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Taxing The Poor: Pakistan's Reliance on Indirect Taxes And Household Welfare

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Abstract

This study analyzes the welfare impacts and structural challenges of Pakistan's tax framework from FY2016–17 to FY2024–25. This study shows that nominal tax revenues tripled to Rs 11.7 trillion and the tax-to-GDP ratio stagnated around 10%. This force a heavy reliance on regressive indirect and hidden withholding taxes to bridge persistent budget deficits. The tac system disproportionately causes a burden on low- and middle-income households. The General Sales Tax (GST) alone driving a two-percentage-point increase in the national poverty rate. The paper highlights a critical fiscal trap: rising debt-servicing costs routinely breach statutory limits, crowding out development expenditures and leaving critical public services like health and clean water chronically underfunded. It shows that lower-income citizens face high out-of-pocket costs despite being net contributors to the national budget. Regional benchmarking shows Pakistan lags behind progressive peers like India, aligning closely with indirect-tax-dependent economies. The study proposes that Pakistan must implement structural reforms to increase the direct tax base.

Keywords: Indirect Taxation, Fiscal Trap, Household Welfare, Poverty Headcount, Commitment to Equity (CEQ), Withholding Tax

JEL: H22, H23, H62, O15, O53

1. Introduction

For decades, Pakistan's fiscal system has been locked in a recurring budget deficit that has been resolved by squeezing more revenue from those who already pay taxes, rather than by expanding the tax base. Instead of taking on the harder political challenge of taxing income, property, and agricultural profits, successive governments have found it administratively easier to increase the General Sales Tax (GST), broaden withholding levies, and increase their reliance on petroleum levy instruments that are easily collected but hit consumption and, consequently, the poor harder. The result is a tax system that is difficult to make equitable and easy to expand (Richter & Martínez-Vázquez, 2009).

In this study, a simple but critical question is raised: who is the real payer of Pakistan's tax structure, and what does the country get? It contends that Pakistan's reliance on indirect and withholding taxes is unjust and welfare-reducing because they are regressive and disproportionately impact low- and middle-income households negatively. This is compounded by the state's failure to provide basic services such as clean water, healthcare, and education that such taxes are designed to finance. Independent evidence supports this hypothesis. A World Bank study, Commitment to Equity (CEQ), found that Pakistan's combined tax-and-transfer system increased the national poverty headcount by approximately two percentage points, with the GST being the largest single factor contributing to this (Ahmed, 2018; Asad, 2025; Hussain et al., 2025)

The remainder of this paper is organised as follows. Section 2 is dedicated to the composition of federal tax collection, which shows the preeminence of indirect and withholding tax. Section 3 traces the welfare impact of this structure through the joint movement of inflation and poverty levels. Section 4 considers the other half of the fiscal bargain: the services citizens receive in return for their money. In Section 5, this reliance on indirect taxation is placed in the context of Pakistan's wider fiscal trap of persistent deficits and expensive debt service. Section 7 provides a summary of the key indicators discussed in this study. Section 6 benchmarks Pakistan's tax mix against regional peers and a developed economy. Section 8 concludes with policy recommendations for a more sustainable and equitable tax structures.(Ahmed, 2018; Asad, 2025; Hussain et al., 2025)

2. A Tax System That Leans on The Poor

In rupees, federal taxation has risen from Rs. 3.4 trillion in 2016-17 to Rs 11.7 trillion in 2024-25. However, it is not much higher in percentage terms compared to the GDP. Till 2022-24, the tax collected by the FBR fluctuated by approximately 10% of GDP due to the rebasing of GDP to the 2015-16 base year. Tax ratios are among the lowest in the region, at 10 percent of GDP, leaving very little room for government expenditure without borrowing.(Khan et al., 2023; Shabeer et al., 2024)

Federal tax collection has increased substantially in nominal terms, from Rs. 3.4 trillion in 2016-17 to Rs 11.7 trillion in 2024-25. However, this growth appears significantly less impressive when scaled to the size of the economy. Since the 2015-16 GDP rebasing, the FBR's tax-to-GDP ratio has stood at about 10% – one of the lowest ratios in the region – leaving little fiscal space for government expenditure without the need to borrow (Khan et al., 2023).

