Tax Income, Not Transactions

Toward a Simpler and More Neutral Income Tax System

Mazhar Waseem (Manchester, IFS & CEPR)

Reforms for a Modern and Growth-Friendly Tax System in Pakistan
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Neutral and Simple Tax System

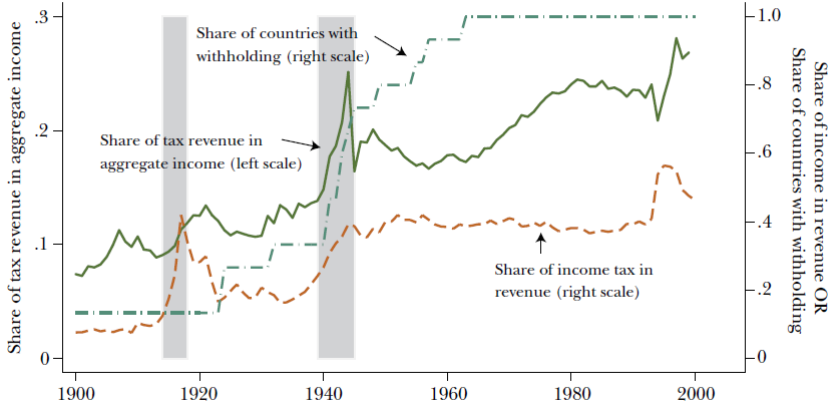
- A neutral tax system does not distort firms and individuals decisions about what to produce, how to produce, how to earn, how to spend....
- A simple tax system has a broad base, few tax rates, few (no?) special provisions, and treats all incomes similarly
- Pakistani tax system is anything but...
  - $>$ 150 "withholding lines"
  - $>$ 50 minimum tax rates
  - Multiple levies (super tax, surcharge, advance tax...)
  - Part of the tax code that lists tax rates is more than 65 pages long!

Withholding Built the Modern Income Tax

- Withholding is not a tax but a collection technology
  - One of the most important innovations in the tax collection technology to date
  - Between 65–90% of the income tax revenue in OECD countries is collected through withholding
- It is so useful because it combines third-party reporting with collection at source
- Classical withholding: deducted tax adjustable against final tax liability + excess deduction automatically refunded
  - Changes only the timing of the tax payment and not tax liability $\rightarrow$ non-distortive other than through small liquidity effects

Withholding Built the Modern Income Tax

Evolution of Tax Revenue, Income Tax, and Tax Withholding in a Sample of 18 Countries

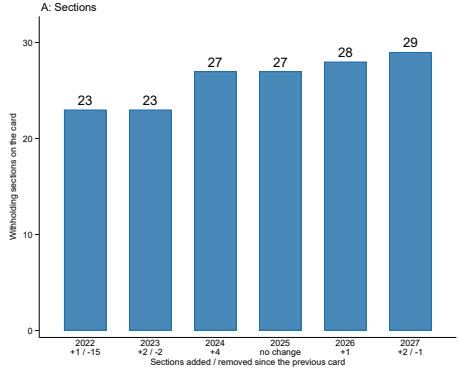


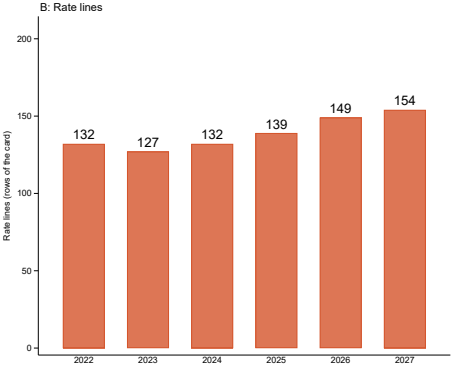
Besley & Persson (2014), *Journal of Economic Perspectives* 28(4)

Why Withholding has a Bad Name in Pakistan

- Withheld amount treated as final tax → presumptive tax
- Withheld amount treated as minimum liability → minimum tax
- Non-adjustable withheld tax on turnover → turnover tax that cascades along the supply chain
- Refund of excess withheld amount is not automatic and very costly → unfair, state has no right to keep amounts not charged as tax
- Only 11 of the 29 "withholding" sections are withholding in the classical sense: 8 are presumptive and 10 mixed

