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A Review of Resource Mobilization Efforts of Central Board of Revenue

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Foreword

The current issue of the CBR Quarterly Review provides in-depth analyses of federal taxes during first half of the FY: 2005-06. The Report also gives an overview of various segments of the economy, especially the contribution of the corporate sector in revenue receipts. While highlighting the contribution of the automobile industry in Pakistan, a separate research paper raises pertinent concerns about production and delivery processes of the Industry that require careful tackling in the interest of various stakeholders.

The issue also includes an article on voluntary compliance in Pakistan. This study draws readers' attention to the efforts made by CBR in promoting voluntary compliance through various tax policy and administration reform initiatives. Some insight has also been provided on CBR's latest initiative on electronic filing of sales tax and income tax returns.

Let me take this opportunity to appreciate the efforts of the staff of the Fiscal Research and Statistics Wing, CBR for their research endeavors that are very helpful in policy formulation and its implementation. I hope this research also caters to the needs of wide array of CBR stakeholders.

We look forward to receiving comments and suggestions from our valued readers for improvements of the future issues of the Quarterly.

M. Abdullah Yusuf
Chairman, CBR

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CBR Tax Collection:
An Analysis of 2nd Quarter Revenue Data[1]

The Economy

FY 2004-05 was one of the most successful years for Pakistan economy in terms of robust economic growth. Compared to that the current fiscal year (CFY) has so far been quite challenging for several reasons. Beside slow growth in the world economy due to high and fluctuating oil prices, rising albeit stabilizing domestic inflation, widening trade deficit, and finally massive relief effort after the October 8th earthquake that required extra resources relative to their availability have 'unfavorably' influenced the overall growth trajectory. Thus, by the end of 2nd quarter, there are mixed signals about the economy on the basis of the leading economic indicators.

Elaborating further on the state of the economy, it is evident that the stance of tight monetary control has been instrumental in stabilizing inflation between 8-9% down from over 11% in December 2004. However, the cost of capital has also risen quite considerably during the process.[2] As a consequence, it is valid to investigate how future investment initiatives will take shape. Will it be deterred further when corporate and industrial profits start sliding? Will the demand for consumer durables be adversely impacted? Can the apparent slow down in the industrial growth be attributed to rising interest rates and escalating costs of inputs? If so, how to resolve the apparent conflict between monetary and fiscal policies would be a difficult challenge for the policy planners in coming months.

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[1] The Research Team of Fiscal Research Wing of CBR has carried out the analysis.

[2] Whether inflation in Pakistan is a monetary phenomenon or it has re-emerged due to supply constraints and imported inflation? It is high time that this empirical question is addressed comprehensively. It is important to add that previous research on the subject has confirmed that money growth affects inflation after a sufficiently long lag (in certain cases after about three years!).

The availability of consumer supplies at affordable prices is an additional risk that will have to be negotiated carefully. The latest crisis of sugar has been the recent example in this respect. The recurrence of artificial supply shortages not only has an adverse impact on prices, but this has also resulted into exploitation of the populace by hoarders and manipulators.

On a positive note, the position of foreign exchange reserves has maintained its strength due to consistency in the inflow of remittances, foreign direct and portfolio investments, international assistance on softer terms, and more recently, the commitments by the world community for relief and rehabilitation efforts for the earthquake victims. Within the monetary policy regime, the stability of the exchange rate has been another area of strength. On the whole, the rupee has remained stable despite the widening of trade deficit at $5.58 billion during July-December 2005. Similarly, notwithstanding the realization of imports of $13.65 billion and exports of $8.07 billion, the overall balance of payments deficit has reached $0.9 billion during the first six months of FY: 05-06. Incidentally, this level is much lower than the last year's comparable figure of $1.5 billion. The improvement has been attributed to surging exports (up by 23.8%), which according to the latest data has increased from $6.52 billion during July-December 2004 to $8.07 billion during H1: FY 05-06.

Regarding natural disaster and its consequences, experiences have shown that the economic impact takes a v-shape pattern after the event. Destruction of the infrastructure, capital and disruption of normal economic activities initially leads to a loss of output, employment and labor force. However, subsequently, the economy receives a boost when the rebuilding process starts.[3] Currently, Pakistan is passing through the initial phase of the post-disaster

[3] There is no doubt that the socio-psychological impact takes a much longer time to recover.

situation. The reconstruction activities have yet to start, as severe weather in the earthquake region is the main constraining factor. Thus, the revival of economic activity and its impact on growth may take some additional time to materialize. Thus, the real growth during FY 05-06 is expected to remain high – i.e., above 6.5%.

CBR Revenue Target: 2nd Quarter of FY 2005-06

Reliable projection of revenue target is not only beneficial for CBR but also for the economy as a whole. It allows economic managers to properly allocate funds for government development and non-development activities. The performance of last three years has confirmed the importance of the accuracy of revenue projections. Unlike earlier years when even the revised targets were difficult to achieve, CBR has been able to meet (even surpass) its assigned start of the year revenue targets.[4] One of the reasons for this performance has been the way the projections are made. Rather than ad hoc procedures, predictions are now based upon scientific knowledge – utilizing information on historical collection of individual taxes, buoyancy of the four federal taxes, new taxation measures, and the movement of key indicators of the economy. Resultantly, the much-needed fiscal space has been generated for social sectors and other important expenditure requirements.

The overall target for the 2nd quarter of FY 05-06 has been fixed at Rs. 163.1 billion. Of this amount, 27.6% has been assigned to direct taxes, 42.7% to sales tax, 21.2% to customs duties and the remaining 8.5% to federal excise. In view of the anticipated higher corporate tax compliance in December, a higher share of 58.8% has been targeted for this month for income tax compared to 20% for October

[4] A breakthrough was achieved when for the first time federal tax receipts exceeded the target in 2002-03 by a small margin. Since then, this feat has been repeated in 2003-04 and 2004-05. The stellar performance 2004-05 is historic because the targets were revised upward and still successfully achieved. The margin of more than Rs. 10 billion can safely be regarded as significant. No doubt that this achievement has been morale boosting for everyone, especially the employees of CBR and its field officers, nonetheless, looking objectively, the reform process has brought about the much-needed change in the tax mix of direct and indirect taxes.

and 21.2% for November. On the other hand, a consistent growth has been projected for the remaining three taxes (Table 1).

Table 1: Monthly and Q2: 05-06 Targets of Federal Taxes

(Rs. Billion)

	Direct Taxes	Sales Tax	Excise Duties	Customs Duties	ALL TAXES
Quarter: 1	**48.8**	**57.1**	**12.7**	**26.9**	**145.5**
October	9.0	22.9	4.4	10.5	46.8
November	9.6	23.2	4.5	11.5	48.8
December	26.5	23.5	5.0	12.5	67.5
Quarter: 2	**45.1**	**69.6**	**13.9**	**34.5**	**163.1**
H1: 05-06	**93.9**	**126.7**	**26.6**	**61.4**	**308.6**

CBR Revenue Position

CBR has significantly surpassed the revenue target of Rs. 308.6 billion fixed for July-December 2005 by collecting Rs. 323.9 billion. This commendable performance has been the result of appropriate steps with respect to administrative reform and tax policy initiatives. Whereas the reforms measures have been mostly facilitating in nature – promoting voluntary compliance and confidence building – the tax policy initiatives were mostly concessionary in nature to promote economic activity in the country. Particularly, the measures like zero-rating of the entire chain of major export oriented industries, reduction of duty on smuggling-prone items, rationalization of tariff structure and reduction of corporate tax rates have been instrumental in promoting international trade activities, discouraging tax evasion, and accelerating industrial growth.

Overall Tax Collection and Refunds

The gross and net collection during July-December 2005 has been Rs. 366.6 billion and Rs. 323.9 billion, indicating an increase of 18.5% and 23.4%, respectively over the corresponding period of PFY. The refund payments during this period were Rs. 42.7 billion against Rs. 46.8 billion during the comparable period of PFY (Table 2). The performance during the 2nd quarter of CFY has been extra-ordinary compared to the 1st quarter due to a number of factors. The most significant of these has been the double-digit growth in income and corporate tax receipts due to improved profitability of the corporate sector, especially banks, insurance companies, and oil and gas sector. Similarly, the impact of zero-rating of the entire chain of five export-oriented industries has enhanced economic activities in two leading commodity groups, i.e., textile and leather. Consequently, the sales tax net collection has also increased in the second quarter. Finally, despite some slowdown in certain categories of imports, the growth momentum in the collection of customs duties and sales tax at import stage has been maintained. This performance of the economy provides the required confidence that the revenue collection will remain on track during the coming months.