However, the composition of the total tax revenue is more important. GST is the largest federal tax in absolute terms, with collections totalling Rs 3.9 trillion in 2024-25, followed by customs duties and excise duty. In the aggregate, such indirect taxes accounted for about 60 percent of the FBR's revenue until 2021-22 and later decreased to around 51 percent due to an increase in direct tax contribution. However, the move towards direct taxes is, to a large extent, a mirage since almost two-thirds of the total income tax collection in Pakistan is actually indirect regressive taxes in disguise (Ahmad, 2010; Ara, 2023; Arslan et al., 2012; Refaqat, 2005)

The Commitment to Equity study performed by the World Bank in Pakistan (Amjad et al., 2025) found that the effect of the tax-and-transfer system in Pakistan was an increase in the country's poverty rate by approximately two percentage points, mostly due to the GST. Simultaneously, according to the same study, most households appear to be net contributors to the budget system, except for the poorest decile, which is a net recipient. Indirect taxes and subsidy expenditures (which constitute the dominant share of the fiscal magnitudes relative to direct taxes or social transfers) appear to be very inefficient in alleviating poverty and inequality.

Pakistan's federal taxation has risen substantially in nominal terms, from Rs. 3.4 trillion in 2016-17 to Rs. 11.7 trillion projected for 2024-25, marking a more than threefold increase. Despite this considerable nominal growth, the tax-to-GDP ratio has not seen a proportionate increase and remains relatively low at approximately 10% of GDP. This ratio is notably among the lowest in South Asia, indicating significant structural challenges in tax mobilisation (Ministry of Finance, Government of Pakistan [MOF], 2025).

A key factor affecting the observed tax-to-GDP ratio is the GDP rebasing exercise carried out around 2019, which shifted the GDP base year to 2015-16. This rebasing increased the nominal GDP figure by approximately 30%, thereby diluting tax revenue as a share of GDP and causing fluctuations in reported tax ratios. Specifically, tax collection by the Federal Board of Revenue (FBR) fluctuated near the 10% GDP mark during 2022-24, largely due to this rebasing effect rather than changes in actual tax collections (Pakistan Bureau of Statistics [PBS], 2020; Federal Board of Revenue [FBR], 2023).

When contextualised regionally, Pakistan's tax revenue effort is modest compared to neighbouring countries that have tax-to-GDP ratios in higher ranges, often exceeding 15%. This gap reflects differences in tax base coverage, compliance, administrative efficiency, and policy design. The relatively low tax ratio constrains the government's fiscal space, leaving limited room for expenditure without resorting to borrowing or increasing debt. Such constraints pose a fiscal challenge, given the demand for increased public spending on infrastructure, health, education, and other priority sectors (International Monetary Fund, 2026).

Fiscal constraints from low tax collections necessitate external borrowing, raising debt, and complicating consolidation. OECD research shows that expenditure cuts and revenue enhancements can improve fiscal balance, but excessive borrowing risks growth, especially when debt exceeds critical GDP threshold (Butkus et al., 2021). For Pakistan, sustaining macroeconomic stability requires tax efforts and expenditure management. Improving tax revenue requires reforms to broaden the tax base and enhance compliance with and administration of tax laws. Structural reforms that reduce inefficiencies and target property, corporate, and income taxes can have an impact, while inefficient structures and tax expenditures can undermine outcomes (Stoilova, 2024). Figure 1 shows the FBR tax-to-GDP ratio.

