



Pakistan's Tax Paradox

Special Report – February 2026



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Note from the Chamber

OICCI is pleased to share this comprehensive document, which outlines key challenges within Pakistan's taxation framework, examines the underlying reasons behind past reform efforts that did not achieve their intended outcomes, and distills critical learnings from those experiences. The report also presents a clear, sequenced roadmap for reform, aimed at supporting the Government of Pakistan in building a more transparent, predictable, and growth-oriented tax system. We hope this serves as a constructive contribution towards enabling sustainable economic development and strengthening investor confidence.



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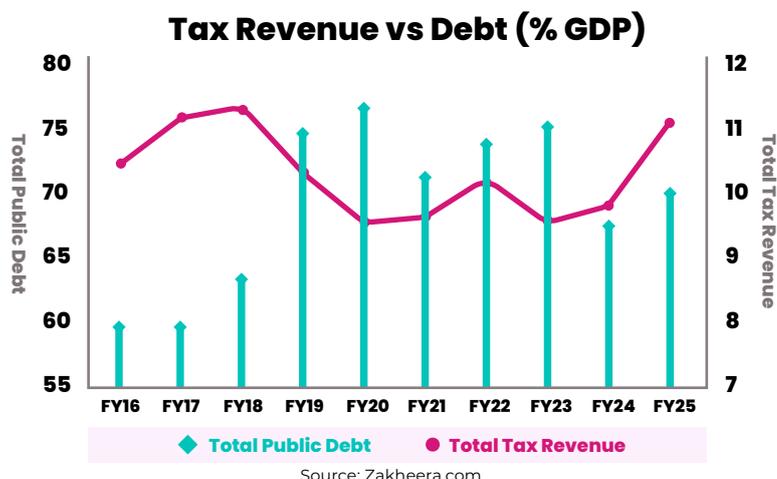
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CORE DIAGNOSTIC

Why Pakistan's Tax System Fails

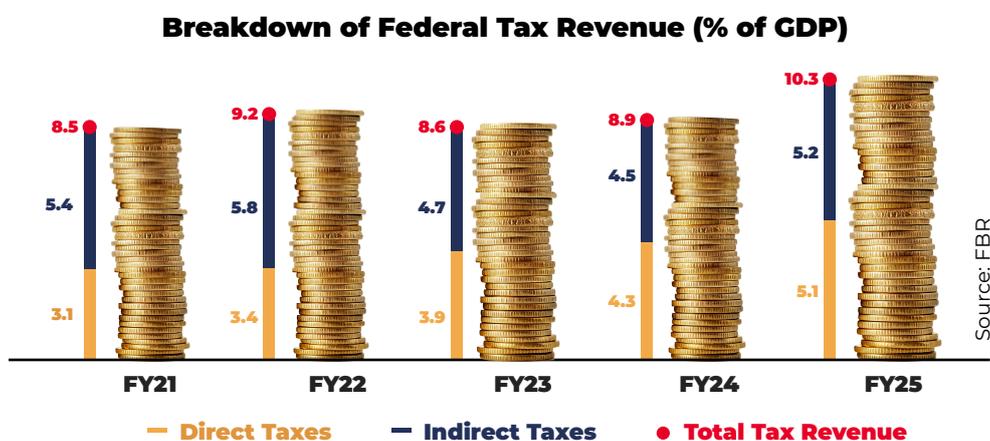
Pakistan’s tax system is characterised by a narrow tax base and high tax rates, with tax revenues remaining largely stagnant as a share of GDP despite growth in absolute collections. Despite various reform efforts, the system remains inequitable and inefficient with deep structural deficiencies, a massive gap between actual collections and economic potential, and heavily reliant on a narrow segment of the population while exempting powerful sectors.



1. Revenue Gap and International Benchmarks

Pakistan faces a persistent and widening gap between its actual tax revenue and its tax capacity. The country’s tax system continues to rely on a narrow base, making revenues volatile and extremely sensitive to economic slowdowns or policy reversals. Even at current levels, tax collection falls well short of what is required to ensure durable fiscal stability and reduce repeated reliance on borrowing.

Historically, Pakistan’s tax-to-GDP ratio has stagnated between 9 percent and 10 percent for over a decade. While tax reforms over the years have shown some improvement with the tax-to-GDP ratio moving into double digits (10.3% in FY25), it remains below the global threshold. The World Bank and IMF establish that a tax-to-GDP ratio exceeding 15 percent is essential for sustainable economic growth, poverty reduction, and the provision of basic public services. OECD countries raise taxes equivalent to 34 percent of GDP, and the Asia-Pacific average is 19.3 percent.¹ Pakistan lags behind India (17%) and Bangladesh (12%) in revenue generation relative to economic size.²



¹PIDE Discourse 2025: Pakistan’s Tax System: Advancements, Challenges and Trillion Dollar Future
²PIDE Discourse 2025: Tax Reforms in Pakistan: Progress Made, Pitfalls Ahead, and the Road Forward

The World Bank and IMF estimate Pakistan's tax capacity at 22.3% of GDP, suggesting that the country is currently capturing only about half of its possible revenue.³ In 2024, Pakistan faced a total tax gap at Rs 3.4 trillion (~3.9% of GDP).⁴

