several areas. A focus on Punjab in no means undermines efforts of other provinces in improving the execution of this important source of tax.

Study on Tax Gap

KPRA's revenue growth has been impressive in the last financial year when it increased its collection to PKR 17.0 billion compared to PKR 10.3 billion in FY19[9]. However, there is a need to benchmark current collection against the potential of sales tax available to KPRA. A good starting point would be to ascertain the exact tax gap so that target setting is precise and hence the policies developed around it also work towards this target.

One of the provincial governments in Pakistan, with the assistance of the World Bank and FCDO undertook a tax gap study which revealed a tax gap (i.e., difference between its revenue potential and revenue collection) of 70%. The study also identified major sectors and reasons for tax gap in the province. Since then, the tax gap has been significantly narrowed but a large part of the potential remains unrealized.

A similar study was undertaken in 2015-16 in Khyber Pakhtunkhwa. However, this study identified the potential of tax from taxable services only. There is a plausible need to undertake a tax potential study covering potential from whole of the services sector. This study will tie in very nicely with the move to negative list of services for sales tax on services. The study would not be a mere diagnostic as it will identify areas with major untapped potential/ tax gaps and lead the authority's efforts to develop a strategy to plug such gaps.

Expansion in Scope of Sales Tax on Services

The Government of Khyber Pakhtunkhwa has done well by bringing a total of 46 services within the scope of sales tax on services[10]. It may be added that the number of taxable services in KP in FY19 was 94. However, during FY20, the Schedule of taxable services was revamped, and classification of services was reorganized in the light of international practices of classification. Resultantly, the number of service categories was reduced from 94 to 46. Still there are many services that are still outside the tax domain. Other provincial governments are also moving in this direction. For example, Punjab Government increased the number of its taxable services from 12 in FY12 to 69 in FY21. Expansion in scope led to increase in revenue for the Government. The case of other provinces is very similar in case of extension in scope of taxable services.

[9] Annual budget statement 2020-21, Finance Department, Government of Khyber Pakhtunkhwa

[10] The number of taxable services in KP in FY 2019 were 94. However, in the year FY 2020, the Schedules of taxable services was revamped, and classification of services was reorganized in the light of international practices of classification. Resultantly, the number of service categories was reduced from 94 to 46.

The Government of Khyber Pakhtunkhwa and other provinces can further broaden their tax base by introducing a negative-list based sales tax regime in the country; whereby all services are taxable unless specifically exempted. Provincial revenue authorities/boards in Pakistan are already working together to come up with a system of negative list to expand the base of sales tax on services. This step will remove anomalies and interpretational disputes and allow revenue authority to improve enforcement.[11] This would be like the regime that the Federal Government is following in respect of sales tax on goods. Broadening of the tax base through the introduction of negative list will help remove obstacles to extending the tax net into untaxed services. It will also help tax enforcement by minimizing interpretational disputes.

Organizational Development & Restructuring

There are a number of areas of organization development/restructuring where KPRA can benefit from the experience of other revenue authorities in Pakistan. These areas have been summarized as follows:

Organizational Structure:

KPRA was initially established in the Directorate of Excise & Taxation. Therefore, the organizational structure of the authority was similar to that of the directorate where different functions are assigned an officer. Lack of functional structure tends to create conflict of interest within the functions performed by the officers. KPRA has recently moved from the administrative control of the Excise Department and assigned to the Finance Department. After this move, KPRA has started to use functional roles. However, this is just a beginning and a lot more needs to be done in this regard. It is, therefore, important that a functional review of KPRA is undertaken and the authority is fully organized on a functional basis in the light of the findings of this review.

Professional Tax Service:

Lack of capacity of tax collectors is a major challenge for KPRA. KPRA (like PRA), to a great extent, has been relying on officers of In-land Revenue Service working at these authorities on deputation. The tenures of such deputations can be unpredictable as they can be recalled by FBR at any time. This, at times, causes serious capacity constraints for the provincial revenue authorities.

