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Zaman, Nadeem Uz and Ghutai, Gul and Zaidi, Syed Raza  
Irfan Shah

Balochistan University of Information Technology, Engineering and  
Management Sciences, Quetta, Pakistan, Sardar Bahadur Khan  
Women University, Quetta, Pakistan

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## **The implication of the value added tax in Pakistan: administration, experiences and fears**

**Nadeem Uz Zaman<sup>1</sup>, Gul Ghutai<sup>2</sup>, Syed Raza Irfan Shah Zaidi<sup>3</sup>**

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### **Abstract**

Since its first imposition in France, the value added taxation has become so popular that except USA there is no other country left that does not have VAT in use. Pakistan has fulfilled its international obligation to replace its sales tax with VAT by the year 2010. This paper examines the available literature and reflects as to how successfully the country has implemented the new taxation, what has it experienced in its efforts in the replacement of sales tax and the fear relating to VAT that still remain unaddressed. It was found that the country has, as a whole, very successfully implemented the new taxation in terms of economic gains and costs to the government. Nonetheless, it is feared that the social aspects relating thereto are altogether ignored and thus this replacement is not socially optimal.

Keywords; VAT: Pakistan; experiences; fears; economic gains and costs; social cost

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<sup>1</sup> Assistant Professor, Balochistan University of Information Technology, Engineering and Management Sciences, Quetta, Pakistan

<sup>2</sup> Lecturer, Sardar Bahadur Khan Women University, Quetta, Pakistan

<sup>3</sup> Assistant Professor, Balochistan University of Information Technology, Engineering and Management Sciences, Quetta, Pakistan

## 1. Introduction

Pakistan has been using value added taxes (VAT) in some form or the other in the country since 1947. However, in order to fulfill its trade agreements with WTO and adjust to the directions of IMF, the country has replaced its old sales tax system with the value added taxation. The change has resulted in some resistance in the economy yet implemented with a high level of consent at the end.

Does the implementation of the VAT results in positive experiences? The implementation of VAT has been reported to have successfully improved the revenues for the countries across the world in most of the cases; yet there are incidents in some developing countries that have shown failures in the implementation of VAT. It is thus believed that the successful implementation of VAT in a country relates to the administration of the collection. This paper thus investigates through an overview of the available literature as to how successfully the government of Pakistan has implemented the VAT in the country in its socio-economic context. Therefore, this study tries to answer the following Research questions:

1. What are the experiences of Pakistan in the implementation of VAT?
2. How successfully has the government addressed the issue arising in the implementation?
3. What are the fears relating to the implementation of VAT in Pakistan?
4. Did the government consider the canons of taxation in the implementation of VAT?

### 1.1. The value added tax: methods and consequences

Taxation, felt as important fiscal necessity, allows governments to earn revenues from the production of goods and services in the economy. The value added taxes (VAT) are indirect multi-point, multi-stage tax that is levied at every stage of the value addition in the production process (Thacker, 2009; Parkins, 1996). This tax is levied by governments through businesses at every stage of the addition to the cost of the product that will increase its price to the ultimate buyer (Thomson and Strickland, 2001).

The price the customers are willing to pay for a product is the value of the product (Thomson and Strickland, 2001) and is shared between the producer and other factors of production. The word 'value' refers to the difference of cost added to the raw material and labor etc. to produce some given output. Thus, it is possible to measure the added value in terms of addition to costs plus the profits or minus the loss and as a result the tax is levied on this addition in value. Consequently unlike the sale tax, the imposition of the value added tax has more impact on the production decisions rather than the sales decisions (DCCI, 2008).

Three major reasons account for the need to impose the value added tax or to replace the sale tax with it; (1) it is a reliable source of revenues, (2) has no discretionary economic effect and (3) is more efficient and administrable than other forms of taxes (DCCI, 2008). As, the tax collection should be efficient and cheap (Anderton, 2004), authorities need to use diverse methods, regulations and collection systems for an effective taxation system in the economy (Thacker, 2009). As far as the value added tax is concerned, there are four methods in use for the collection of value added tax; (1) the additive direct method, (2) the additive indirect method, (3) the subtractive direct method and (4) the subtractive indirect method. Since its first successful imposition in France (Keen and Lockwood, 2007), VAT has become an important source of revenue for over 145 countries world over that generates somewhat 25% (around 20%

higher) of the income for countries around the world (DCCI, 2008; Keen and Lockwood, 2007).

Keeping in view the success of the value added taxes and the modernization of its implementation as well as considering the difficulties in making income taxes border-adjustable, IMF and WTO have proposed that countries- especially the developing ones-should resort to value added taxation (Nicholson, 2010; Keen and Lockwood, 2007; Ahmed, n.d.). In line with the proposition of IMF, Pakistan is also among those countries which are trying to replace the old sales tax with the value added tax (VAT). Though the value added tax is expected to increase the revenue for a country, it is important that how the government manages its burden on the nation that is already facing difficulties of heavy cost of living.