Table 2: Federal Gross and Net Revenue Receipts: A Comparison

(Revenue Receipts in Rs. Billion)

	FY 05-06		FY 04-05		Growth (%)	
	Gross	Net	Gross	Net	Gross	Net
July	41.5	34.6	38.4	30.7	8.1	12.7
August	50.3	44.9	41.4	34.2	21.6	31.4
September	78.4	72.5	68.5	60.8	14.5	19.3
October	56.3	49.2	48.0	40.9	17.2	20.2
November	53.5	47.6	46.4	38.5	15.1	23.5
December	86.6	75.1	66.5	57.4	30.2	30.8
Half-Year	366.6	323.9	309.3	262.5	18.5	23.4

Figures are rounded to one decimal place

Detailed Analysis of Individual Taxes

It is encouraging that the target of Rs. 308.6 billion has been surpassed by about 5%. The two leading taxes, i.e., income and corporate taxes and sales tax have exceeded their respective targets by 11.1% and 4.8%, respectively. While the customs duties are right on the target, the collection of excise duties has been short by Rs. 1.2 billion. However, this shortfall has been more than compensated by other taxes. The tax-wise details are provided in the following.

Direct Taxes**:** The direct taxes are the second major source of federal tax revenues after sales tax. This source has contributed about 32.2% of total receipts during July-December 2005. The net collection has been Rs. 104.3 billion against the half yearly target of Rs. 93.9 billion. The refund payments have grown by around 46% during the same period, which has led to 34.6% growth in the gross collection of direct taxes. It may be recalled that the collection of direct taxes comprises of withholding taxes (WHT), voluntary payments (VP) and collection on demand (COD). The collection during July-December 2005 confirms that the share of WHT, VP and COD in income and corporate tax gross collection has been 52.6%, 42.6% and 4.9% respectively. Whereas, the contribution of WHT remains historically high, the drastic change in the configuration of other two components is consistent with the way the taxation system has been re-designed in recent years.

Components of Income & Corporate Taxes

Voluntary Payments (VP): The VP has emerged as one of the leading components of income and corporate taxes. As a welcome development, the share of voluntary compliance has improved significantly after the introduction of USAS. Its share in gross income tax collection was around 29% in FY: 02-03 that increased to 35% in FY: 04-05. For the CFY, it has reached 42.4% during the July-December 2005. Within VP, the two major components are payments with returns that are made under section 137 and advance tax payment made under section 147 of the Income Tax Ordinance, 2001. It is encouraging to observe that the overall VP grew by around 36% during the first half of CFY as compared to the corresponding period of PFY. Specifically, the collection has jumped from Rs. 35.9 billion in H1: FY 04-05 to Rs. 48.8 billion in H1: FY 05-06. For the two major components, the gross collection with returns increased by a massive 194.6% (Rs. 22.2 billion versus Rs. 11.4 billion), the growth in advance tax receipts was 11.5% (Rs. 25.6 billion versus Rs. 23 billion).

Box 1: Improvement in Voluntary Compliance

As a facilitating measure CBR introduced the system of universal self-assessment in income tax. The primary objective of this policy change was two fold: (a) to minimize interface between tax collectors and tax administrators; and (b) to promote voluntary tax compliance. Simllarly, changes were also introduced in the advance tax regime whereby payment of advance tax on the basis of past turnover ratio was replaced by payment on the basis of expected income. The evidence confirms that both these measures have been successful in promoting voluntary compliance. There has been significant growth all around; i.e., in the number of returns field, payment with returns, and advance tax payments as shown below.

A) Introduction of USAS – the Status of Voluntary Compliance

Number of Returns filed in 2003-04: 1,029,279
Number of Returns filed in 2004-05: 1,229,952
Growth: 19.5%
July- December 2004: 1.12 million
July-December 2005: 1.27 million
Growth: 12.8%

Payment with returns in 2003-04: Rs. 9853 million
Payment with returns in 2004-05: Rs. 14213 million
Growth: 44.3%
July- December 2004: Rs.11, 432.5 million
July-December 2005: Rs.22, 243.3 million
Growth: 194.6%

B) Advance Tax Receipts

Prior to Regime Change (2003-04): Rs. 56.7 Billion
After the regime Change (2004-05): Rs. 59.7 Billion
Growth: 5.3%
July- December 2004: Rs. 23 Billion
July-December 2005: Rs. 25.6 Billion
Growth: 11.5%

Collection on Demand (COD): The collection on demand has increased by 46.8% mainly due to 91% increase in arrears demand during July-December 2005 (Table 3). The increase in arrears demand has been due to clearing of the Brought Forward (BF) cases. While stagnation in growth on account of current demand has been anticipated after the introduction of the self-assessment, it is relevant to add that this decline has been more than compensated by enhanced voluntary payments, as indicated above.

Table 3: Collection on Demand: A Comparison

(Rs. Million)

Heads	FY:05-06	FY:04-05	Difference	
			Absolute	Percent
Arrears				
Quarter 1	1,682.1	930.1	752.0	80.9
Quarter 2	2,003.8	999.2	1,004.6	100.5
July- December	3,685.9	1,929.3	1,756.6	91.0
Current				
Quarter 1	437.4	639.7	-202.3	-31.6
Quarter 2	1,480.1	1247.2	232.9	18.7
July- December	1,917.5	1,886.9	30.6	1.6
Total Demand				
Quarter 1	2,119.5	1,569.8	549.7	35.0
Quarter 2	3,483.9	2,246.4	1237.5	55.1
July- December	5,603.4	3,816.2	1787.2	46.8

Withholding Taxes (WHT): As indicated, WHT is the major contributor (52.6%) of the gross income tax collection. During July-December 2005 the collection from this source was Rs. 60.5 billion against Rs. 46.9 billion during PFY, yielding an increase of 28.8%. Currently deduction at source is allowed on 18 major WHT heads (excluding sub-sectors). The information on relative strength of withholding taxes confirms that seven sources have contributed Rs. 50.7 billion of gross revenue, which constitutes 83.8% of total WHT receipts during July-December 2005. Even among these seven sources only two heads, i.e., contracts and imports have contributed Rs. 31.4 billion worth of revenue, which is more than half of the WHT receipts during the period under consideration. This confirms that notwithstanding the rather large number of WHT sources, there are only few of them that are contributing significantly towards revenue receipts. Even within the major contributors, the deductions are generally in lieu of the submission of complete income tax returns provided no other source of income is there.

Box 2: Reduction of WHT on Import Related Categories

The WHT rates have been slashed for three important categories, viz, imports of plant, machinery, and equipment, smuggling-prone items, and import of inputs of export-oriented industries. The purpose of these policy changes was specific to each category. The impact of these measures is as follows:
Reduction of WHT rate on import of plant, machinery, and equipment from 6% to 0% reduced collection by about Rs. 300 million during but created investment-friendly environment.

Reduction of rate on smuggling-prone items from 6% to 2% resulted into improved collection of Rs. 231 million during , indicating strength of policy- import of these goods from regular channels has started

Reduction of rate on five export-oriented industries from 6% to 1% resulted into reduced collection of Rs. 360 million during . Nonetheless, it reduced refund claims and improved liquidity position of export related business.

Specific Details: The seven-major WHT heads are: contracts, imports, salary, exports, electricity and telephone bills, and deduction bank interest and WHT. The share of contracts (30.1%) remains at the top, followed by imports (21.8%), salary (10.6%), exports (7.7%), electricity (3.9%), telephone (5.3%) and bank interest (4.3%). All these sources have shown a notable growth in the collection (Table 4). The collection from bank interest, telephone, contracts, exports, salary and imports has increased by 54.2%, 51.2%, 45.2%, 28.7%, 15.2%, 7.0%, respectively. The growth in electricity is only 2.8%. Barring WHT on electricity, the increase in other deductions at source is consistent with enhanced sectoral economic activities in the economy. In particular the significant growth of 54.4% on account of interest payments by banks reflects a steady rise in interest rates after the change in monetary policy stance by the State Bank of Pakistan. Consequently, its contribution in total collection of withholding taxes has also increased during H1 of CFY. Similarly, the increase in WHT on contracts is consistent with increased government spending on infrastructure and related development.