KPRA will be best served in the long run if it recruits young, qualified officers of their own and builds their capacity over time to fill important positions. After recruitment, these officers can be trained at FBR's Department of Training (DOT) on various aspects of sales tax. Over time, these young officers can take over more important responsibilities in KPRA. PRA also recruited two batches of Enforcement Officers and is now in the process of developing service rules for these offices. Development of service rules will determine a career path for these newly recruited officers. These officers can be a future asset of the provincial authorities and help reduce dependence on officers on deputation from FBR.

It is, however, important that such recruitments are planned in the light of HR gaps identified through a functional review of the authority.

[11] White paper on budget 2019-20, Finance Department, Government of the Punjab

Training Academy:

Lack of capacity of officers in KPRA can be overcome by providing targeted training courses to the existing workforce of the department. A list of such topics should be developed in consultation with KPRA. The authority may choose to develop its own training facility like PRA has done or alternatively it can collaborate with leading academic institutions in the country. PRA established a Training Academy for capacity building and training. New officers recruited by the authority are trained at this academy. The facility is also used to impart trainings to existing officers of the authority on new areas of tax policy and administration. In addition to exposing the trainees to the conceptual dimensions of tax regime, training content includes practical dimensions of tax collection and administration. PRA has also developed a Virtual Learning Environment (VLE) platform for the training academy to save time and resources and allow flexible schedule for learning and self-discipline of trainees.

Use of Information Technology

Use of information technology is vital for taxpayer facilitation, effective administration of sales tax and audit of taxpayers' returns. KPRA has fully automated its collection systems. Process of registration, filing of return, generation of tax challan etc. are performed electronically. In Punjab, the E-Pay system is also functional for ten taxes which includes sales tax on services. So, taxpayers can also make payment of sales tax on services using E-Pay. They don't have to face the hassle of going to a branch of State Bank of Pakistan or National Bank of Pakistan to deposit their taxes in the public exchequer. Government of KP is also in the process of automating the process of payment of taxes by the taxpayers. It is a useful and a low-hanging reform that must be expedited.

KPRA has also undertaken a number of initiatives to make use of information technology systems for collection of sales tax on services. KPRA can further benefit by automating a number of its internal systems and processes. These include development of Human Resource Management Information System (HRMIS), electronic attendance monitoring system and legal dashboard for effective monitoring of litigation. In addition, IT systems being used for effective tax administration are as follows:

1. PRA-Mirror & PRA-Eye:

For efficient monitoring of its workforce, PRA has developed PRA-Mirror & PRA-Eye, dashboards that enable the top management to get real-time data of the operational activities of its officers and the staff. PRA-Eye also provides analytics for decision making by the top management. Through these tools, senior management of PRA tracks performance of officers with a view to ensure operational efficiency.

2. E-Courts:

To facilitate taxpayers and improve efficiency of the existing systems, PRA has come up with an initiative of establishing e-Courts. KPRA has also made use of E-courts recently during the times of COVID-19. The e-Courts ensure speedy disposal of cases by Appellate Tribunal and Commissioner Appeals. The functioning of e-Courts involves online filing of appeals against decisions of the officers of PRA, issuance of hearing notices, cases list being heard by Commissioner Appeals and Appellate Tribunal, request for adjournments, video hearing of appeals, and finally online issuance of order. As noted above, KPRA is also planning to use automation in adjudication upto the stage of appellate tribunal. This is likely to help expedite dispute resolution and recovery settlements.

KPRA will look at these initiatives in light of the lessons learnt over the last year since these initiatives were rolled out.

3. Restaurant Invoice Monitoring System (RIMS):

International experience shows that business-to-business transactions are more tax compliant compared to business-to-consumer transactions as the transactions between two businesses generate a tax liability; and the businesses have an advantage of reporting tax paid to claim tax credit. However, the final consumers do not get a tax credit. Therefore, they have no incentive to report deduction of sales tax to tax authorities. This is a relatively bigger issue for services as they are more likely to be supplied to a final consumer than another business. In view of this, governments need to create incentives for consumers to generate paper trail/records which tax authorities need to enforce compliance by suppliers of services.