International best practice shows that administrative capacity (people, audits, processing speed, and automation) is often the biggest driver of sustained revenue gains—more than frequent policy tinkering. On these benchmarks, Pakistan is severely underpowered: it has 0.4 tax officials per 1,000 taxpayers vs. the 5.0 benchmark, audits only 0.3% of taxpayers vs. a 5% norm (India 3.1%, Bangladesh 2.4%), takes 240 days per assessment (India 45, Bangladesh 60), and automates just 32% of processing (India 89%, Bangladesh 76%).⁵

2. Structural Pathologies

Pakistan's tax system is characterised by three interlinked structural weaknesses that systematically undermine revenue mobilisation and equity:

- First, an extremely narrow direct tax base: Less than 1 percent of the population (approximately 0.57% in 2023) files income tax returns.⁶ And around 90 percent of tax revenue is collected from sectors that contribute only 25 percent to the GDP, primarily manufacturing and large-scale industries.⁷
- Second, Pakistan's tax structure is highly regressive and skewed toward indirect taxation. More than 60 percent of total tax revenue comes from indirect taxes—primarily sales tax, along with customs duties and federal excise duties—while direct taxation remains limited due to a narrow and concentrated taxpayer base. A handful of sectors, including banking, telecom, oil and gas, cement, and imports, account for a disproportionate share of direct tax collections.
- Third, the transformation of withholding taxes into quasi-indirect taxes: major structural weakness is the excessive reliance on withholding and advance taxes, which have effectively transformed direct taxes into quasi-indirect levies. Around 70–80 percent of direct tax revenue is collected through withholding mechanisms on banking, utilities, and telecom transactions.⁸ This "presumptive" regime turns businesses into unpaid tax collection agencies and effectively converts direct taxes into indirect costs, much of which is neither refunded nor adjusted.

This structure has also created an imbalance in the overall tax mix. Sales taxes, federal excise duties, customs duties, and cascading withholding taxes dominate collections, contributing to regressivity and price distortions across the economy. These features raise the cost of doing business, pass a disproportionate burden onto consumers, and strengthen incentives for firms and individuals to remain informal rather than enter the documented economy.

³State Bank of Pakistan Annual Report 2023-2024

⁴IMF Technical Report - PAKISTAN (Governance and Corruption Diagnostic Assessment NOV-25

⁵ibid

⁶Karandaaz - The State of Business Taxation in Pakistan - Challenges for SMEs

⁷ibid

⁸Karandaaz - The State of Business Taxation in Pakistan - Challenges for SMEs 2023

3. Political Economy and Sectoral Distortions

Pakistan's tax burden is unevenly distributed across sectors, reflecting deep political economy distortions and elite capture. Documented sectors—particularly industry and the corporate sector—bear a disproportionate share of the tax burden, while large segments of the economy remain lightly taxed or untaxed.

Industry is heavily taxed because it is easier to monitor through formal channels such as banking, imports, and utilities. The corporate sector's effective tax rate becomes even higher with additional levy of Super Tax, WPPF and WWF, approaching, and in some cases, crossing over 50 percent, due to specialized tax regimes discouraging corporatisation and incentivising firms to remain small and informal.

In contrast, agriculture, which contributes around 24 percent of GDP, generates only about 0.1 percent of tax revenue due to high exemption thresholds and weak provincial enforcement.⁹ Over 90 percent of farmers are untaxed due to high exemption thresholds, reflecting elite capture and weak provincial enforcement. Influential landowners resist meaningful taxation, while fragmented provincial administration and weak enforcement undermine collection.

Real estate sector operates as a "parallel economy" and "tax haven," due to valuation challenges and benefits from extensive tax exemptions, significantly undermining the country's revenue mobilization efforts, contributing just 0.3 percent of taxes despite representing 7 percent of GDP.¹⁰

Retail, accounting for roughly 18 percent of GDP, contributes only about 1 percent of tax revenue.¹¹ The influx of untaxed goods, from imports, manufactured in non-tariff areas, counterfeit & infringed and untaxed goods manufactured in tariff areas. Enforcement is also a key failure, as large wholesale markets in major cities remain undocumented being political capital of the successive governments. Moreover, the weak enforcement has been restricted to Karachi, Lahore and Islamabad only.

The unrealistic assessment of economic activities resulted in tax exemptions and preferential treatments further entrench these distortions. In FY24, exemptions and concessions cost the state Rs 2.4 trillion (2.32 percent of GDP), disproportionately benefiting powerful groups including large traders, high-net-worth individuals, and politically connected sectors.¹²

These patterns reveal that Pakistan's tax system is not merely inefficient but politically skewed: the state taxes what it can see, not what it should tax.

4. Regulatory Inefficiencies, Incompetencies and informality

Regulatory inefficiencies remain a central driver of informality in Pakistan's economy, with the Federal Board of Revenue (FBR) frequently criticized for weak enforcement and limited administrative capacity. Audit coverage is

⁹CONUNDRUM OF PAKISTAN'S TAX SECTOR: REINVIGORATING THE ECONOMY THROUGH TAX REFORMS. (2025). ISSRA Papers, 17(1), 16-30.

¹⁰PIDE - Tax Reforms in Pakistan: Progress Made, Pitfalls Ahead, and the Road Forward.