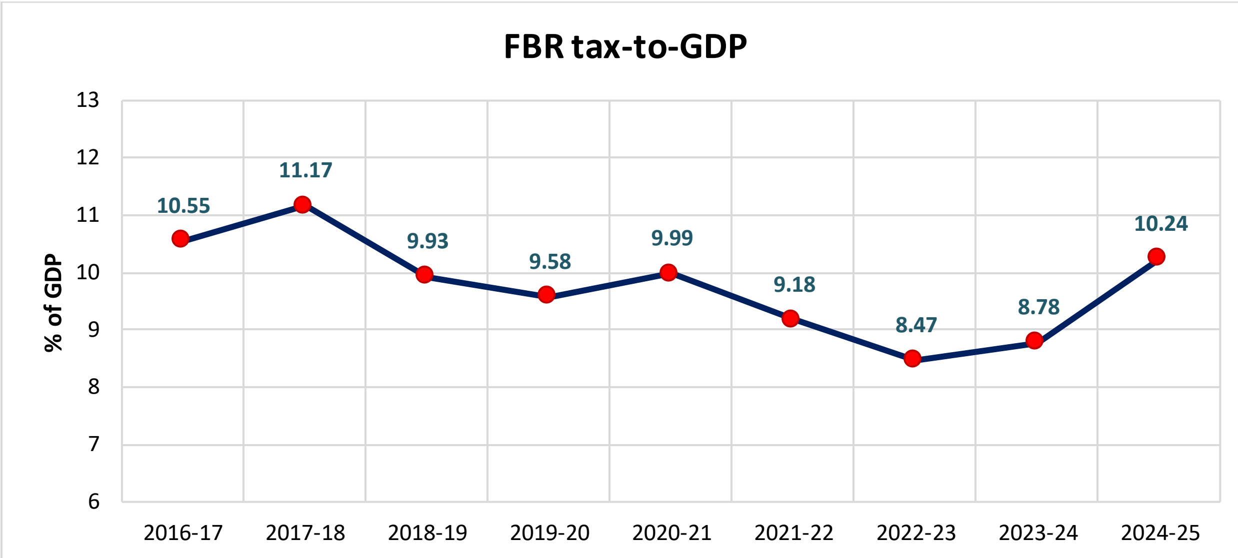

Figure 1: FBR Tax-to-GDP Ratio, Source: MOF's Fiscal Operations.

The point is not the magnitude but the composition of the tax burden. The sales tax (GST) is the largest federal tax collected at Rs 3.9 trillion in 2024-25, higher than customs and excise taxes. Along with these last taxes, indirect taxes constituted about 60% of FBR collections up to 2021-22. Subsequently, their share decreased to approximately 51% owing to the growth in the direct tax share. At the same time, it should be noted that some of the direct taxes are actually deducted (around two-thirds of total income taxes) and regressive. Figure 2 shows the composition of federal tax collection and the relative contribution of its major components.

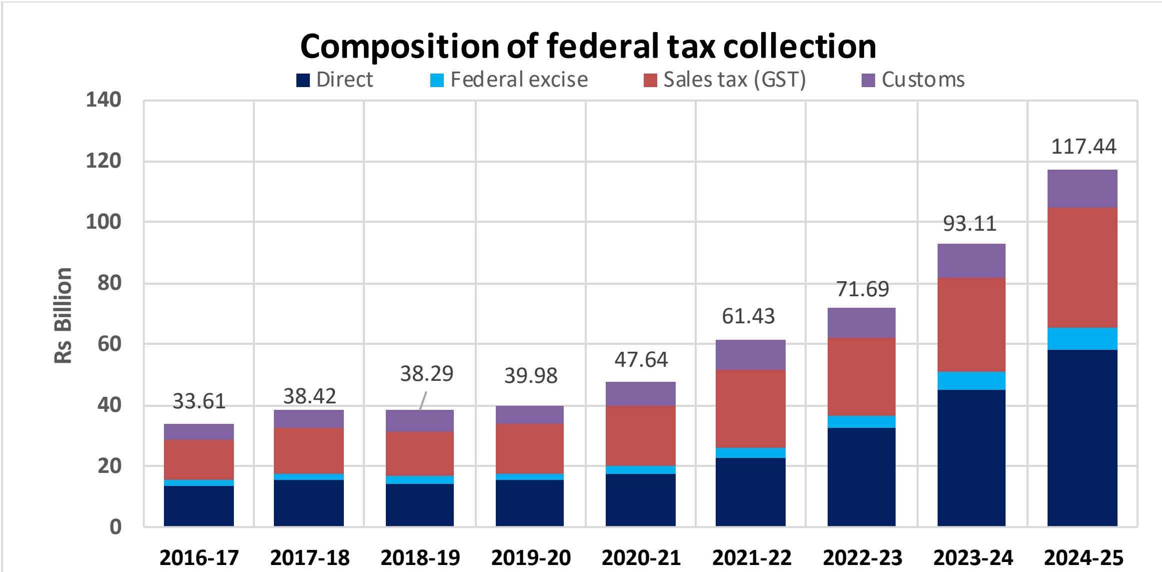

Figure 2: Composition of Federal Tax Collection (Trillion Rupees)
Source: Ministry of Finance, Government of Pakistan