Table 4: Quarterly Collection from Major Revenue Spinners Related to Withholding Taxes

(Rs. Million)

Collection Heads	FY:05-06	FY:04-05	Difference	
			Absolute	Percent
Imports	13202.8	12336.4	866.4	7.0
Q1	6687.0	6293.0	394.0	6.3
Q2	6515.8	6043.4	483.6	8.0
Contracts	18226.7	12552.2	5674.5	45.2
Q1	9104.0	6121.9	2982.1	48.7
Q2	9122.7	6430.3	2692.4	41.9
Salary	6428.8	5582.8	846.0	15.2
Q1	2965.4	2840.3	125.1	4.4
Q2	3463.4	2742.5	720.9	26.3
Export	4679.0	3635.8	1043.2	28.7
Q1	2306.5	1735.8	570.7	32.9
Q2	2372.5	1900.0	472.5	24.9
Telephone Bills	3189.0	2109.7	1079.3	51.2
Q1	1313.9	1021.9	292.0	28.6
Q2	1875.1	1087.8	787.3	72.4
Sub-total (5 major items)	45726.3	36216.9	9509.4	26.3
Share in Total WHT	75.6%	77.1%		
Other WHT	14753.3	10727.2	4026.1	37.5
Total WHT	**60479.6**	**46944.1**	**13535.5**	28.8
Share in Gross I. Tax	52.6%	53.9%		

Tax Profile of the Corporate Sector

The tax profile of the corporate sector reveals a growth of 10.8% in receipts during FY 2004-05. Individually, the public companies registered 13% growth, and the growth in corporate taxes by private companies was 10.6%. The collection from this sector has further improved during the H1: 05-06 due to improved profitability, with gross collection reaching Rs. 56.3 billion, as against Rs. 49.9 billion in the corresponding period of last year. The growth rate has been

12.8% and its share in the total income tax gross collection stood at 49%. The improvement in revenue realization is mainly due to promulgation of the Income Tax Ordinance, 2001, which provides for progressive reduction in corporate rates by 2% for the private companies per annum and 3% for the banking companies to achieve parity in rates at 35% by tax year 2007. A further break down into public, private and banking companies presents a healthy growth pattern during the period under review. The public companies have registered a growth of 15.4%, followed by private and banking companies with 11.3% and 10.8% growth, respectively (See also Box 2).

Box 2: Corporate Sector is Growing in Response to Reduction in Corporate Tax Rates

Gross Receipts from Public Companies
2003-04: Rs. 70.6 B
2004-05: Rs. 79.8 B
Growth: 13%

Gross Receipts from Private Companies
2003-04: Rs. 46.6 B
2004-05: Rs. 50.0 B
Growth: 10.6%

More Recent Comparison

Gross Receipts from Public Companies
July - December 2004: Rs. 21.0 B
July - December 2005: Rs. 24.2 B
Growth: 15.4%

Gross Receipts from Private Companies
July - December 2004: Rs. 23.7 B
July - December 2005: Rs. 26.4 B
Growth: 11.3%

Gross Receipts from Banking Companies
July - December 2004: Rs. 5.2 B
July - December 2005: Rs. 5.7 B
Growth: 10.8%

***Sales Tax**:* The sales tax has exhibited 21.4% growth in tax collection during July-December 2005-06. The gross and net collection of sales tax stood at Rs. 150.0 billion and Rs. 132.7 billion respectively. The refund payments have been less by 40.3% as compared to the corresponding period of last year. This substantial decline is mainly due to zero-rating of five major export oriented industries i.e., textile, leather, sport and surgical goods and carpets. Consequently, the net collection has increased by 21.4%. Within sales tax, the growth in sales tax (imports) is rather low at 16.5% as compared to phenomenal 29.9% growth in the (domestic) sales tax during 1st half of CFY.

Domestic Sales Tax Collection and Major Revenue Spinners:
The analysis of domestic sales tax has been carried out on the basis of ten major items. These commodity groups have contributed around 71.5% of gross collection of sales tax domestic during July-December 2005 against 65.8% in the corresponding period last year. Out of these ten sources, four have exhibited a double-digit growth during H1: FY:05-06, while the collection from cigarettes, sugar and electrical energy has declined by 8.1%, 8.6% and 10.1%, respectively.

A detailed look into the major commodities reveals that the collection of services including telephone has increased by more than 40% in H1: CFY as compared to the corresponding period last year. The increasing demand for cell phones and other communication apparatus continues to remain robust that, in turn, has contributed in the enhanced collection from this source.

There is a marginal increase in the collection from POL products during July-December 2005. After a decline of 4.5% in the in the first quarter of CFY the collection has increased by 5.9% in the second quarter. The negative growth in collection on account of cigarettes is due to earlier adjustment of payment otherwise its growth pattern is consistent with growth in FED collection. The decline the collection of sugar by 8.6% can be attributed the higher input adjustment. Finally, the double-digit growth in the cement, natural gas, beverages and motorcars has been mainly due to higher demand for these products as compared to the corresponding period of last year (Table 5).

Table 5: Gross Collection of GST (Domestic) from Major Revenue Spinners

	FY: 05-06	FY: 04-05	Growth (%)		FY: 05-06	FY: 04-05	Growth (%)
POL Products				Cement			
Q1	5420.4	5676.7	-4.5	Q1	1155.0	934.5	23.6
Q2	5812.6	5488.5	5.9	Q2	1147.0	878.1	30.6
Jul-Dec	11233.0	11165.2	0.6	Jul-Dec	2302.0	1812.6	27.0
Services Including Tele/Fax				Cigarettes			
Q1	6231.1	5078.0	22.7	Q1	813.1	1075.9	-24.4
Q2	7533.0	5520.8	36.4	Q2	1348.8	1275.5	5.7
Jul-Dec	13764.1	10598.8	29.9	Jul-Dec	2161.9	2351.4	-8.1
Natural Gas				Beverages			
Q1	2932.0	2635.4	11.3	Q1	750.8	665.4	12.8
Q2	3353.5	2788.4	20.3	Q2	653.2	465.3	40.4
Jul-Dec	6285.5	5423.8	15.9	Jul-Dec	1404.0	1130.7	24.2
Sugar				Motor Cars			
Q1	2016.2	1734.3	16.3	Q1	684.9	533.5	28.4
Q2	1390.8	1995.2	-30.3	Q2	776.1	527.7	47.1
Jul-Dec	3407.0	3729.5	-8.6	Jul-Dec	1461.0	1061.2	37.7
Elec. Energy				Auto Parts			
Q1	1247.1	2589.5	-51.8	Q1	578.2	399.5	44.7
Q2	5098.7	4466.8	14.1	Q2	487.8	660.5	-26.1
Jul-Dec	6345.8	7056.3	-10.1	Jul-Dec	1066.0	1060.0	0.6
Major Ten Commodities				All Commodities			
Q1	21828.8	21322.7	2.4	Q1	31535.2	33019.3	-4.5
Q2	27601.5	24066.8	14.7	Q2	37625.9	35996.4	2.6
Jul-Dec	49430.3	45389.5	8.9	Jul-Dec	69161.1	69015.7	-0.8

Customs Duties: Despite emergence of sales tax and income tax as important sources of collection, customs duties are still sharing significant portion in total tax collection in the recent years. Spurred by large-scale tariff rationalization and industrial expansion, total imports and dutiable imports have increased by 35% and 29%, respectively during the first half of CFY. The ratio of dutiable to total import has been 62% during this period. Consequently, the revenue has also increased by a healthy margin. It is expected that the continuous rationalization and reduction of CD rates will further increase the pace of the industrial and economic activities, as the cost of production is reducing gradually. As a consequence, the customs duties have performed significantly and achieved the allotted target of Rs. 61.4 billion by collecting Rs. 61.5 billion during July-December, 2005. The gross and net collection stood at Rs. 71.5 billion and Rs. 61.5 million during H1: FY: 05-06, depicting an increase of 21.9% and 20.1%, respectively. The difference between gross and net collection was due to increased refund/rebate payments.