¹¹CONUNDRUM OF PAKISTAN'S TAX SECTOR: REINVIGORATING THE ECONOMY THROUGH TAX REFORMS. (2025). ISSRA Papers, 17(1), 16-30.

¹²FBR Tax Expenditure Report 2025

negligible—around 0.3 percent—while staffing levels stand at just 0.4 tax officials per 1,000 taxpayers, far below the international benchmark of 5.0.¹³ This enforcement gap allows non-compliance to persist with minor risk, reinforcing incentives to remain outside the formal tax system. The capability and capacity of the tax machinery is also a key factor driving inefficiency in enforcement.

Policy unpredictability further undermines compliance. Frequent ad-hoc changes introduced through Statutory Regulatory Orders have increased complexity and uncertainty, with more than 160 SROs issued in 2024 alone.¹⁴ These interventions create opportunities for rent-seeking and erode confidence in the stability of tax policy.

Pakistan FBR Statutory Regulatory Orders (SROs)

Tax Type	2020	2021	2022	2023	2024
Income Tax	56	41	100	25	80
Sales Tax	33	43	23	14	20
Customs	53	63	95	80	65
Excises	2	3	3	3	3
Total	144	150	221	122	168

Source: FBR/IMF

Institutional fragmentation between federal and provincial authorities compounds these problems. The division of taxing powers—particularly for sales taxes—has produced overlapping regimes, cascading taxes, and high compliance costs for businesses operating across jurisdictions. Weak coordination and data-sharing enable tax arbitrage and fraudulent refund claims, while delayed refunds of OICCI members amounting to Rs96 billion undermine business liquidity and trust in tax administration. The lack of coordination between various division and functions results in double taxation e.g. taxation of services.

As a result, Pakistan's informal economy is estimated to account for nearly 59 percent of GDP¹⁵, highlighting how institutional failures have entrenched informality rather than reduced it. In essence, Pakistan's tax system is trapped in a low-capacity equilibrium: weak institutions produce low compliance, which in turn justifies reliance on distortionary taxes and short-term policy fixes.

¹³PIDE - Tax Reforms in Pakistan: Progress Made, Pitfalls Ahead, and the Road Forward.

¹⁴IMF Technical Report - PAKISTAN (Governance and Corruption Diagnostic Assessment NOV-25)

¹⁵An Appraisal of Pakistan's Informal Economy: Causes, Patterns, and Socioeconomic Footprints, Policy Brief - Islamabad Policy Research Institute (IPRI) 2025



WHY PAST REFORMS DID NOT DELIVER

Lessons from the Past

Pakistan's history of tax reform also highlights a cycle of short-lived successes followed by policy reversals, primarily due to weak political ownership and institutional resistance. Moreover, the policy reforms are made to achieve short term gains, which lack the capacity to sustain short term losses for longer term gains. Despite 24 IMF bailout programs, multitude Finance Acts, and multiple tax reforms, the system remains trapped in an inelastic structure with a stagnant tax-to-GDP ratio.

1. Failure of Donor-Driven and Externally Imposed Reforms

The donor recommended reforms are based on ensuring full and timely recovery of their debt and therefore, have repeatedly fallen short because they focused on administrative “quick fixes” instead of repairing deeper structural flaws. The Tax Administration Reform Project (TARP) is a case in point: despite significant spending, it did not translate into stronger revenue performance, and the tax-to-GDP ratio moved in the wrong direction from 9.4 percent to 8.8 percent between 2005 and 2011.¹⁶

Another recurring issue is weak domestic ownership—reforms are often seen as IMF or World Bank prescriptions rather than a nationally led agenda, which reduces commitment from political and economic elites who ultimately control implementation.

And even when reform packages deliver early momentum under IMF programmes, progress tends to reverse once political pressure rises and policy discipline weakens. The broader takeaway is clear: tax reform must be locally owned, structurally grounded, and designed to survive beyond short programme cycles.

2. Administrative Reform without Enforcement and Institutional Capacity

A central lesson from Pakistan's tax reform experience is that administrative restructuring, on its own, does not translate into stronger compliance or lower evasion. The transition from Large Taxpayer Units (LTUs) to Large Taxpayer Offices (LTOs) and weak enforcement has been illustrated by a PIDE study.¹⁷ While the LTU/MTU model, introduced to modernise large/medium taxpayer management, failed to significantly improve performance due to weak enforcement, unclear jurisdiction, and limited audit capacity, the subsequent shift to LTOs brought better institutional design and some gains in revenue collection without fundamentally altering taxpayer behaviour or reducing evasion.

This experience shows that organisational redesign can improve efficiency, but it cannot substitute for strong enforcement, stable leadership, and systemic reform. More broadly, repeated reform efforts have failed because tax administration remains vulnerable to political interference, limited capacity, and weak governance. Without institutional autonomy and professionalisation, administrative changes have produced only modest and short-lived improvements in tax compliance.¹⁸ Persistent capacity gaps, weak incentives, and entrenched corruption within tax administration have further constrained

¹⁶Ikramul Haq and Huzaima Bukhari, *Tax Reforms in Pakistan: Historic and Critical View* (Pakistan Institute of Development Economics, 2020)

¹⁷REFORMING TAX ADMINISTRATION: INSIGHTS FROM LARGE TAXPAYER UNITS (LTUS) IN PAKISTAN (Pakistan Institute of Development Economics)

¹⁸ibid

reform outcomes, highlighting the need for deep human resource and governance reforms.