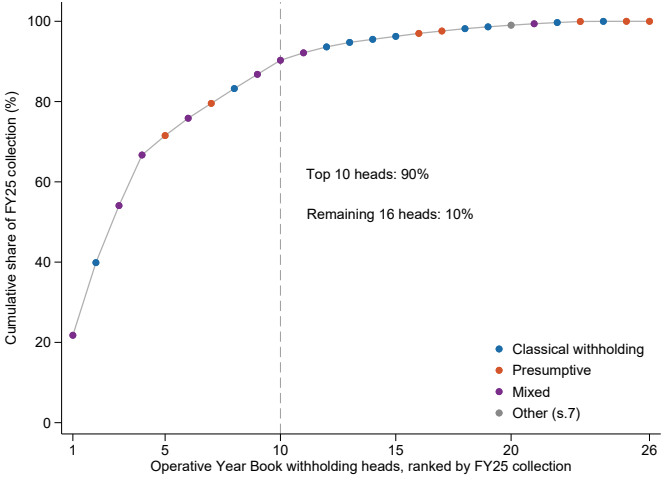
Withholding Score Card





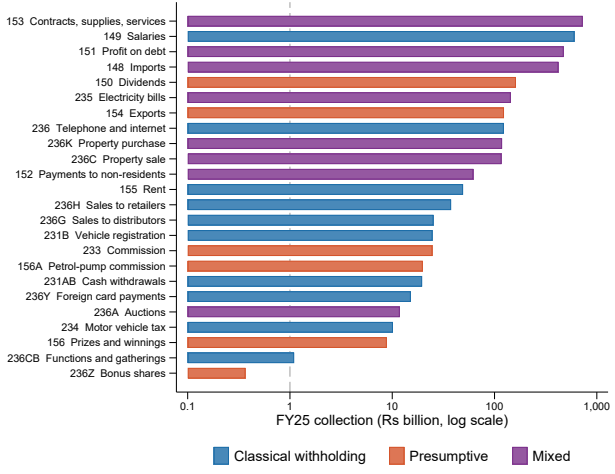
Source: FBR withholding tax rate cards, TY2022-TY2027; author's calculations.

Withholding Revenue by Heads (FY25)



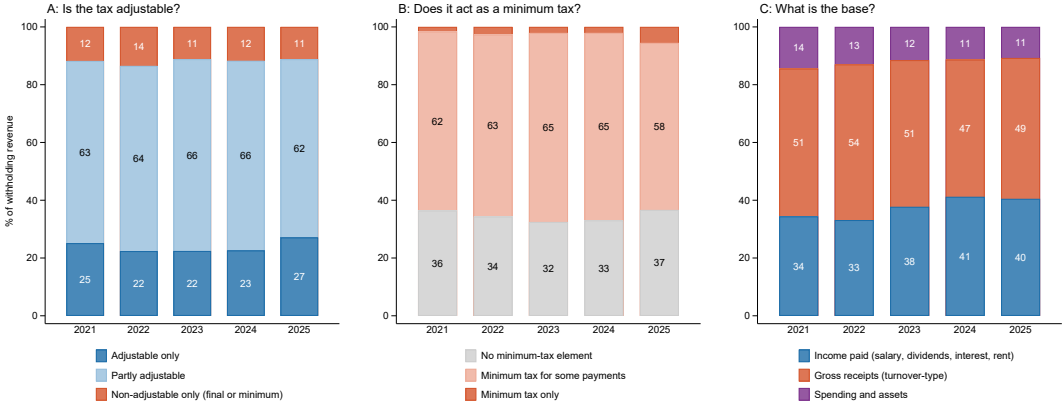
Source: FBR Year Book 2024-25, Table 9; author's classification of the 29 operative sections.

Withholding Revenue by Heads (FY25)



Source: FBR Year Book 2024-25, Table 9; author's classification of the 29 operative sections.

Withholding Revenue by Categories

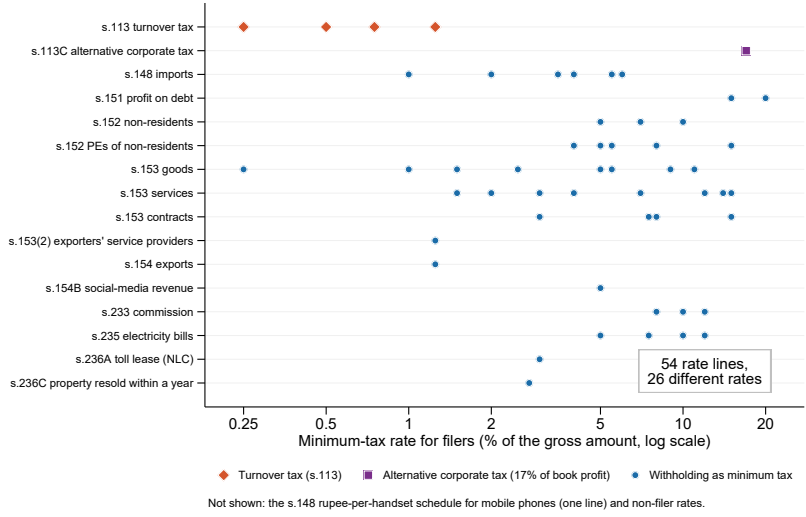


Revenue of the FBR Year Book withholding heads (Table 9), fiscal year = tax year, assigned to the category of the section in that year. Arrears under sections no longer on the card (0.1-1.1%) are in the top segments.
Source: FBR Year Book 2024-25 and earlier; FBR withholding tax rate cards; Income Tax Ordinance 2001; author's classification.