The collection of CD and import value of major revenue spinners is presented in Table 6. These 15 major groups (Chapters) contributed around 61.4% of gross collection of CD during H1:05-06. On the top of the list of major revenue spinners has been vehicles (Chapter 87), which contributed 40% higher collection mainly due to reduction in CD rates on CBU cars during the budget FY: 05-06. Total import and dutiable imports of vehicles has gone up by 50% and 54% during H1:05-06. The decline in CD rates has also been instrumental in lowering the effective rates on vehicles from 40% in FY: 04-05 to 36% in FY: 05-06, thus addressing the concern about tariff peaks. According to the sustained policy of the government to step up the inflow of machinery and parts, the CD rates have also been reduced on specific machinery items while machinery including parts has been declared zero-rated for sales tax purposes. Total imports and dutiable imports of mechanical machinery (Chapter: 84) have increased by 15% and 37% for mechanical machinery while the collection of CD has increased by 4%, notwithstanding substantial tariff reduction. Similarly, total imports as well as dutiable imports of electrical machinery (Chapter 85) have also increased significantly i.e., by 58% and 61%, respectively. Resultantly, the CD collection from this source has also increased by

10%. This reflects that negative impact of tariff reduction has largely been compensated by increased volume of imports.

Besides machinery, some of the other items that exhibited growth in CD during the first half of CFY are iron & steel (40%), paper & paperboard (27%), and articles of iron & steel (41%) due to continuous strong demand for these goods. On the other hand, few commodities groups have recorded a decline in collection mainly due to lowering of tariff rates that have not been compensated by higher imports. These items include organic chemicals, plastic, coffee and tea, rubber products and dyes/paints, miscellaneous chemicals.

Table 6: Major Revenue Spinners of Customs Duties and Effective Rates

(Growth and Effective Rates in percent)

PCT Chapter	Tariff Description	July-December Growth: CFY over PFY			Effective Rates on Dutiable Imports	
		Total Import	Dutiable Imports	Customs Duties	Up to Dec-05	Up to Dec-04
87	Vehicles	49.9	53.2	40.1	36.5	40.0
15	Edible oil and Waxes	11.9	11.9	19.8	32.3	30.2
84	Machinery	14.9	37.1	4.8	6.8	8.8
27	POL Products	51.8	64.6	63.3	10.0	10.1
85	Electrical Machinery	58.5	61.4	9.9	7.8	11.4
39	Plastic Resins, etc.	32.1	34.1	-4.3	9.0	12.6
29	Organic Chemicals	11.2	-20.8	-27.5	8.4	9.2
72	Iron and Steel	85.5	41.0	40.7	10.6	10.6
48	Paper and Paperboard	26.2	27.2	26.8	18.9	18.9
38	Misc. Chemical Prod.	3.9	1.7	-14.8	8.4	10.1
40	Rubber Products	20.5	4.8	-1.8	11.9	11.5
9	Coffee and Tea etc.	4.2	2.3	-5.7	10.1	10.9
32	Dyes, Paints etc.	14.9.	5.8	-3.0	13.0	14.2
54	Man-made Filaments	92.6	94.8	-12.4	9.2	20.4
73	Articles of Iron & Steel	44.1	36.2	40.7	14.6	14.1
Sub-total		*33.7*	*34.6*	*20.8*	*13.3*	*14.8*
Others		36.2	7.4	24.2	18.0	15.5
Grand Total		**34.6**	**28.9**	**21.5**	**14.1**	**15.0**

Federal Excise: The net collection of FED has recorded 7.6% growth over the corresponding period of last year. In absolute terms, an amount of Rs. 25.4 billion has been collected during H1: CFY against Rs. 23.6 billion in the H1: PFY. The growth in FED collection has been shown around 6% during the 2nd quarter of CFY, whereas the growth in the 1st quarter was 25.3%. The commodity-wise collection of major spinners provides details of collection during H1: CFY against H1: PFY (Table 7). It is worth adding that major five items have contributed around 92% of gross FED receipts during H1: CFY against 90.2% during H1: PFY.

Table 7: A Comparative Analysis of CED Collection

Rs million

Major Revenue Spinners	JD:2005	JD:2004	Difference	
			Absolute	Percent
Cigarettes				
Q1	4,537.8	3,955.8	582.0	14.7
Q2	5,592.1	5,118.6	473.5	9.3
Total	10,129.9	9,074.4	1,055.5	11.6
Cement				
Q1	2,950.7	2,642.6	308.1	11.7
Q2	2,938.4	2,552.6	385.8	15.1
Total	5,889.1	5,195.2	693.9	13.4
Natural Gas				
Q1	1,341.5	1,339.2	2.3	0.2
Q2	1,377.2	1,325.1	52.1	3.9
Total	2,718.7	2,664.3	54.4	2.0
POL Products				
Q1	1,021.3	1,135.0	-113.7	-10.0
Q2	1,102.8	1,112.1	-9.3	-0.8
Total	2,124.1	2,247.1	-12.3	-5.5
Beverages & Concentrate				
Q1	1,397.7	1,129.5	268.2	23.7
Q2	1,028.4	964.8	63.6	6.6
Total	2,426.1	2,094.3	331.8	15.8
Sub-Total				
Q1	11,249.0	10,202.1	1,046.9	10.3
Q2	12,038.9	11,073.2	965.7	8.7
Total	23,287.9	21,275.3	2,012.6	9.5
All Commodities				
Q1	12,343.1	11,256.2	1,086.9	9.7
Q2	13,1017.4	12,333.7	683.7	5.5
Total	25,360.5	23,589.9	1,770.6	7.5

The collection of cigarettes has increased by 11.6%, despite a slow down in its production by 4.9% during July-December 2005. This divergence could partly be due to the upward revision in prices for middle and lower slabs of cigarettes in the budget 2005-06. Similarly, the collection from cement also grew by 13.4% backed by 7.2% growth in production during July-December 2005. It is expected that the production of cement will increase in the coming months due to increased domestic demand that may eventually lead to enhanced FED collection from this source. Finally, beverages and natural gas have also recorded growth of 15.8% and 2%, respectively during July-December 2005.

Concluding Observations

It is indeed encouraging that despite some slow down in the manufacturing sector and a receding trend in the growth of imports, CBR has surpassed the revenue target set for the first half of the current fiscal year. Improvement in voluntary compliance both in terms of the number of returns and payment with returns on the one hand and significant growth in collection on account of customs duties despite the reduction and rationalization of tariff rates indicate that policy measures are yielding desired results. The cost of doing business is coming down gradually in response to wide-ranging administrative changes. Keeping in view the performance of federal taxes during the first half year of CFY, it is anticipated that the resource mobilization will remain on track during the 2nd half of the current fiscal year.

II

Industry Profile:
Automobile Industry in Pakistan[5]

Introduction

The automobile assembling industry claims to be playing a vital role in Pakistan’s economy. Undoubtedly, with a long chain of backward and forward linkages, it mobilizes and generates diverse activities in the services sector. The upstream economic contributions and downstream impacts of the automobile industry signify its central role in gearing up the economy of a country. It is often contented that no economy can develop on modern lines without the development of its automobile industry. Many material-producing industries such as iron and steel, aluminum, plastic and rubber industries etc. rely on automotive industry purchases for a substantial share of their production. Similarly, the services sector relies on the automotive sector as a major contributor to their growth. The industry is a global phenomenon. A small number of companies with worldwide recognition are the major players around the world.

With this background, the purpose of present study is to ascertain the strength of automobile industry in Pakistan. The focus is on its growth within the existing protective barriers, its role in the development of vendor industry, its tax contribution, consumer satisfaction, and future prospects.

Historical Background

The history of automobile manufacturing in Pakistan begins from 1950 with the installation of assembly plant by international automobile company General Motors in the private sector.

[5] Author: Sharfuddin Pirzada, Secretary Fiscal Research and Statistics Wing, CBR.