The continuous challenge which is being faced by tax administration for many decades is lack of credibility. The performance evaluation of the workforce and the accountability to drive transparency in the administration is the least of the government's concern. Time and again, commitments made by the successive governments have not helped in restoring the confidence of the taxpayers towards tax collectors. An accountability framework to drive efficiency and transparency needs to be put in place through policy intervention rather than administrative intervention.

3. Institutional Confusion between Policy and Administration

Pakistan's reform experience shows that the concentration of tax policymaking and tax collection within the same institution has encouraged reactive, ad-hoc taxation driven by short-term fiscal pressures rather than economic analysis. The absence of an independent tax policy function has led to frequent, poorly designed tax measures with limited long-term impact. The lesson is that sustainable reform requires institutional separation between tax policy and tax administration through a dedicated tax policy framework. The recent decision to separate the Tax Policy Office from the FBR is a positive step forward; however, its true impact will ultimately depend on the effectiveness of its implementation over time.

4. Short-Term Revenue Obsession & Failure to Tax Large Sectors

Another central lesson from Pakistan's tax reform experience is that an excessive focus on short-term revenue targets has produced a distorted and regressive tax system that disproportionately burdens the formal sector. Rather than pursuing structural reform, policymakers have relied on incremental measures—such as tax rate increases and temporary revenue tools—that deliver immediate gains but weaken the long-term foundations of the tax system.

A key manifestation of this imbalance is the persistent failure to tax large sectors such as agriculture, retail, services and real estate, despite their significant contribution to GDP. This has narrowed the tax base and shifted the burden onto documented firms and salaried individuals, reinforcing inequity and informality. At the same time, the proliferation of exemptions and concessions has further hollowed out the tax base, while weak enforcement capacity, high compliance costs, and governance failures have undermined tax morale and encouraged non-compliance.

As a result, revenue extraction from existing taxpayers has replaced genuine base broadening, creating diminishing returns from higher tax rates and a shrinking pool of compliant taxpayers. These dynamics have entrenched a vicious cycle of high rates, low compliance, and persistent informality.

The broader lesson is that Pakistan's tax policy has prioritised revenue

extraction over economic expansion. Sustainable reform requires a decisive shift from a revenue-centric approach to a growth-centric tax framework that prioritises equity, simplicity, and documentation as core objectives of fiscal policy.

5. Policy Volatility and Poor Sequencing Undermine Tax Reform

Pakistan's tax reforms have been undermined by policy volatility and weak sequencing. Frequent reliance on mini-budgets and ad-hoc Statutory Regulatory Orders has created persistent uncertainty in the tax regime, weakening investor confidence and embedding an anti-growth bias in the policy framework.

At the same time, reforms have often been implemented without strengthening institutional and administrative capacity. Changes in tax instruments have preceded improvements in enforcement, documentation, and governance, limiting the effectiveness and sustainability of reform efforts.

As a result, tax reforms have delivered episodic revenue gains but failed to produce durable improvements in compliance, investment, or long-term revenue mobilisation.

6. Withholding as a Substitute for Tax Base Broadening

Over time, withholding tax (WHT) has expanded far beyond its original purpose as a supplementary collection mechanism and has become a central pillar of Pakistan's revenue system. However, despite its growing role, WHT has failed to broaden the tax base because the data generated through withholding agents is rarely used to identify and bring new taxpayers into the net.

Instead of strengthening documentation and enforcement, the state has relied on WHT as a convenient revenue tool. This has shifted the cost and risk of tax collection onto businesses through extensive reporting requirements, audits, and penalties. As a result, WHT has effectively evolved into a quasi-indirect tax on formal economic activity, discouraging business expansion, incentivising informality, and weakening efforts to expand the tax base.

7. Institutionalisation of Non-Compliance through the Non-Filer Regime

Pakistan's experience shows that the legal distinction between filers and non-filers has effectively legitimised non-compliance. By allowing individuals and firms to remain outside the tax system in exchange for higher withholding taxes, the state normalised evasion rather than enforcing universal compliance. The lesson is that sustainable reform requires replacing the filer–non-filer distinction with universal filing obligations.

8. Federal–Provincial Fragmentation and Compliance Burden

Pakistan's tax system is deeply fragmented across federal and provincial

jurisdictions, creating structural inefficiencies and heavy compliance costs for businesses. Following the 18th Constitutional Amendment, the federal government retained authority over taxation of goods, while provinces assumed responsibility for services, effectively creating multiple tax regimes within a single national economy. This division has resulted in overlapping rules, inconsistent procedures, and a complex compliance environment, particularly for firms operating across provinces.

Businesses are required to file multiple returns with different authorities under varying formats and timelines. While federal sales tax and withholding tax filings are mandatory at the national level, service providers operating nationwide must also submit separate monthly returns in each province. This multiplicity of filings significantly increases administrative burdens and raises the cost of formal compliance. At the same time, persistent trust deficits between federal and provincial governments have hindered meaningful integration of tax systems and data sharing.