RIMS is a flagship initiative of PRA, which was launched in July 2015. The system inter-alia aimed at monitoring the sales tax collection system at restaurants on real time basis with a view to ensure the deposit of the charged sales tax in the government exchequer besides identifying any concealment or tax leakages at the restaurant level. The initiative was supplemented by the introduction of "Amanat Scheme" in March 2016 which gave the necessary impetus to its adaption by restaurants and the general public. Under the system, through real-time internet-based connectivity, the invoice data of restaurants is captured by PRA into its system and propriety of monthly declarations of restaurants are checked by the system on the basis of invoice data received through the system. The scheme helped increase tax revenue from restaurants by 28%.[12]

KPRA has also developed its own RIMS which is ready to be rolled out initially at 200 pilot sites. However, it could further enrich its system by looking at RIMS implementation in Punjab during the last 5 years.

4. E-IMS (Electronic Invoice Monitoring System):

A software suite that enables real time capturing and monitoring of invoices issued by the target sectors i.e. hotels and courier services to ensure proper declaration of Punjab sales tax on service. Its web-based dashboard allows PRA to monitor and analyze real time data provided by different sectors. e-IMS provides target sector customers the facility to verify invoices online as well.

5. Pre-Populated Return:

Using RIMS and e-MIS, PRA is now in a position to provide a facility of pre-populated return to businesses using the systems. This helps reduce taxpayers' efforts in preparing tax returns and improving tax compliance. It may, however, be added that this is a futuristic initiative which is still passing through its early stages of implementation.

6. E-Proceedings Module:

PRA has developed an E-Proceeding module which facilitates the features of issuing notices to taxpayers with least amount of effort while documenting this important step. Authorized officers store taxpayer

[12] Javed Ahmed, Economist, Punjab Revenue Authority at CDPR webinar titled Taxation for growth in KP: A focus on sales tax on services

information in the system and are able to compose, issue, track and verify notices using the PRA E-Proceeding module.

7. E-STRIVE:

A system for Cross verification of backward/forward invoicing and input tax adjustment developed by FBR. Sindh Revenue Board and PRA are already on e-STRIVE. KPRA is in the process of joining e-STRIVE.

8. Database Integration and Data Scraping:

Private sector entities register and apply for various licenses with the provincial governments. The departments maintain an independent record of these registrations and the details of the private sector. However, this data is not integrated with the data maintained by tax authorities; such integration could lead to significant enhancement in the tax base. PRA is piloting an intervention to integrate various datasets in government institutions which would lead to identification of potential taxpayers and help in informed decision making. For example, the Labour Department registers a large number of private sector entities, similarly other departments. This data can be integrated to develop a master taxpayers list and identify potential taxpayers, who are not paying their taxes. Additionally, the pilot includes use of data scraping tools to help identify new taxpayers using information available on the internet. Considering the widespread use of the internet by small and medium businesses (service providers), this appears to be an excellent option to widen tax net. The technique could also be used to fetch information from third party data sources to check the veracity of returns filed by taxpayers. The intervention could also be piloted by KPRA.

Mass Audit

Development of this area can help overcome tax evasion and thereby increase in tax revenue for KPRA. KPRA is aware of the PRA's experience with establishment of an Audit and Compliance Unit and wants to have a similar unit set up. Officers recruited in PRA's recently set up unit have been trained on tax laws. Using the compliance requirements set in the tax legislation & rules, the officers have developed risk criteria to review tax returns submitted by taxpayers.

The technique can be used to conduct mass audits of tax returns. Use of third-party data in future could also be very useful in this type of audit. The exercise has already helped identify potential evasion of billions of rupees in the last one year. PRA estimates at least 5% to 10% of the identified evasion can be recovered.

Taxpayer Awareness & Communication Strategy

Taxpayer awareness is an important aspect of taxation. Non-compliance of tax laws/rules, in many cases, is an outcome of lack of awareness of taxpayers especially the small and medium level businesses. The experience of other provinces has shown that taxpayer awareness campaigns can help increase voluntary tax compliance by also developing a communication strategy to institutionalize this important aspect in its day-to-day work. KPRA can review these communication strategies and tools/products to contextualize them to KP to increase taxpayer awareness and reap benefits of improved tax compliance.