Notwithstanding the significant increase in manufacturing of various products during 1960's, the auto-manufacturing was badly hurt in 1970's due to government policy of nationalizing the industries in Pakistan. For instance, despite achieving accelerated indigenization of about 80% in the manufacturing of Bedford trucks by 1972, the assembling units almost ceased its operation during the remaining period of decade. However, from 1980 onward, especially after the privatization of automobile industrial units, a new phase of the industry started with the collaboration of local companies and foreign manufacturers in the form of joint ventures. Major joint ventures include:

i) Pak Suzuki Motor Co. with Suzuki, Japan for manufacturing Cars, Van, Jeep, Pick-up;

ii) Indus Motor Co. and Toyota & Daihatsu, Japan to manufacture Corolla & Cuore Cars.

iii) Atlas Honda Ltd with Honda Japan to manufacture Honda Cars/Motorcycle

iv) Gandhara Nissan Ltd with Nissan Japan for the production of Cars & Trucks; and

v) Dewan Farooq Motors with Kia and Hundai, Korea for manufacturing of Cars and LCVs.

The industry in Pakistan is divided into five major categories that include: Cars/ LCVs; Tractors; Buses/ Trucks; Motorcycles and three wheelers; and Vendor industry. Currently the industry consists of 67 industrial units, involved in the assembly and manufacturing business and providing sizeable employment opportunities. During the past few years, the industry has registered a magnificent growth ranging from 28% to 58%. The Car/ LCV manufacturing is placed at the center due to its major contribution in the overall value addition by the automobile sector. There are 15 manufacturing units involved in the manufacturing of cars/LCVs providing employment to about

6000 persons, with an investment of Rs. 21 billion.[6] Six units are engaged in the manufacturing of tractors; two-wheelers and three-wheelers industry consist of 39 units, and for manufacturing of Buses and Trucks there are five units. All these units of automobile sector are working as a hub for vendor industry in the country spread over around 1000 units. Although, lack of automation at different levels of economy and full documentation restricts the ability to estimate the contribution of the auto sector in terms of value addition, employment, and foreign exchange savings, notwithstanding the availability of various claims, suffice is to state that the contribution is substantial and quite visible in the economy.

Capacity and Production:

The automobile sector has shown an impressive growth during the past few years (Table 1). The major factors that have contributed in this upsurge are better performance of the economy, increase in the purchasing power of the general public, continued growth in the home remittances, and easy access to the financial assistance through attractive car financing schemes. With increasing of inflation and escalation in borrowing rates, the financial assistance for purchase of cars is still available and thriving. This phenomenon may be attributed to availability of excess liquidity in the financial Sector. The higher than production demand has resulted in long queue of customers waiting for delivery of cars for a period of 4 to 8 months despite making the full payments at the time of booking. The car dealers and speculators have invested heavily on booking of variety of cars models in advance and have developed a chain of delivery from the manufacturers. It has further increased the pressure of demand. Thus, a quick delivery requires payment of ‘premium’, which is fast declining due to the import of cars under the latest regime change.

[6] Source: Engineering Development Board, Islamabad

Table 1: Capacity and Production of Auto-Industry during Last 4 Years

Product	Capacity (Latest)	2001-02	2002-03	2003-04	2004-05
Cars					
Production	153,000	40,088	62,073	98,461	126,403
Sales		41,838	61,955	97,620	127,309
Trucks					
Production	24,550	1,134	1,929	2,022	3,345
Sales		1,208	1,883	1,868	3,345
Busses					
Production	4,800	1,086	1,296	1,380	1,762
Sales		1,065	1,332	1,363	1,605
LCVs					
Production	30,000	9,055	12,548	14,896	25,177
Sales		9,033	12,383	14,933	25,056
SUV					
Production		513	820	802	414
Sales		503	814	698	425
Tractors					
Production	50,000	23,801	26,240	35,770	43,200
Sales		24,001	26,832	35,900	43,578
Motorcycle					
Production	807,000	120,627	165,105	303,383	416,189
Sales		120,113	161,863	301,746	417,066

Source: Engineering Development Board and PAMA.

The sharp increase in demand has resulted in higher production of automobile during the past few years. The existing manufacturers have envisaged the ambitious plans for increasing their production capacity. The following Table 2 indicates company-wise future plans of expansion in their production capacity.

Table 2: Installed Capacity of Major Car Manufacturers with their Projections for 2012

Unit	Current Capacity	Projection for 2012	% Growth
Suzuki	80,000	250,000	212.5
Indus Motors	37,000	130,000	251.4
Honda	30,000	60,000	100.0
Dewan	15,000	48,000	220.0
Nissan	6,000	15,000	150.0
Total	168,000	503,000	199.4

Source: Engineering Development Board, Islamabad.

Vendor Industry

The vendor industry has passed through several stages of development and has achieved a level where some of the products are being exported. This verifies that efforts to improve quality and maintain quality control have started yielding dividends and therefore materializing its strength by retrieving its share from the international open market of the industry. The table indicating the major products of the auto vendor industry is given below.

Table 4: The Products of Vendor Industry in Pakistan

Domestic Use	Domestic Use and Exports	
Piston	Wheel Rims & Spokes	Filters
Wheels	Timing Gears	Forged Machine Parts
Engine Valves	Transmission	Rubber
Seat Belts	Gear Box Shafts	Break Disc
Gaskets	Silencer and Exhaust Pipes	Axle
Bumpers	Piston Cylinder Liners	Heat Treated Steel Components
Tyres	Engine Valves	Tractor's Wheel Rims
Shock Absorbers	Hand Breaks	
Rubber Trims	Radiator Cop Assy	
Gears	Saddles	
Radiators, Auto Air Conditioners	Seat of Motorcycles	
Silencer and Exhaust Pipes	Hub & Fire Wheel	

Source: Engineering Development Board, Islamabad

The technical processes available for the manufacturing of auto parts include designing, forging, casting fabrication, plastic & rubber molding, machining, mould & Die manufacturing, press work, electrical and electronic component assembly, 3-D laser scanner and CAD/ CAM.

It is important to note that vendor industry is surviving due to its cost effectiveness. After the full compliance of TRIM as per WTO arrangements, some of the local vendors have developed better technical and production efficiencies with the collaboration of foreign companies (see Table 5 below) that have allowed them to compete within the highly competitive environment.

Table 5: Technical collaboration of Vendor Industry with Foreign Companies

Components	Collaborating Company	Vendors in Pakistan
Shock absorbers	Showa, Kayaba Japan.	M/S Honda Atlas Ltd
		M/S Agri Auto Ind.
Radiators	U.E. Radiators Japan	M/S Alwin Engg.
	Toyo Radiators Japan	M/S Loads Pvt.Ltd
Car A/C	Sanden, Denso Japan	M/S Sanpak, M/S Thal Engg
Radio Cassette Player	Panasonic Thailand	M/S Automate Ind.
Lamps	Koito Japan	M/S Techno Pak
Spark Plugs	NGK Japan	M/S Shaigan Electric
Glass	NGS Japan	M/s NGS Pak
Steering Case Set	I.S.Seiseki Japan	M/S Polymer & Precision
Brake Drum Assembly	Nissin Kogyo Japan	M/S Alsons Auto Ltd

Source: Engineering Development Board, Islamabad.

Deletion Policy or Local Content Requirement (LCR)

With the objective to encourage development of a domestic component industry and consistent and sustainable technical infrastructure for manufacturing of automobile industry, the government adopted a deletion policy and imposed the condition of local content requirement. This policy not only created jobs and reduced the effect on the balance of payments of imports of vehicle parts, but also stimulated domestic technological capability more generally through spill over effect. It was further enhanced by joint ventures between local companies of the domestic component industry and transnational companies. The periodic levels of deletion for cars, LCVs, motorcycles, tractors and buses are fixed on the basis of technology levels prevalent in the engineering industry of Pakistan. The industry-wise ISDP targets adopted for the last five years are given below.[7]

Table 3: Industry Specific Deletion Targets (ISDP) - Automotive Sector

Products	2001	2002	2003	2004	2005
CARS (800 CC to 1200 CC)	50-70	53-70	56-70.25	59-70.5	62-71
TRACTORS					
Between 40 & up to 80 HP (2x2)	82.50	62.5-83	65-83	68-83	69-85
Above 80 HP (2x2) and (4x4)	0.00	0.00	45-65	47-66	50-67
MOTOR CYCLES (70 CC to 175 CC)	74-83	81-85	82-86.5	83-88	84-90
COMMERCIAL VEHICLES					
Different Capacities	42.7-63	42.7-65	42.7-67	42.7-67	43.7-68
BUSES (30 t0 75 Passengers)	44.7-46.5	45.8-47.5	47-48.5	47-50	48-52
SPORTS UTILITY VEHICLES (SUV) 4x4	0.00	40.00	43.00	45.00	48.00

Source: Engineering Development Board, Islamabad

The latest position regarding local content level achieved in manufacturing of automobiles include 50-70% for cars, 43-88% for tractors, 84-90% for motorcycles, 50-55% for commercial vehicles and 43-52% for buses and trucks.