The split between goods and services has also disrupted the Value Added Tax chain. Input taxes paid in one jurisdiction cannot be seamlessly credited in another, leading to cascading taxation, price distortions, and incentives for informality.¹⁹ Weak coordination between tax authorities further creates opportunities for tax arbitrage and fraudulent refund claims, undermining the integrity and efficiency of the tax framework.²⁰ Overall, this fragmentation reflects the absence of a coherent federal–provincial fiscal architecture, resulting in duplication, inconsistencies, and systemic inefficiencies.

Some progress toward harmonization has been made under IMF-supported reforms. The National Fiscal Pact seeks to rebalance federal–provincial responsibilities by devolving selected expenditures while strengthening provincial revenue efforts. Provinces have also moved to align Agricultural Income Tax regimes with federal income tax structures and agreed to shift GST on services from a positive list to a negative list, reducing exemptions and loopholes. Additionally, the launch of the Single Sales Tax Return for the telecom sector in 2024 marks a crucial step toward unified filing, with the potential to extend across sectors in the future. However, these initiatives remain partial and have yet to resolve the deeper structural fragmentation of Pakistan's tax system.

9. Taxation and Automation Complexity

Pakistan's tax system has become excessively complex, marked by multiple tax slabs, special credits, and fragmented indirect tax regimes. This structural complexity has distorted economic incentives and made compliance costly, undermining both enforcement and the effectiveness of digital reforms. Rather than simplifying compliance, digitisation has often transferred existing complexity into digital platforms, increasing procedural burdens instead of reducing them.

When fragmented rules and overlapping jurisdictions are automated without

¹⁹Karandaaz – The State of Business Taxation in Pakistan – Challenges for SMEs 2023

²⁰World Bank – Strengthening Government Revenues – Towards an Equitable, Efficient and Sustainable Tax System (Discussion Note 6)

prior simplification, digital systems multiply filings, procedures, and reporting requirements, turning technology into a source of friction rather than facilitation. This dynamic is particularly evident in the service sector, where firms operating across provinces must file multiple returns with both federal and provincial authorities, resulting in an excessive and costly compliance burden despite the availability of digital systems.

The core lesson is that digitisation cannot substitute for structural reform. Automation must be accompanied by regulatory simplification and process rationalisation; otherwise, digitalisation merely mechanises inefficiency and deepens mistrust between taxpayers and the state.



STRUCTURAL CONSTRAINTS

in the Current System

1. Digital Progress, Structural Constraints in Tax Administration

Though Pakistan started its automation journey quite early when compared with other emerging markets as well as with developed markets, we failed to exploit the available data to broaden our tax base. The FBR failed to do well coordinated assessment of taxpayers through digitisation. The data collected through Broadening of Tax Base (BTB), retail tax directorate etc, was not utilised due to lack of seriousness or political will. Pakistan has made measurable progress in digitalising its tax administration, though these advancements are often described as superficial or isolated successes that have yet to resolve deep structural pathologies. Measures that have facilitated the country's digitalising efforts for tax administration include:

The Federal Board of Revenue (FBR) has transitioned to IRIS 2.0, a web-based system that manages income and sales tax declarations, refund applications, and notices. The "Tax Asaan" mobile application was launched in FY24 to facilitate taxpayer engagement, contributing to a 65% reduction in filing times and an 83% reduction in refund processing times.²¹

To curtail evasion, the government implemented Track-and-Trace systems in high-risk sectors such as tobacco, sugar, cement, and beverages. Furthermore, the integration of Point of Sale (POS) terminals has reached 38% of Tier-1 retailers in 2025 with the government aiming to cover all 40,000 installations over the next two years.²²

The Pakistan Single Window (PSW) has successfully integrated over 20 core government departments and regulatory authorities, alongside 29 commercial banks as of mid 2025.²³ The platform connects these agencies to provide a single-entry point for importing, exporting, and transit trade, with plans to expand connectivity to 77 total departments in its final phase.

FBR in collaboration with Provincial Tax Administrations has launched Single Sales Tax Portal to allow businesses to file returns across multiple jurisdictions through a unified interface, starting with the telecom sector.²⁴

The regulator also developed a machine-learning-based Compliance Risk Management (CRM) risk engine to detect anomalies in taxpayer profiles, which has helped create substantial tax demands from risky cases.²⁵

However, as reflected in the FBR's own Annual Performance Report FY2023–24, Pakistan's automation and digitalisation drive faces several deep structural challenges despite significant investments in technology as well as concrete results yielded particularly from IRIS electronic filing system and sector-specific track-and-trace mechanisms. While major tax processes have been digitised, automation remains uneven across critical functions such as audits, enforcement, registration, and intelligence, where reliance on manual intervention persists. The report also highlights fragmented digital systems that do not fully integrate or "talk" to each other, limiting the administration's ability to effectively analyse data, detect underreporting, and identify tax evasion. Moreover, the implementation of cross-jurisdictional digital

²¹Annual Performance Report 2023–24– FBR

²²International Monetary Fund. Middle East and Central Asia Dept. "Pakistan: Second Review Under the Extended Arrangement Under the Extended Fund Facility, First Review Under the Resilience and Sustainability Facility, Request for a Waiver of Nonobservance of a Performance Criterion, and Modification of Performance Criteria–Press Release; Staff Report; and Statement by the Executive Director for Pakistan", IMF Staff Country Reports 2025, 332 (2025), accessed 1/25/2026, <https://doi.org/10.5089/9798229032353.002>

²³<https://www.psw.gov.pk/knowledge-base/pakistan-single-win-dow-transforming-trade-facilitation-pakistan#:~:text=Since%20its%20inception%2C%20PSW%20has,promoting%20gender%20equality%20in%20trade.>

²⁴Annual Performance Report 2023–24– FBR

²⁵ibid

platforms—such as the single sales tax return portal—has been constrained by coordination gaps between federal and provincial authorities.