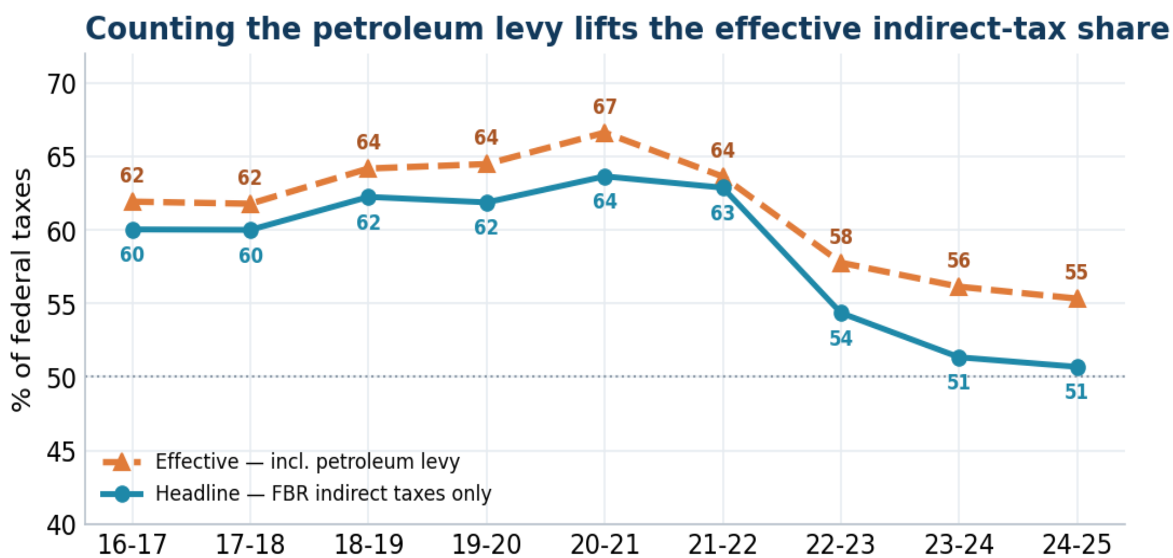

Figure 3: Indirect Taxes as a Share of Federal Taxes: Headline FBR vs. Effective Rate, Including the Petroleum Levy, Source: Ministry of Finance, Government of Pakistan

Figure 3 compares headline FBR indirect taxes with effective indirect taxes, including the petroleum levy, as a share of federal tax collection. According to the Commitment to Equity study performed by the World Bank in Pakistan (Amjad et al., 2025), the overall effect of the tax-and-transfer system was an increase in the country's poverty rate by approximately two percentage points, mostly due to the GST.

3. The Welfare Toll: Inflation, Prices And Poverty

For indirect taxes, the burden is immediately evident in household prices, independent of households' ability to pay the tax. Inflation, as measured by the CPI, grew from less than 10 percent in the pre-2019-20 period to 30.8 percent in 2023-24 and then fell to 12.6 percent in 2024-25, while the national poverty headcount rate increased from 18.3 percent in 2021-22 to 28.9 percent in 2024-25 (MOF, 2025). The co-movement does not show the presence of one causal relationship only; currency depreciation, energy price pass-through, and floods in 2022 were involved in the process, but it is compatible with a tax system where the welfare cost of macroeconomic shocks is made heavier for poorer households instead of being reduced.

The evidence provided by the CEQ study, which is outlined in Section 2, is the most immediate indicator that such a mechanism is effective. Using the fiscal-incidence analysis of CEQ for FY2019 and applying it to household data for the same period, it was found that the Pakistani tax and transfer system increased the national poverty headcount rate by two percentage points, while the contribution of the GST was the highest among the rest of the taxes used, and there was no change in the inequality level (Amjad et al., 2025).The It should be noted that this estimate relates to the pre-COVID period and does not consider the currency inflation crisis in 2022, the floods, and the subsequent tax reforms. Therefore, the welfare effect of the current tax system may be higher than the estimate above; thus, rerunning the above analysis based on the data from the latest HIES should be the next step in this research. According to the World Bank analysis, the GST represented more than 7 percent of household pretax expenditure, although it was neither progressive nor regressive. Figure 4 shows CPI inflation and the national poverty headcount during the study period.