High Protection to Automobile Industry

The manufacturing of automobile industry has been enjoying high protection for decades in Pakistan. The long period protection was provided on the grounds that the industry being at the initial stage required due support to attain self-sufficiency in manufacturing of vehicles. However, this nourishing treatment resulted in inefficiency within the industry as well as higher cost to the consumer. The absence of competitive environment provided easy opportunities for the manufacturers to make profits and therefore, the growth in the field of R&D left far below than other parts of the world. A

[7] Indicative targets keeping in view that the tariff based system to be put in place at an appropriate time to ensure promotion of indigenization in line with our international commitments.

periodical picture of customs tariff on the imports of automobile is given below (Table 6).

Table 6: Rates of Customs Duty on Imports of Automobile

Period	Cars	Buses	Tractors
1981-82	70 – 350	50	20
1991-92	100 – 435	80	10 – 20
2000-01	100 – 250	20	30
2002-03	75 – 200	20	30
2003-04	75 – 150	20	30
2004-05	50 – 100	20	10 – 30
2005-06	50 - 75	20	10 – 30

Source: Respective Customs Tariffs, CBR, Islamabad

It is evident from the above table that the undue protection remained in place in the past. The tariff rate of automobile sector remains as one of the outliers in the tariff structure of Pakistan.

Revenue Receipts

The automobile industry is contributing favorably to the exchequer in the form of taxes, especially indirect taxes. Nonetheless, the industry, as a whole, has contributed Rs. 3.8 billion in Income Tax collection during 2004-05, which was only about 2% of the total direct tax receipts. Given the rather meager amount of direct taxes, there is a need to have a detailed and in-depth review of the automotive sector so that a consistent relationship between production, sales and profitability could be developed for accurate assessment of tax liabilities. The following Table 7 highlights the income tax collection from some of the major players in the automobile industry.

In terms of indirect taxes, the automobile industry has generated significant amount of taxes in the shape of sales tax and customs duties. This has been due to substantial increase in the imports of completely built, completely knocked down and semi-knocked down (CBU, CKD, SKD) Cars and auto parts. It is worth emphasizing that the collections of indirect taxes from the automobile sector should not be regarded as the taxes paid by the industry, as the burden of these taxes is passed on to the consumers – the typical forward shifting of indirect taxes. Nonetheless, the significance of the industry as primary generator of economic activity and taxes cannot be denied.

Table 7: Collection of Income Tax from Major Automobile Industries

Rs. in Million

Name of Company	2001-02	2002-03	2003-04	2004-05
Pakistan Suzuki Company Limited	365.4	471.2	1426.9	845.6
VPL Ltd	265.1	526.0	657.3	788.6
Indus Motor Company	219.1	477.7	1058.2	725.2
Atlas Honda Ltd.	160.7	308.1	265.1	207.0
Hinopak Motors Ltd.	47.4	63.2	44.2	126.0
Millat Tractors	249.2	175.4	204.3	170.2
Al-Ghazi Tractors Ltd.	309.8	470.1	306.3	597.9
Sub-Total	1616.7	2491.7	3962.3	3460.5
Share (%) in Total Income Tax of Auto Industry	81.9	86.1	87.6	90.0

Source: PRAL, Islamabad

The overall collection of taxes from the automobile sector during the past four years is given below in Table 8.

Table 8: Collection of Federal Taxes from Automobile Industry

(Rs. Million)

Tax Head	2001-02	2002-03	2003-04	2004-05
Sales Tax	5,579	8,871	11,432	17,429
Customs Duty	5,528	9,370	12,826	23,585
Withholding Tax	278	564	870	1,515
Income Tax	1,973	2,893	4,521	3,846
Total	**13,658**	**21,698**	**29,649**	**46,375**

Source: CBR Wings, DRS and PRAL

A Lesson from the History

In 1990s, the automobile industry in the developed countries reached at its maturity and got plagued with overcapacity, cost pressure and low profitability. This stagnation of production and sales in the developed countries lead the global producers towards developing countries so as to get the benefits of economic expansions in those regions and spreading vehicle development costs; for establishing cheap production sites. At the beginning of the 1990s, the ten largest vehicle assemblers had 28 light vehicle assembly plants in the leading emerging markets. Till the end of the decade, the number of assembly plants rose to 62. The rush to invest was driven by oligopolistic competition between global auto companies. This created over-investment in several parts of the world so that capacity increases greatly exceeded any realistic short-term sales expectations. This can be well illustrated by the cases of Brazil, India and Viet Nam where the leading multinational companies entered the market and invested heavily. The major factors that played vital role in attracting the foreign investment were:

1) Consistency in the policies;
2) Political stability;
3) Sufficient guarantee for the safety of investment and better economic condition.

Foreign investment provides a gateway for adopting advance technologies and provides impetus to overhaul the industrial profile and provides favorable environment to local industry to transform into modernization through spill over effect. Pakistan, during this period was caught by political instability, uncertain and inconsistent economic policies and uncertain future of foreign investment. This environment restricted the leading automobile manufacturers to enter in the market. However, with improvement in the environment, foreign investment has started to pour in. The automobile industry had also jumped on the band wagon and enjoying the benefits of doing business in one of the growing economies.

Issues and Concerns

A collective view of production/ assembly pattern of automobiles, capacity utilization of the existing facilities, excess demand by consumers and resultantly rent seeking by people with vested interest presents an untenable and unexplainable phenomena prevalent in the automobile sector of Pakistan. Strangely enough, despite significant increase in demand, the capacity utilization has remained low (Table 9). One of the reasons given by the producers has been the limited capacity of the vendor industry that is unable to catch-up with the demand of the producers. The vendor industry while acknowledging this claim argues that the increase in capacity has been a relatively recent phenomenon. As the time progresses, the vendor industry should be able to meet the additional demand of the producers. This justification appears to be as murky as the entire business of auto-industry in Pakistan. The businesses are generally not run on *ad hoc* basis. Rather there is a complete cost-benefit analysis not only for the short-run, but also for medium to long-run.

Meanwhile, the consumers have to pay for their 'excess demand' in the shape of premium or 'On Money' if they want to have immediate delivery. In the past, the additional money requirement ranged between Rs. 75, 000 and Rs. 150, 000 depending upon the make of the car. Even now this amount remains in place, albeit with small reduction. Needless to add that such gains in the business promote non-productive rent seeking activities that are mostly undocumented and therefore remain outside the tax net.

The booking procedure and delivery of vehicles by the industry needs a thorough investigation. The advance full payment has now become a rule rather than exception even though the delivery takes several months. To add insult to injury, while the consumers are asked to pay extra for currency depreciation that may have been encountered between the time of full payment and delivery date, they are never compensated for any appreciation of the currency. Similarly, the interest income that the auto-assemblers accrue on holding advance payments for up to a year never gets any mentioning in the books of account and consumers are again left high and dry.

The exemption obtained for the deletion program till 2003 and subsequent applied extension till 2005 is now over and the government has to submit the compliance as per WTO agreement signed by the GOP. Whereas the vendor industry has acquired reasonable competence in some of the products, its operations are mainly concentrated in labor-intensive low-technology products. In order to increase the strength and capability of the vendor industry, additional measures are required to promote investment in high-tech equipment so that the auto-industry continues to rely on domestically produced products. This shift from labor-intensive to technology-oriented products will initially require technology transfer treaties with leading manufacturers due to limited investment in R&D by the vendor industry. The cross-country experience confirms that this approach has been adopted by many East-Asian economies who are now reputed car producers. Simultaneously, the emphasis should also continue on a new tariff based system (TBS) to protect local manufacturers of auto parts and accessories.

Within the same context, an additional bottleneck in development of overall engineering sector in general and the automobile sector in particular has been the shortage of skilled and technical workforce. One of the reasons for this malaise is the absence of national level strategy towards human resource development (HRD) and management. There appears to be ample room for collaboration between the industry and educational institutions to regularly produce skill and knowledge-based workforce for the industry. If such a strategy can be successful in other sectors, including textile, it should also be so for the automobile sector!