Equally important is the fact that digitalisation has not translated into meaningful expansion of documentation: large segments of the economy remain outside the tax net despite POS systems and digital invoicing initiatives. It seems that automation has often added a layer to existing complexity rather than simplifying compliance, leaving businesses—particularly those operating across provinces—facing multiple filings and high compliance costs even within digital systems.

The lack of integrated data across government agencies and incomplete digitisation of supply chains continue to undermine the effectiveness of digital reforms. Together, these challenges reveal that Pakistan’s problem is not the absence of technology, but the absence of systemic integration, simplification, and institutional capacity to fully leverage digital tools for compliance and enforcement.

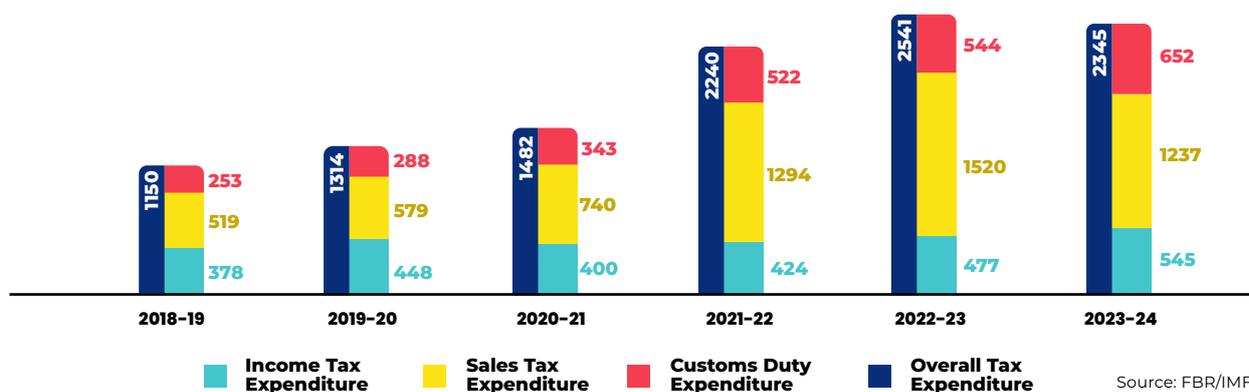
2. Pakistan’s Tax Expenditure Regime: Scale, Structure, and Risks

Tax expenditures—defined as revenue foregone through exemptions, reduced rates, tax credits, deductions, deferrals, and preferential treatments—constitute a significant but uneven component of Pakistan’s fiscal architecture. In FY24, federal tax expenditure is estimated at Rs. 2.4 trillion, equivalent to 2.32 percent of GDP and 26.2 percent of FBR’s total tax collection. In practical terms, more than one-quarter of potential federal tax revenue is forgone through explicit policy choices embedded in the tax code.

a. Structural Composition: Bias toward Indirect Tax Incentives

Pakistan’s tax expenditure regime is structurally skewed toward indirect taxes. Sales tax accounted for 50.8 percent of total tax expenditure in FY24, followed by customs duties (26.8 percent) and income tax (22.4 percent).²⁶ This composition reflects a policy bias in which incentives are disproportionately embedded in consumption and trade taxes rather than in direct income taxation.

Pakistan Annual Trend of Tax Expenditure Estimates - Rs(bn)