Despite the successful experiments of replacing the other taxes with the value added, there are also reports that the imposition has resulted into negative consequences for countries. Thus, Keen and Smith (2006) have found out that the imposition of value added taxes in some cases have reduced the efficiency of the country's taxation system. In addition to this, they have also suggested that the implementation of value added taxes is also prone to "criminal attack" for example carousel fraud etc. Moreover, Desai and Hines (2005) have shown that the imposition of value added taxes has resulted into a reduction of exports and national output. Furthermore, Piggott and Whalley (2001) have also indicated that the imposition of value added taxes has resulted into increase in inefficient production and thus welfare losses. Similarly, Keen (2006) and Emran and Stiglitz (2005) have reported VAT is inferior to tariffs and resultantly most of the taxes collected by the developing countries relate to the imports and thus act as tariffs.

## **2. The Imposition of the value added tax in Pakistan**

By the year 1996 Pakistan had been using a very liberal sales tax legislation that was administrated to physical control and documentation. Nonetheless, in 1996 – 97 a drastic change was brought about in the sales tax legislation that incorporated different sales exemptions under the reteam of statutory framework. This change allowed several adjustments into the tax system whereby small enterprises were accommodated accordingly by fixing different thresholds.

Thus, in Pakistan differing levels of thresholds are fixed for the collection of value-added tax with the lower level being to Rs. 0.5 million by the manufacturers and Rs. 1 million further retailers; the value-added tax be 2% within this category. Whereas, far thresholds higher than Rs. 5 million payment of the added tax at a rate of 15% of the total turnover.

The registration form value-added tax has been done by the sales tax offices that required a large number of documents to investigate the amount of tax payable. These documents include the National tax number, income tax returns for the last two years, rent or the ownership detail of the commercial premises, utility bills besides a physical inspection of the premises, plant and machinery (Ahmed, n.d.).

## **3. The experiences relating to the implementation of VAT in Pakistan**

The value added tax has been a part of the taxation system in Pakistan since 1947 in some ways or the other, nonetheless, the government has planned to replace the sales tax with the value-added tax in 2010. In order to do so, a tailor-made value added tax design has been implemented in Pakistan which has resulted in a fall in the cost of collection as this new tax base has proved to be more compliance – oriented. Moreover, this replacement has provided the small businesses with extra safeguard against excessive taxation (Ahmed, n.d.).

Though it is commonly believed that the new design of the value added tax sufficiently and just is the economic conditions of the country, the replacement has resulted into several problems too in the implementation of the new design. At first, several sections of the server sector have remained out of the new value added tax coverage. Secondly, the country has still not been perfectly successful in minimizing the value-added tax exemptions and broadening the tax base due to the issues of fixing a good lower threshold. Thirdly, it has become easy to fraudulently under wrong categories – in order to solve this problem, the government has decided to fix different thresholds for manufacturers and retailers by sacrificing the revenues of about 26%.

Fourthly, the administration of the value-added text has resulted in substantial delays and harassment by the administration towards the taxpayers (Ahmed, n.d.). Fifthly, the implementation of the value-added tax has also resulted in problems in the area of refund payments. An important issue relating to this problem is that at anyone of the sources where the value-added taxes imposed, fake invoices are noticed at the intermediary manufacturing and processing activities. In addition to this, several intermediate processors are unrecognized as different sectors are highly undocumented. Lastly, the number of deals for tax refunds has increased considerably in the last two years and the time involved in the settlement of those appeals is normally too long for the taxpayers as their cost of doing business in creases with those delays (Ahmed, n.d.).

The garment has adopted some measures to improve the admin of issues relating to the imposition of the value added tax. At first, the government has reduced a large range of thresholds and settled on a few. This has made the connection and calculation of taxes easy for both the government and the taxpayers. Secondly, the comment is trying to completely automate the registration process to reduce the documentation involved in registration and

refunds. This automation is also expected to uncover the unrecognized and undocumented intermediate manufacturers and processors. Thirdly, in order to reduce the corruption in the taxation department, the comment has centralized the registration process at the Central Board of Review, Islamabad. Fourthly, an automated risk-based registration module has been put in practice to overcome the registration problems and broaden the tax base. The government has simplified and minimized the process and requirements of documentation which has resulted in reduced delay in the process (Ahmed, n.d.).

#### **4. The fears relating to the implementation**

The introduction of VAT in Pakistan, with effect from July 01, 2010, stems out of its commitment with free trade agreements to replace customs duties with value added tax (Bloomberg, 2008). Despite the fact that Pakistan has differing provincial economic endowments and tax paying capacities, the implementation of the taxes in Pakistan are supposed to reflect the colors of the top class of the country especially the politicians. Pakistan is already notorious for not implementing philanthropic tax policies and the nation is notorious for tax aversion, thus the new plans for the imposition of VAT call for insights into the historical, social and economic facets for success in the implementation (Masood, 2010).

Historically Pakistan has been using the sales tax method to collect its revenues from the customers whereby most of the burden of taxes fell on the ultimate buyer. As a result, the sales tax is often found to be correlated with inflation through increased consumer price index, which is ultimately reflected in the nominal GDP of the country. On the contrary, the imposition of VAT is expected to resolve this issue. Thus, the experiments in other countries promise that a switch to the VAT from the sales tax will lead to consumption led growth of the economy. Nonetheless, in some countries like France, EU and Singapore have

also successfully experimented by reforming the sales tax using improved and more scientific method of value addition instead (Masood, 2010).