Concluding Remarks

Notwithstanding the advantage of high protection, the automobile manufacturers in Pakistan have not been able to transform auto-industry into an internationally competitive structure. There are concerns about quality of its produce. The technological advantage acquired so far has been of low-value-added nature. The command over advanced technology appears to be a distant possibility. On its end, the Government has been fairly generous in providing concessions and protection to promote growth in the industry. However, it is still struggling to play its vital role as a catalyst to industrial growth in the country. Its stakeholders are disenchanted with the way goods are being produced and delivered. Huge funds are seen stuck up for months before automobiles are delivered. Unfortunately, customer satisfaction has not been a favorite topic among its producers and auto-dealers.

It is generally believed that the auto-industry is in take-off position. The recent improvement in the economy and the significant growth in the demand for automobiles have opened yet another window of opportunity for the industry to make necessary changes in its operations. There is a need to adopt confidence-building measures to ensure that congenial relationship is developed between the industry and its various stakeholders, particularly the consumers and the government.

III

Promoting Voluntary Tax Compliance: The Strategic Approach[8]

Background

The most important reason for any government to levy taxes is to raise revenue to meet its diversified expenditure needs. Some of the spending requirements include funds for poverty alleviation, maintenance of law and order and defence, social sector expenses on health and education etc. Other motivation includes redistribution of income and wealth and promotion of special goals set for various development and non-development activities. Consequently, the resource mobilization effort is spread over the three tiers of the government. Within this effort, revenue generation through taxation has the largest share. Over the years, importance has been concentrated on voluntary tax compliance by taxpayers rather than continuing with outmoded tax structure that is open to abuse. There is a definite shift from conventional tax collection system to functional operations.

Like other countries, achievement of high level of voluntary compliance through tax policy and administrative reforms is a top priority agenda of Pakistan. A broad ranging approach incorporating both, tax policy and administrative, features is being followed to achieve this objective. It is believed that simplicity of tax rules and procedures not only provide a hassle-free environment to the taxpayers, it also lowers the processing costs of compliance. Similarly, compliance is generally high when tax rates are low. Within this perspective, the purpose of this article is to revisit, analyze various issues concerning voluntary tax compliance and provide suggestions to further improve the system.

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[8] Author: Mr. Umar Wahid Secretary (Fiscal Research & Statistics Wing) CBR.

Voluntary Compliance

Voluntary Compliance has a direct relationship with the existing tax culture prevailing in a country. If a tax culture is developed on the basis of simplicity, equity and fair play with active public participation and collective thinking/ brainstorming, then voluntary compliance is expected to be higher. On the other hand if taxes are collected through coercive ways by adopting autocratic approach, then the voluntary compliance is generally lower. Invariably the tax culture in the developed countries is aligned with the public perception. Resultantly, compliance ratio to population ranges between 75-85%. This situation is completely opposite to most of the developing country where compliance to population ratio is low. Realizing this yawning gap, many developing economies have started initiatives to promote voluntary compliance through administrative reforms. Needless to add that the knowledge base of the society also grows with time, and civilization also takes roots in the governing system. The taxpayers also feel obliged to contribute towards national exchequer.

Like others, Pakistan has also made strenuous efforts in transforming the tax culture from conventional to operational functioning. The legacy taxation system in Pakistan was suffering from major weaknesses in the shape of complicated laws and procedures, high tax and tariff rates, wide array of exemptions, and many other distortions. Consequently, the taxation system was rendered inefficient and open to abuse. The concept of voluntary compliance was almost non-existent. In an effort to correct this situation, a comprehensive reform agenda focusing on wide ranging revisions in tax laws and procedures and tax and tariff structure, as well as improvement in tax administration was envisioned that has started to deliver.

Income Tax: In order to broaden the income tax base and encourage voluntary compliance a number of reforms measures have been initiated in the income tax structure with the promulgation of Income Tax Ordinance, 2001 effective from 13th September 2001. The objective was to simplify the language of the Ordinance by removing ambiguities for ensuring uniformity in treatment for various categories of taxpayers, reduce dependence on withholding taxes, and encourage voluntary compliance backed by strong audit and minimum tax exemption.

The introduction of the concept of universal self-assessment (USAS) for all categories of taxpayers, without any conditionality has been a major break through. Under this system all the taxpayers automatically qualify for self-assessment. The concept of immunity from selection of cases for audit has been done away with. The returns received are no more examined (assessed) in detail at the time of receipt. However, a limited percentage of cases are selected for audit on risk assessment basis for various classes of taxpayers. One of the important features of the USAS has been the requirement of maintenance of accounts and related documents by the taxpayers for ensuring effective audit.

On the administrative front, special tax departments have been established to cater to the needs to large and medium taxpayers. The objective of these model units has been to reduce compliance cost for the taxpayers and encourage voluntary compliance.

These changes have started to contribute positively. The return filers have increased from 1 million to 1.23 million between FY 2002-03 and FY 2004-05. It has been estimated that the income tax filers will increase by 20% at the end of the year 2005-06. The voluntary compliance has improved significantly. From a negligible growth of 0.3% in FY 00-01, it has shot up to around a 13% in FY 04-05. More importantly, the share of voluntary payments in income and corporate tax receipts has jumped to around 37% in FY 03-04 and FY 04-05 (Table 1).

Table 1: Post-Reforms Performance of the Income Tax

(Rs. in million)

Revenue Heads	FY 02-03	FY 03-04	Growth (%)	FY 04-05	Growth (%)	%Age Share	
						03-04	04-05
Voluntary Payment	59.0	66.5	12.7	73.8	10.9	37.3	36.6
Collection on Demand	25.5	19.9	-22.1	17.5	-12.0	11.2	8.4
Withholding Tax.	85.0	91.8	8.0	111.6	21.6	51.5	55.0
Gross Income Tax	**169.6**	**178.2**	**5.1**	**202.9**	**13.8**	**100**	**100**

A significant improvement has been recorded in compliance to live cases ratio. This ratio increased to 71.2% in 2004-05 as against 66% in 2003-04. It is expected that in the CFY, the compliance ratio will improve further. However, further efforts to broaden the tax base and raise the level of compliance would always be fruitful, as the ultimate objective of compliance by every registered taxpayer is still far away. Nonetheless, the reform process has set the stage for better and improved performance.

Sales Tax: To broaden the sales tax base, and enhance voluntary compliance, a number of steps have been taken such as reduction in compliance cost, introduction of simplified schemes for small taxpayers and expanding the scope of tax by increasing the number of services liable to sales tax. Similarly, legislation to allow presumptive taxation together with improving registration procedures have also ensured more compliant response from new business. These measures have been instrumental in increasing the registrant persons from 101,851 in 2003-04 to 115,702 in 2004-05, showing a growth of around 14%. For the CFY 2005-06, a target of 15% increase in new registration has been set.

In terms of specific numbers, tax compliance is sales tax (which is voluntary in nature, as the system operates under self-assessment) has been around 70%. The 69.8% compliance in 2004-05 has been due to de-registration of retailers/ turnover manufacturers having capacity of less than five million turnovers. Many initiatives have been introduced to make the system more fair and easy. For example voluntary disclosure (before commencing of audit) does not attract penalties. To facilitate taxpayers, separate returns for different taxpayers have been designed. Electronic filing of return has also been launched in the CFY to facilitate the taxpayers and ensure transparency in the sale tax system.

Table 2: Sales Tax Compliance

(Numbers)

Years	Registered Taxpayers	Filers	Compliance (%)
2001-2002	144537	92769	64.2
2002-2003	156417	98664	63.1
2003-2004	163188	101097	62.0
2004-2005	**114952**	**80208**	**69.8**

It is expected that continuous interaction with the trade and business communities, greater moves towards education and facilitation of taxpayers, a constant improvement in rules and procedures, design of forms and invoices, publication of self help leaflets on VAT provisions, media campaigns, automation of tax administration and addressing taxpayers' queries in a meaningful way would help in evolving an environment where voluntary compliance would be encouraged.