Harmonization of Sales Tax

Lack of harmonization of sales tax between governments in Pakistan is causing major production inefficiencies (as a result of cascading due to denial of input adjustments) and costs for businesses/taxpayers. The Federal Government has agreed with the IMF to create a National Tax Council to harmonize and integrate sales tax on services. Implementation of this plan will help ensure provision of input adjustments, agreement on the basic principles of taxation, uniform rates and lower costs of compliance for businesses. However, this plan is subject to development of a political consensus. The provincial government/KPRA may start to work on partial integration by working with PRA, SRB, BRA and FBR. By integrating the tax between the governments, production inefficiencies can be reduced. This can perhaps be the biggest reform in the system of sales tax in Pakistan. According to PRA, more than 80% of the work on development of a common IT platform has been completed. If there is consensus among the provincial and federal government, the remaining work could be completed quickly.

4. Conclusion

With growing concerns regarding provincial revenue generation and complex center-province relations post-18th amendment, the issue of sales tax on services has emerged at the forefront of many discussions between the federation and its four provinces. While, the primary purpose of sales tax on services is to generate revenue for the provinces, there is a growing need to harmonize the sales tax regime in Pakistan, create a distinction between the taxing powers of the FBR and provincial revenue collecting authorities, and devise common rules and definitions for efficient data sharing.

KPRA has made significant progress on developing a system of collection of sales tax on services in KP. In order to further develop its tax collection systems, KPRA needs to improve its organizational structure, quality of its human resources, its audit policies/plans. Effective use of information technology can also go a long way towards improving quality of revenue administration in KP.

In this regard there are important lessons/reforms implemented elsewhere in Pakistan that can inform the Government of KP's efforts to further reform sales tax on services in the province. Most importantly, Government of KP needs to work with other provincial revenue authorities and revenue collection agencies/governments to harmonize collection of sales tax in the country. This will help reduce the current production inefficiencies and pave the way for improvement of the business environment in the country.

HARMONIZATION OF SALES TAX

CHALLENGE

Lack of harmonization across governments in Pakistan may lead to:

- Production inefficiencies
- Higher compliance costs
- Rise in cost of doing business

WHAT NEEDS TO BE DONE?

- Develop consensus among federal and provincial revenue collection agencies on principle of taxation, tax rates, return and coverage

HOW?

- Identify potential benchmarks for an integrated system of sales tax
- Develop a consultative forum for all revenue authorities/governments to discuss harmonization of sales tax
- Assist KPRA to develop tax legislation and infrastructure to support harmonization
- Establish a national tax council to collect sales tax on services

MOVE TO NEGATIVE LIST OF TAXABLE SERVICES

CHALLENGE

- Limited coverage of services – 46 services currently taxable under the Schedule 2 of Sales Tax on Services Act in KP
- Adding new services to the tax net is cumbersome
- Service providers evade taxes by entering litigation and claiming the services they are supplying are different from the schedule of taxable services under the law

WHAT NEEDS TO BE DONE?

- Introduce a negative-list based sale tax regime, whereby all services are taxable unless exempted

Will help broaden tax base and increase revenue without increasing burden on existing taxpayers

Will avoid significant amount of litigation (classification disputes)

HOW?

- A comprehensive definition of services needs to be included in the tax law for implementation of a negative list
- A prior consensus among all provincial authorities once developed will make move to a negative list more effective
- A comprehensive Value Added Tax regime will help document the economy, help create a level playing field for businesses and derive the negative list

REVISION OF SALES TAX ON SERVICES ACT

CHALLENGE

- Sales Tax on Services Act lacks a clear definition of services
- No explicit statement in the law regarding the time when payment is due, creating issues in compliance under the tax
- Weaknesses in the legislation reduces tax compliance and gives rise to litigation

WHAT NEEDS TO BE DONE?

- KPRA and the KP Government require capacity to develop a high-quality legislation (rather than revise existing legislation) to overcome deficiencies

HOW?

- Connect KPRA with international experts on sale tax legislation to help
- KPRA establishes a comprehensive definition of services
- Design a tax collection system/process more efficiently
- Assist in tailoring legislation to support harmonization of sales tax on services to make it business friendly
- Provisions requiring taxation on the principle of origin should be deleted from the law and tax law must only be based on the principle of destination
- Extend support if possible to develop subordinate legislation

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