INSTITUTE FOR POLICY REFORMS

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Single- Stage Sales Tax VS Value Added Tax

There is a strong view within FBR and among the policy makers in Islamabad in favor of reversion to a single-stage sales tax. The primary reasons are as follows:-

(i) The revenue losses due to excessive tax invoicing of inputs will be avoided;
(ii) In a fragmented sales tax system, with collection on goods by the Federal government and on services by the Provincial governments it is difficult to operate a national, integrated VAT;
(iii) Extension of the sales tax system to wholesalers and retailers has proved elusive, as demonstrated by the failure three year ago to move to the Reformed General Sales Tax (RGST). This became one of the principal reasons for disruption of the IMF program at the time.

In effect, reversion to a single-stage system is an admission of defect by FBR. The 1990 Sales Tax Act had placed Pakistan in the forefront of countries which were attempting to make a transition to the VAT. Since then the GST share in FBR revenues has increased from 15 % to over 43 % and today it is the largest tax. Currently, over 90 % of the countries are operating a VAT. As such, reversion to a single-stage sales tax will be seen as a very retrogressive step.

There are, in fact, two types of single-stage sales tax. The first is the type being contemplated by the FBR of essentially. Keeping the existing tax base unchanged and simply levying the tax on value of sales at the manufacturing stage. No input tax invoicing will be allowed. Consequently, the standard rate can be brought down to say, 50 %. This will certainly create the perception that the tax burden has been substantially reduced and that prices ought to fall.

But if revenues are not to fall then the new rate on value of sales rather than value added will have to be set at an appropriate level. This will have four consequences. First, the tax burden will fall on some industries and rise in others. The latter will, no doubt, agitate this change. For example, a 5 % tax rate on sales will raise the tax

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burden on the fertilizer industry, which currently enjoys tax invoicing of the large nature gas input.

Second, there will be 'cascading' of the tax. Since inputs are no longer tax invoice able, the tax paid on these inputs will tend to be transferred to the price. The effective rate will then no longer be 5 % but much higher in industries where the ratio of value of inputs to value of sales/production is high. Third, it will not be possible in this system to zero-rate exports, with the consequential impact on competitiveness of industry. Fourth, there will be no longer be the incentive for documentation of transaction s in the value chain. As such, tax evasion will rise.

The second type of single-stage sales tax is one which is levied only on consumer goods. This avoids the problem of cascading. In this system varying rates of the tax are applied on goods, depending on whether they are necessities or luxuries. For example, Egypt separates a consumption tax and the rates vary from Zero to 45 %. This system has the advantage of being able to achieve greater progressivity of the tax burden. If this system is introduced then there will be many goods which will have taxed at higher rates than the existing rate of 17 %, which is being applied on a larger tax base, including intermediate and capital goods. This will negate any perception of tax break.

On balance, the FBR is well advised to retain the present system, based largely on the principle of value added taxation. The introduction of the CREST software has already contributed to a reduction in excessive in put tax invoicing. An automatic refund policy should be introduced of, say 60% of the claim. Also, the large number of SROs, especially in the import GST, needs to be withdrawn. This will enable a significant reduction in the present rate of 17 % without leading to any loss of revenue.