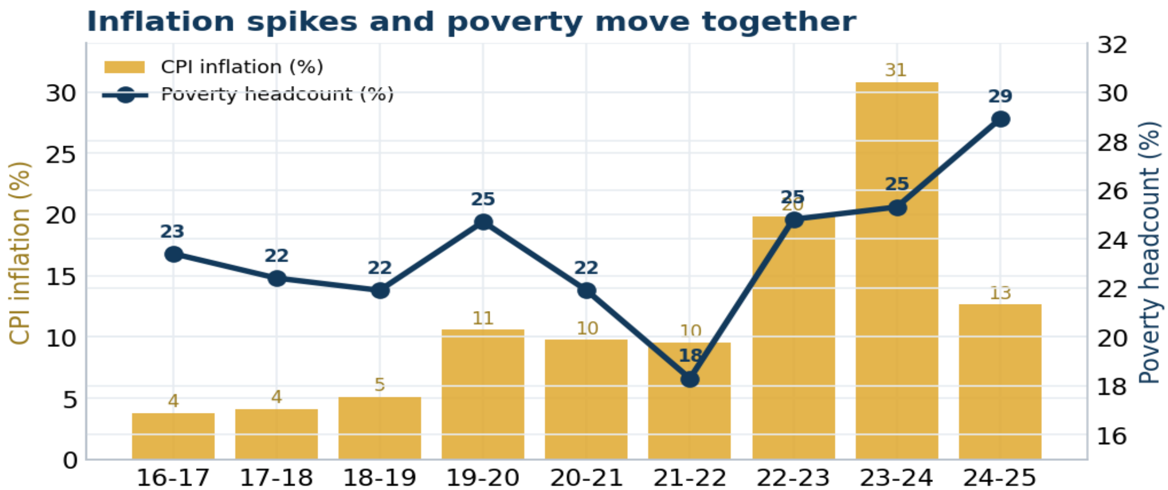

Figure 4: CPI Inflation (Bars) and National Poverty Headcount (Line), Source: Ministry of Finance, Government of Pakistan, 2025

4. Taxes Paid, Services not Delivered

In contrast, a regressive tax structure would be easier to justify if it were associated with appropriate public goods; however, the facts appear to speak otherwise. Even for essential needs, coverage is far from being adequate. According to estimates, 36-47 percent of Pakistanis have access to a safe drinking water supply, while healthcare, education, and necessary infrastructure are chronically underfunded compared to requirements. Although poor households pay their share of the tax burden via GST and withholding taxes, they still face out-of-pocket costs associated with water, education, and healthcare that the state should deliver.

The problem lies in the insufficient fiscal capacity generated by a tax ratio of 10 percent of GDP, excluding debt payments. As shown in Section 5, interest payments on debt sometimes exceed the amounts spent on development and net lending. This means that the last rupee taken from already taxed households will be used to repay the previous loan rather than financing any new construction or water supply. Thus, the fiscal system looks like one that breaks its promise: taxes are paid, but public services promised by them are never delivered, which negatively impacts citizens' tax compliance and incentivises them to move into the economic shadow zone. In addition, the same World Bank incidence analysis shows that rich households receive more subsidies and in-kind transfers (electricity, tertiary education, and inpatient health), while poor households contribute to the budget net (Amjad et al., 2025)

5. The fiscal trap: deficits, debt and the FRDLA

According to FRDLA norms, the consolidation target for the fiscal deficit was set at 4% of GDP and was subsequently lowered to 3.5%. Over almost the whole previous decade, the country was unable to meet this target, and the budget deficit was from 5.4% to 8.9% of GDP, with the ceiling being surpassed several times by the twofold factor (MOF, 2025). These deficits required borrowing and expanding the portfolio of debts to have funds to pay the interest on them, which competed with the budget of development for financing.

These numbers demonstrate the intertemporal competition for resource use. The interest payments in the net federal receipts reached 103% in 2018-19 and were higher than the latter in 2022-23 (122%) and 2023-24 (115%). Thus, the government had a constrained choice and could rely mostly on borrowings to repay the debt, with very little possibility of financing development (MOF 2025). In such a situation, implementing simple administrative measures, such as increasing the GST rate or introducing withholding, appears more reasonable than widening the tax base or introducing a tax on agricultural income. This situation explains why deficits in the past were financed via measures which were simply unjustified. In other words, the fiscal trap can be regarded as a vicious circle: regressive measures help deal with current deficits but not with the future's interest burden. Figure 5 compares Pakistan's consolidated fiscal deficit with the FRDLA ceiling of 4%, which was later reduced to 3.5% of GDP. Figure 6 compares interest (mark-up) payments with development spending and net lending in trillions of rupees.