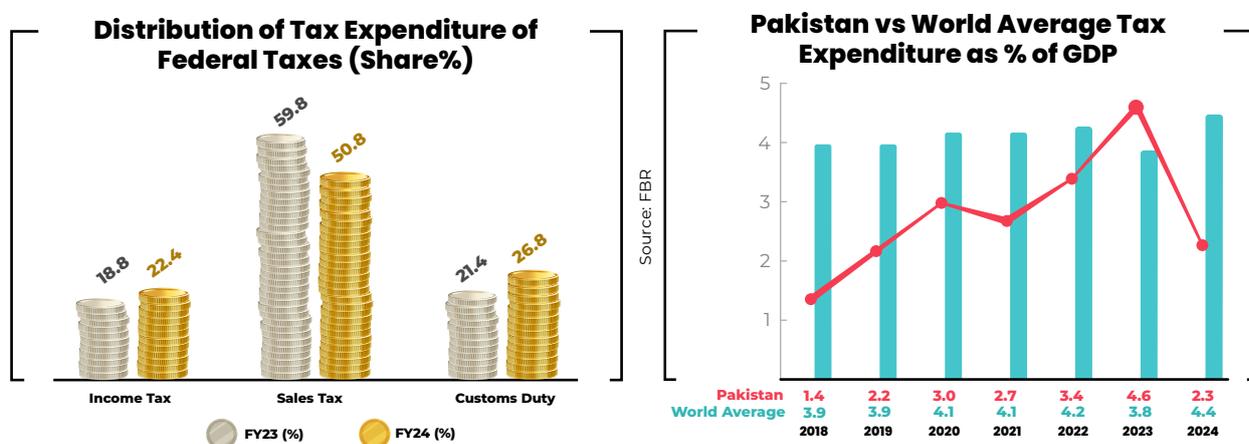
²⁶Tax Expenditure Report 2025 – FBR

This structure has important implications. By concentrating incentives in indirect taxes, Pakistan effectively subsidises consumption and specific sectors rather than productivity, investment, or formalisation. It also weakens the integrity of the value-added tax (VAT) system, creating cascading effects, distortions in relative prices, and opportunities for rent-seeking.

b. Trends and International Comparison: A Misleading Decline

Over time, Pakistan’s tax expenditure has shown volatility rather than a clear trajectory of rationalisation. While tax expenditure declined from over 4.5 percent of GDP in FY23 to 2.32 percent in FY24, this reduction reflects episodic policy adjustments and accounting changes rather than a systematic reform of exemptions. Over the past 15 years, Pakistan’s tax expenditure has averaged around 2.1 percent of GDP—significantly below the global average of approximately 4.0 percent and the OECD average of 4.9 percent.²⁷

This comparative evidence highlights a critical paradox. Unlike many economies where excessive tax expenditures are a primary cause of weak revenue mobilisation, Pakistan exhibits a relatively moderate level of tax expenditure alongside an exceptionally low tax-to-GDP ratio. This suggests that Pakistan’s fiscal weakness is not driven solely by exemptions, but by deeper structural constraints, including a narrow tax base, widespread informality, weak compliance, and limited enforcement capacity.



c. Political Economy of Exemptions: Concentrated Benefits

Tax expenditures in Pakistan are highly concentrated across sectors. Income tax concessions primarily benefit energy and mining, financial services, education, and information technology. Sales tax exemptions disproportionately favour fertiliser and agriculture, health and pharmaceuticals, food, manufacturing, and energy.

This pattern reflects the political economy of tax policy, where exemptions are shaped less by systematic cost-benefit analysis and more by social

²⁷ibid

sensitivities, lobbying pressures, and strategic sector narratives. The frequent use of Statutory Regulatory Orders (SROs) to introduce sector-specific concessions has institutionalised discretion in tax policymaking, undermining transparency, predictability, and policy coherence.

d. Systemic Risks: Distortion, Inequity, and Governance Failures

Hence, the country's tax expenditure regime generates multiple systemic risks:

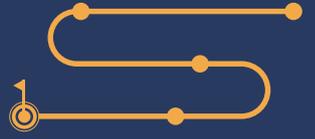
- **Economic distortion:** Selective incentives distort resource allocation, weaken VAT integrity, and encourage tax arbitrage rather than productive investment. Import is a major revenue spinner, however, lack of export is creating an imbalance, which are managed through slipshod measures to create artificial balance.
- **Equity concerns:** Benefits accrue disproportionately to privileged sectors and politically influential groups, while the formal economy and salaried classes bear a higher effective tax burden.
- **Fiscal fragility:** Persistent revenue leakages constrain fiscal space, increasing reliance on indirect taxation and debt financing.
- **Governance risk:** The discretionary nature of exemptions—often introduced without rigorous evaluation—erodes institutional discipline and credibility in tax policy.

Critically, the coexistence of relatively modest tax expenditures (relative to other countries) with low revenue mobilisation underscores that Pakistan's tax problem is structural rather than purely policy driven. Exemptions amplify distortions, but they do not fully explain the weakness of the tax system.

e. IMF Reform Agenda: From Enumeration to Evaluation

The IMF has called for a fundamental reorientation of Pakistan's approach to tax expenditures. Under the current programme, Pakistan has committed to refrain from introducing new preferential tax treatments—including exemptions, zero-rating, tax credits, accelerated depreciation, and special rates—whether through legislation or SROs. Furthermore, the IMF has required the transformation of Pakistan's Tax Expenditure Report from a descriptive inventory into an analytical instrument capable of systematic cost-benefit evaluation.

The goal is to make tax policy more data-driven, remove costly and unjustified exemptions, and gradually fix a system dominated by selective privileges. This is not just about raising revenue, but about creating a fairer, more disciplined, and efficient tax system.



PROPOSED REFORMS

Roadmap for the Government of Pakistan

Tax is an outcome of the economic activity and therefore, formulating tax policy in isolation will not work. The better the engagement with other ministries and coordination with provincial governments, the more effective the tax policy would be. Pakistan's tax reform agenda must be guided by clear outcome targets and disciplined sequencing. The central objective is to raise the tax-to-GDP ratio on an equitable basis, from the current 10–12 percent range to around 13 percent in the short term and above 15 percent over the medium term—levels necessary to sustain growth, strengthen fiscal stability, and reduce reliance on debt.