Referring to the imposition of VAT in Pakistan, Masood (2010) has suggested that the endemically corrupt political culture and fiscal manipulation will have drastic implications on the imposition of VAT. He argues that in the presence of the current political and economic setup, the value added tax will become more regressive in nature and thus will result into hyperinflation. This will expand the pockets of poverty in the country as the CPI will become prohibitive. Thus, he has suggested that the imposition of VAT in Pakistan should only be used to broaden the tax base and raise the taxes. He has also indicated the need for reforms in the Central Bureau of Revenue to properly implement perfect VAT model in terms of technical expertise, organizational reforms, IT programming and an effective methodology.

### **5. The strengths and weaknesses of the administration of VAT in Pakistan**

Economic theory has outlined some criteria of good taxation called the canons of taxation (Anderton, 2004). These criteria suggest that a good tax is not heavy as to negatively affect production (George, 2009). When we consider the literature on the imposition of VAT in Pakistan, it is obvious that government has focused on the increase in the revenues and not on the effects on the production in the country. Moreover, there is no indication as to whether the government has paid any heed to the social implications of the taxes.

The canons of taxations further suggest that taxes should be easy and cheap to collect and the cost in the collection should be recovered from the ultimate tax payer. If the cost is high and the taxes do not include them, the tax loses its effectiveness (George, 2009). Besides this, good tax is easily measureable and certain. In addition to this, the amount, time and place of the tax payments must be confirmed and known to the tax payers and the methods of payments

must be simple to understand (Anderton, 2004). The case of Pakistan in this sense is positive. The cost to the tax payer is reduced in terms of documentation and payment by the government. Moreover, the amount of tax payable is easily measureable, known to the payers.

Thacker (2009) and Mikesell (2007) have argued that considering the experiences in different parts of the world, the success of VAT depends on the implantation policies and practices. Therefore, the implications of Value added taxes require reforms and improvements in the policies, organizational structures and resources as well as reforms in the administrative setups (DCCI, 2008; Yesegat, 2008). According to Jantscher (1990) collection of a good value added tax collection comprises several administrative and institutional requirements including the identification and registration of the taxpayers, invoicing, filing and payment requirements, control of filing and payments, refunds, audits and penalties. We have seen that the administrative aspects of the implementation of VAT in Pakistan are in fact commendable.

In addition, Bird and Gendron (2005) and Jantscher (1990) have suggested that before the VAT is imposed there is a dire need to understand the effects of the imposition of the VAT on the production processes, the implication related to equity (the ability to pay principle), the treatments of items like food and capital goods and the identification and registration of the taxpayers. Considering the socio-economic context of the poverty stricken countrymen, it is highly possible that the current imposition of VAT will result in criminal aversion of taxes. The welfare loss of the imposition of VAT is not measured rather not even considered in the implementation of VAT by replacing the sales tax. Furthermore, the government has mainly focused on the revenues and altogether ignored as to what will be effect of VAT on the production sector in the country.

Thus, the overall picture reflects that the government has focused more on the economic aspects of VAT in Pakistan and has altogether ignored the social side. The government has in fact tried to increase the overall rise in the revenues rather than the rise in the burden on the taxpayers. Thus it is concluded that the implementation of VAT in Pakistan is more positive in economic terminology rather than benevolent or normative. Thus, the implantation of VAT is undoubtedly an economic success in Pakistan.

## **6. Conclusions**

The value-added taxes are important multistage tools that are associated with successful implementation and rise in the revenues for governments. The value added taxation is supposed to be superior to the sales taxes when it comes to trade among countries. Nonetheless, the experiences of different countries show that the success of VAT rests on the administration of the taxation in the economy as well the economic and social disposition. In fact, the principles of canons of taxation are of extreme relevance to the success of VAT-especially as a replacement of sales tax.

Pakistan has replaced the old sales tax with the value added tax and has had a mixed experience though relatively successful. It goes without saying that the country is still undergoing a reform phase to fully exploit the benefits of the VAT. Nonetheless, the efforts in successful implementation of the government are commendable. The government has been trying not only to collect maximum revenues but also positively adjusting the costs to the taxpayers as well as collection.

Despite the relevant success of the VAT in Pakistan, there are certain fears that are felt within the economic scenario of the country. It is expected that the political interests will dominate the public good in the implementation of the VAT. Moreover, it is also expected that this replacement will result in increased

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tax burden on the taxpayers that are already suffering from the omens of inflation, unemployment, terrorism, corruption in the government offices as so on. Furthermore, it is also expected that the new taxes will discourage the manufacturing sector of the economy but promote that retail. It is thus definite that the government of Pakistan has focused more on economic gains rather than the social issues and problem in order to implement the value added tax in Pakistan.

In short the experience of VAT in Pakistan is positive; the government, nonetheless, has several economic as well as social aspects relating to the implementation of the taxes in Pakistan.

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