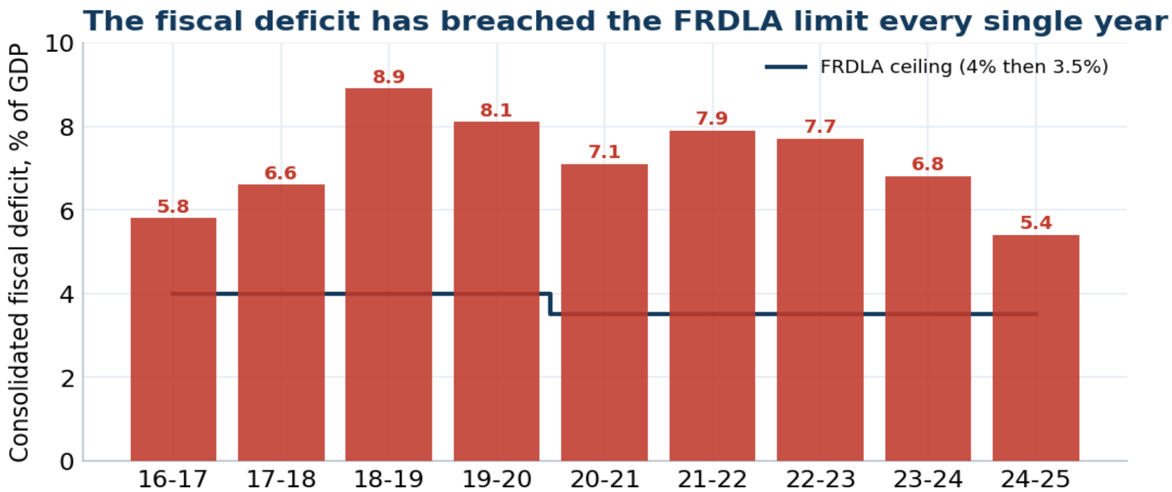

Figure 5: Consolidated Fiscal Deficit vs. the FRDLA Ceiling (4% Then 3.5% of GDP) Source: Ministry of Finance, Government of Pakistan

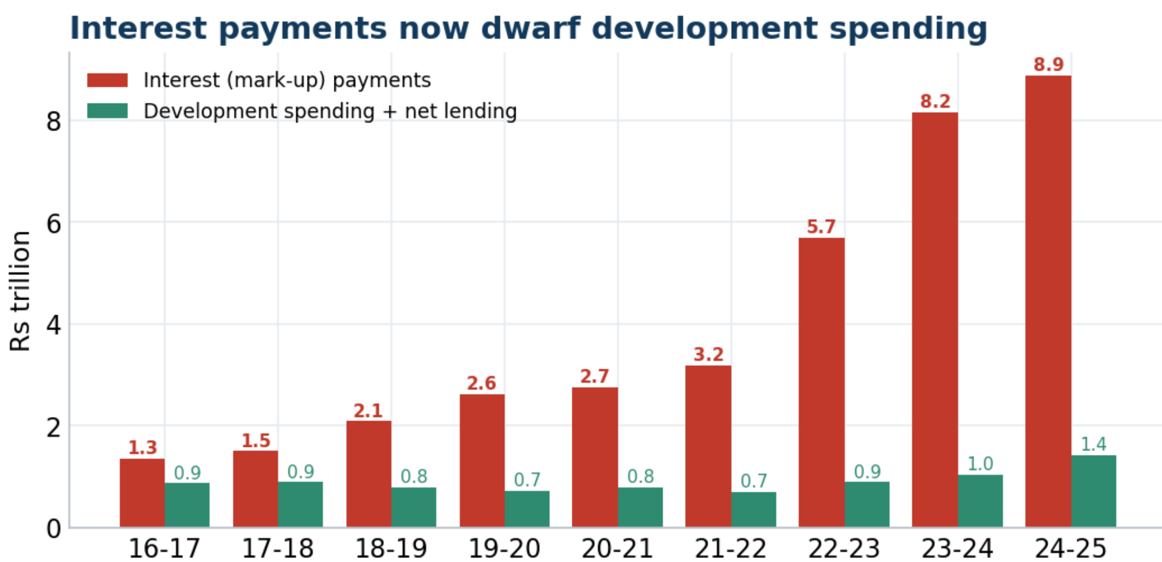

Figure 6: Interest (Mark-Up) Payments vs. Development Spending and Net Lending (Rs. Trillion), Source: Ministry of Finance, Government of Pakistan