Achieving this requires a fundamental shift in the tax mix: moving away from excessive dependence on quasi-indirect withholding and minimum taxes toward a system anchored in return-based direct taxation and a genuine value-added tax framework. Equally critical is restoring trust and reducing compliance costs through faster refunds, fewer discretionary policy changes, simplified filing requirements, and expanded automation supported by risk-based enforcement.

We need to carefully choose the manner of tax collection, higher tax rates or higher withholding tax rates. The simultaneous adoption of higher tax rates, higher withholding taxes and complex compliance is an incentive to evade tax. Withholding taxes should be used for documentation/broadening the tax base rather than as a revenue collection tool. The reform strategy must follow a clear sequencing logic: simplify the tax system first, then scale digitalisation, and only thereafter rationalise rates and remove distortions—recognising that digitising a complex and fragmented system merely mechanises inefficiency rather than resolving it.

Phase 0: To be done immediately - Political and Institutional Reset

- Immediately operationalize the Tax Policy Office (TPO) as a gatekeeper for all tax changes and effective separation of tax policy from FBR administration
- Freeze all preferential treatments including new exemptions/zero-rating/special regimes via SRO or law unless routed through TPO with published rationale.
- Remove arbitrary form of taxation to minimise incidence of refunds. Act on refunds clearance plan starting with refund heavy sectors.
- Consultative approach for levying and reviewing taxation regimes will ensure the true potential of the economic activities, its direct tax potential and effective value addition.
- Super tax should be eliminated (4B & 4C).
- Corporate tax should be reduced to 28% with a clear roadmap for reducing the same to 25%.
- Minimum taxation regime to be kept only for specified sector(s).

- Withholding taxes rates should be reduced to 5% maximum and used for documentation purposes only.
- Maximum slab of salary should be 25%.
- Clear roadmap for reducing the Sales Tax to 12%.

Phase 1: Year 1-2 – Simplification and Base Expansion

- Design and announce a 2–5-year tax simplification strategy with fewer rate schedules, minimal special regimes, reduced excessive withholding/advance taxes, exemption rationalization, etc.
- Also shift away from WHT focused regime to return-based taxation gradually especially where it functions as transaction taxes while retaining core WHT such as on salaries, interest/dividends.
- Strengthen FBR’s capacity through centralized, data-driven, and risk-based enforcement to target major tax evasion and standardise core processes. Shift focus from deepening to broadening enforcement and monitoring from current major taxpayers to major tax evading sectors.
- Rapidly broaden the tax base by ensuring VAT/GST registration for large retailers, wholesalers, and importers, expanding digital invoicing and track-and-trace systems, and linking compliance to audits and refunds with strong enforcement.
- Strengthen federal–provincial coordination by enforcing data sharing, taxing services by default with minimal exemptions, and implementing agreed harmonisation measures to reduce duplication and gaps in taxation.

Phase 2: Year 2-3 - Structural Rebalancing of Tax Mix

- Create an integrated VAT/GST system by expanding the single sales tax return across sectors and gradually moving toward a unified GST administration.
- Increase provincial revenues by focusing beyond Karachi, Lahore and Islamabad, linking land records to tax IDs, harmonising property valuations, and raising effective property tax levels.
- Broaden agricultural taxation by introducing advance taxation on agriculture output, adjustable against agriculture income, lowering exemptions, improving land classification, and using FBR data to enforce compliance and raise meaningful revenue.
- Once the tax base widens, reduce distortionary tax rates and phase out inefficient taxes to support investment and formalisation such a lower corporate tax and removal of some distortionary taxes (super/turnover/presumptive).

Phase 3: Year 3-5 - Enforcement, and Competitiveness

- End the filer–non-filer distinction by introducing universal filing obligations, whereby the tax return filed on the basis of withholding tax (WHT) also serves as the tax registration form; taxpayers may amend the return within 45 days, after which it shall be deemed correct. A clear definition of “non-filer” should be provided, limiting it to persons above 60 years of age whose only income is subject to full and final taxation through deduction of WHT or advance tax.
- Reform tax dispute resolution by strengthening dispute resolution and litigation processes to reduce uncertainty and improve tax collection.
- Shift customs from revenue extraction at the border to data-driven compliance and trade competitiveness by gradually reducing distortive import taxes including Regulatory Duty (RD), Additional Customs Duty (ACD), and Federal Excise Duty (FED), etc.

Vision: A Modern, Growth-Oriented Tax System

By the end of the reform cycle, Pakistan’s tax system should be anchored in a clear and independent tax policy function supported by stable, multi-year reforms rather than frequent ad-hoc tax changes. The system should move towards a broader tax base with lower rates, fewer exemptions and special regimes, reduced reliance on withholding taxes, and a stronger emphasis on return-based income taxation through effective enforcement and a genuine value-added tax framework.

Tax compliance should be digitally simplified through a single-window system across federal and provincial jurisdictions, ideally evolving towards a unified GST administration to reduce filing burdens and cascading taxes.

Digitalisation should be fully integrated and effective, with data sharing across FBR, provincial authorities, banks, land records, and the Pakistan Single Window, supported by automation of low-risk processes and large-scale risk-based enforcement.

Tax return filing must be simplified, not complicated. If broadening the tax net is truly the goal, simplification has to be the top priority, especially when even tax experts struggle with the current system. A simpler, user-friendly process is the only way to drive real compliance and bring more citizens into the formal economy.