Minimum Taxes Work But Tax Turnover

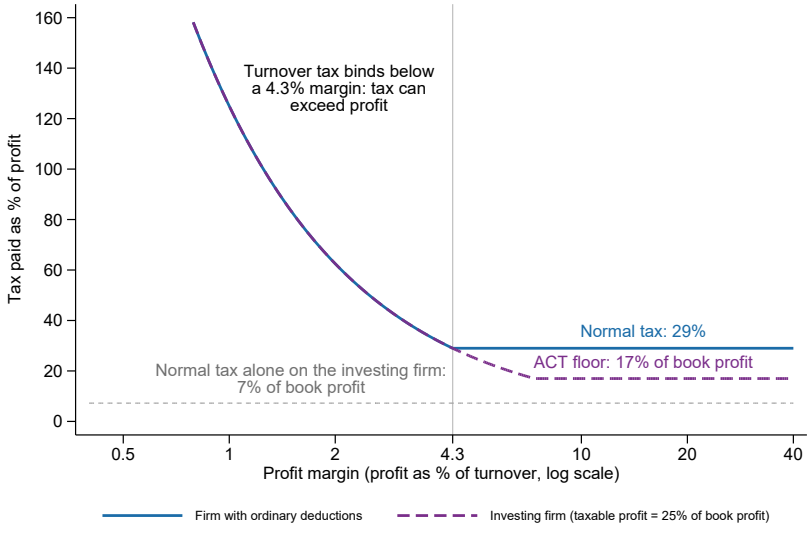
- Minimum taxes are revenue efficient but distortionary
- They have a place in the optimal instrument mix of an economy like Pakistan with limited tax capacity (Best et al., 2015)
  - In 2025, 45% of companies reported a loss; one in five report losses for three consecutive years; one in nine for five consecutive years
- Minimum taxes act as a backstop against egregious tax evasion but add to the complexity of the tax system
  - Pakistan has four different rates of minimum tax, an alternative corporate tax (17% of book profit), and 49 withholding lines that act as minimum taxes

Minimum Taxes: 54 Rates on Gross Amounts



Not shown: the s.148 rupee-per-handset schedule for mobile phones (one line) and non-filer rates.

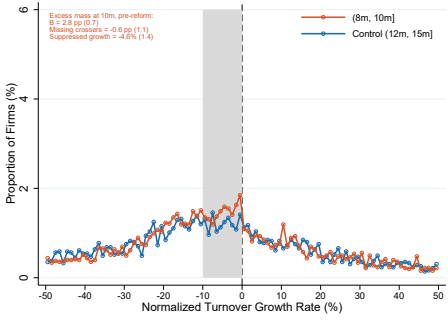
The Corporate Tax Jumble: Three Instruments, Three Bases



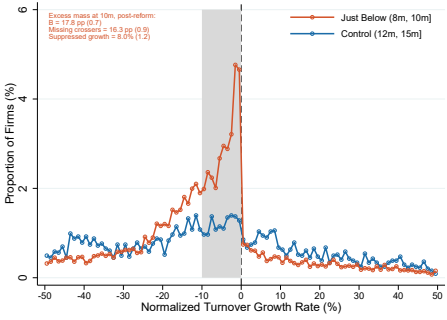
Illustrative. Tax = max(29% of taxable profit, 1.25% of turnover, 17% of accounting profit).
Investing firm: allowances cut taxable profit to 25% of book profit (assumed), so 29% x 25% = 7.25%.

Distortions Are Not Just Theoretical Curiosity

Before 2016: no threshold at Rs10m



After 2016: threshold at Rs10m



- Firms grow 10–13 percentage points slower because of the VAT exemption threshold

Source: Bashir et al., (2026)

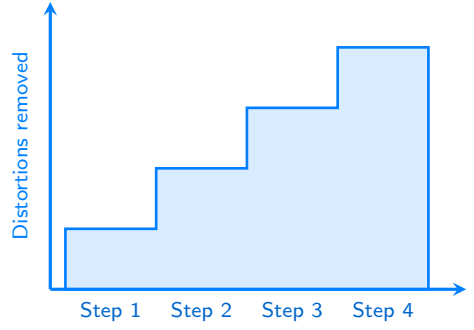
The Income Tax We Should Aim For

1. **One schedule for personal income**
   Salaried, business and partnership income taxed alike; thresholds indexed to inflation
2. **One corporate rate, heading to 25%**
   Super tax and the alternative corporate tax repealed
3. **Withholding only on income**
   Every rupee credited against the final bill
4. **Minimum tax as a backstop**
   A low, creditable floor that is carried forward, not a parallel tax
5. **No permanent special regimes**
   Presumptive schemes time-limited; every concession costed and sunset

- Revenue-neutral in the short run, revenue-positive as the base broadens

A Staircase to Reform

- We know what the ideal tax system looks like; the question is how to reach it in a fiscally responsible way
- Second-best instruments are **distortionary but revenue-efficient**, so they cannot all be removed at once
- **A staircase:**
  - Invest in enforcement capacity: track and trace, e-invoicing, risk-based audits, third-party data
  - With every **measurable** improvement, remove some distortions
  - Each step fiscally neutral or positive



Rule: no step without a published indicator that has been met