6. How Pakistan Compares

It is not unavoidable for Pakistan to be dependent on indirect taxes, but it is a conscious decision made by the policymakers. Located at the regressive end of the spectrum in association with Bangladesh, Pakistan can be compared to India, another developing economy, which now depends on direct progressive taxes for the majority of its revenue, and even to advanced economies, whose two-thirds of revenue is derived from direct taxes. Table 1 shows a comparison of countries in terms of taxation.

Table 1: Tax Comparison

Country/economy	Direct	Indirect	Comment
Pakistan (FBR, FY2024-25)	~49%	~51%	Plus ~2/3 of "direct" tax is withholding, often shifted to consumers
Bangladesh (FY2023-24)	~32%	~68%	Most indirect-reliant regional peer
India (FY2023-24)	~57%	~43%	Comparable developing economy; now majority direct
United Kingdom	~60%	~40%	Developed benchmark; VAT is the main indirect tax
OECD average	~67%	~33%	Advanced economies are direct-tax dominant

Sources: Author's compilation from various sources (Ministry of Finance, national budget documents of comparator countries, OECD Revenue Statistics).

This perspective makes it clear that Pakistan's fiscal policy is more aligned with the tax mix of Bangladesh than India or the OECD average, indicating that a direct tax-focused approach is achievable by other economies at the same stage of economic growth. Furthermore, the World Bank's CEQ results for Pakistan show that Pakistan is different from its peers, who use progressive personal income tax and effective transfer systems to bring about net poverty reduction through their fiscal policies (Amjad et al., 2025).

7. Selected Indicators At A Glance

Table 2 shows the summary of indicators mentioned in Sections 2-5, indicating how the stagnant tax-to-GDP ratio and high dependency on indirect taxes,

Table 2: Summary of Indicators

Indicator	16-17	17-18	18-19	19-20	20-21	21-22	22-23	23-24	24-25
FBR tax-to-GDP	10.5	11.2	9.9	9.6	10.0	9.2	8.5	8.8	10.2
Indirect % of FBR tax	60	60	62	62	64	63	54	51	51
Fiscal deficit (% GDP)	5.8	6.6	8.9	8.1	7.1	7.9	7.7	6.8	5.4
Interest % of net revenue	52	61	103	80	78	85	122	115	89
CPI inflation (%)	3.8	4.1	5.1	10.6	9.7	9.5	19.9	30.8	12.6
Poverty headcount (%)	23.4	22.4	21.9	24.7	21.9	18.3	24.8	25.3	28.9

Source: MOF Fiscal Operations

8. Policy Recommendation

However, Pakistan's use of indirect and withholding taxes is a matter of policy design rather than necessity, and the preceding evidence points to a plausible reform path rather than requiring a radical overhaul of the entire tax system. Five key priorities emerge from the above discussion.

1. Adopt progressive direct taxes by broadening the tax base, which should include taxing agricultural income and under-taxed sectors.

2. Ease the tax burden of poor households through specific relief programs, such as cash transfers or tax rebates, as part of indirect tax reforms.

3. It is recommended to reduce reliance on withholding taxes, which function as indirect taxes, and eventually replace them with progressive income taxes.

4. Harmonising the GST between the federal government and provinces can increase efficiency, reduce compliance costs, and avoid tax distortions.. Maintaining fiscal discipline by strictly enforcing the FRDLA and reducing recurring fiscal deficits.

First, given that the best current estimate of welfare losses attributable to this tax regime was based on data from fiscal year 2019, the re-estimation of the CEQ fiscal incidence analysis using the most recent round of HIES data will have to be one of the steps to accompany the above-mentioned reforms. It is impossible to fine-tune the tax structure without knowing who bears the tax burden now. In addition, it is crucial to protect social sector expenditures during consolidation episodes, report human development spending per capita in budget documents, and explicitly address education and health expenditures in the medium-term fiscal framework.

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