Customs: The Customs department handles all the imports/exports activities carried out in the country through various entry and exit points. Thus the department plays a significant role and generates significant revenue for the CBR. Since the system of Goods Declaration (GDs) was largely manual, therefore, complaints pertaining to delay in clearance, under-invoicing and connivance between the taxpayer and tax administrators were too frequent. To address all these issues and also to introduce self-assessment system in the customs department, a major reform initiative with the objective to ensure hassle free and speedy declaration of goods was introduced. The Prime Minister inaugurated the CARE project in April 2005. At the first stage the project has start functioning at Karachi International Container Terminal (KICT). However, soon it has been replicated in all the customs collectorates. This project has introduced computerized Processing of Customs documents (PACCS) under which the GD can be filed by an importer on-line without physical interaction with customs officials. The processing has reduced the clearance time of goods to few hours from more than ten days. This is a major step towards customer facilitation that has reduced the up-front cost of doing business considerably. This new system has revolutionized the working of Pakistan customs, which is now at par with the modern set ups. Simultaneously, the One-Customs concept has also been introduced that allows equal treatment to all taxpayers at each entry and exit points. The evidence confirms that both these systems have been instrumental in promoting voluntary compliance in country.

Federal Excise: A major policy change has been introduced in the CFY budget regarding federal excise. The system of self-assessment has been introduced by withdrawal of federal excise staff from the manufacturing units. The idea is to improve the confidence of taxpayers that should promote voluntary compliance. Similarly, the federal excise Act has been transformed in conformity with the sales tax Act and the registration procedure has been changed. The sales tax registration number will be sufficient for the federal excise taxpayers as well. The mode of payment has also been rationalized to provide relief to the taxpayers.

Issues and Concerns

With the introduction of tax policy reforms in CBR, the tariff rates have been rationalized, uniformity in GST rates has been ensured and also reduction in the corporate rates are the major policy shift from protection to openness. The tax administration reforms has provided relief to the taxpayers through simplification of rules and procedures, better facilitations and ensuring minimum interface between the taxpayer and the tax collector. These measures no doubt have improved revenue realization and also increased the level of voluntary compliance to a greater extent, but the tax base and the level of voluntary compliance in Pakistan remaining low as compared to the emerging economies. On the part of CBR, greater efforts are needed to launch a massive campaign against tax evaders and defaulters, who have seriously hampered the revenue mobilization efforts of the Government. There is a need of fresh assessment of all those concessions and exemptions which are being enjoyed over the years. Capital gains tax should be broadened as much as constitutional restrictions allow. Until these and other distortions are not corrected, the tax base and resulting tax-GDP ratio will remain low and stagnant. Some of areas where further effort is required are discussed in the following.

- Taxpayers' perception holds key to success. Thus, the need for internal and external surveys should be a priority agenda item;
- Utilization of third party information has become absolute necessity. Even though major emphasis has been laid on this in recent months, the time is now ripe to materialize this inter-connectivity. 'NEXUS' is a definite way forward, that needs to be operationalized on urgent basis;
- The tax potential areas that are currently outside the tax net for one reason or the other need to be taped so that the principle of equity and fairness are established. To this end, a number of sectors have already been identified whose contribution towards taxes is far too low as compared to their share in GDP. Better strategy is needed to bring income of transporters, large formers, wholesalers and retailers, bankers and insurance agents into the tax net. Similarly, taxation of capital gains (both in capital market and real state) still remains elusive;

- Economic activities in certain areas continue to remain outside the tax net. For instance, the activities in FATA/PATA are exempted from taxation except salary received by the Government employees posted in these areas, property income if derived from a property located in settled areas. Without going into political economy of the reasons behind these exemptions, it is valid to state that serious distortions in the taxation system could not be rectified if equal treatment is not effectively implemented in all areas;
- Ironically, religious factor also plays a role in noncompliance of tax payment. The preaching for payment of Zakat and Usher being the only religious levy and its distribution on the free will of individuals has created doubts about government taxes in certain minds. To them tax evasion is not a delinquent act, as they are fulfilling their religious obligations. An open debate is needed to promote tax compliance within this specific category.
- Lack of education is one of the leading factors contributing to non-compliance. There are instances where people are found ignorant about their tax obligations while concerted effort has already been undertaken towards taxpayers education and facilitation, a large part still remains uncovered.
- On CBR part, besides administration reforms a monitoring approach needs to be adopted for proper record keeping of the taxpayers. In the past the record keeping of CBR taxpayers was extremely ordinary. Multiple numbers were in vogue and it was difficult to determine tax liabilities of different taxpayers. Now the effort on adoption of a unique taxpayer identification number (TIN) and its linkage with sales tax registration number has already progressed. To streamline the process and remove duplications all infructuous cases are being deleted. With the progress on this area, CBR would have a clean tax base to project tax liabilities and collection.

Conclusion

The world is undergoing rapid changes every day. This is an era of competition. Protective barriers are falling. The cumbersome laws and procedures are being replaced. Simplicity and automation of business processes are the taking central positions in conducting businesses. With growing needs for resources, the tax collection procedures are being modified. Pakistan has also modified its taxation system – the system of full scrutiny of tax returns has given way to a system of self-assessment. The taxpayers are now treated differently. Rather than having an adversarial relationship, they are treated as partners in growth. The hindsight is that better understanding of each other – i.e., the taxpayers and the tax administrators would promote voluntary compliance. The recent evidence provides due support to the argument that mutual trust has been rewarding for everyone. Hopefully, the new tax culture would strengthen further as the time progresses.

IV

Electronic Filing of Tax Returns: Beginning of a New Era[9]

Introduction

During the last decade transfer of business information electronically has expanded very rapidly in the world. Tax return is no exception and electronic filing has become a common place. As part of major initiatives to facilitate taxpayers and collect and process data more accurately, CBR introduced e-filing of income and sales tax returns from December 2005. Whereas e-filing of sales tax returns is mandatory for persons registered in the jurisdiction of LTUs and private and public limited companies registered in LTUs and other collectorates of sales tax, filing of income tax return in electronic form has not yet been made compulsory.

Objective

CBR is using catch phrase like 'filing of return has never been easier' to attract taxpayers to file their returns electronically. The fact that manual filing was not only error prone and time consuming it was also a sheer duplication of effort. Thus, the major objective of introducing e-filing is to make the process of filing tax return easier and transparent for the taxpayers and to reduce the time required for data entry.

Procedure

Before filing e-return a person needs to obtain Digital Certificate from National Institutional Facilitation Technologies Pvt. Ltd. (NIFT) who have been entrusted with hired for this job by CBR. Step by step procedure for obtaining the certificate is as follows:

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[9] Prepared by Robina Ather Ahmed, Chief (FR&S) and Mr. Naeem Ahmed Second Secretary Fiscal Research and Statistics Wing, CBR.

- Download the Digital Certificate Request Form from NIFT website;
- Submit filled Digital Certificate Request Form to NIFT along with a copy of CNIC/ NTN certificate and a demand draft/ pay order for Rs. 2500;
- Obtain Digital Certificate from NIFT and install it inside PC’s e- mail client (Outlook Express or MS Outlook);
- Download MS Excel based, blank tax e-forms (and filing instructions, if desired) from CBR’s website;
- Save the downloaded tax e-forms on PC’s local storage device;
- Fill all required information in the downloaded tax e-form and save it with a new file name;
- Send it through e-mail;
- CBR would send an acknowledgement receipt.

Analysis of Returns filed electronically

Five thousand taxpayers have obtained have obtained Digital Certificates from NIFT up to February 2006. CBR has started receiving e-returns of sales tax from January 2006. Though limited, yet data of returns received gives some idea about the response of the taxpayers to this facility and the problems faced by them. As anticipated, the collectorate wise break up of returns indicates that there is substantial increase in the number of returns filed in February 2006 as compared to January 2006.

Issues/ Concerns

There are certain concerns about the new system. These include: improper response and acknowledgement of returns by CBR, difficulty in digital signing, problems in sending returns through e-mail and entering data in payment information etc. Of these, the security appears to be the major concern. It includes role of e-intermediaries, smart card and digital certificates. E- Intermediaries are the persons filing return on behalf of the taxpayers. It needs to be ensured that taxpayer's tax return is not viewed by anyone other than the relevant person.

There also seems to be an apparent discrepancy between the number of registrants with NIFT and number of returns filed. Further probing has revealed that the duplication has occurred because some of the taxpayers observing some delay in getting the acknowledgement from the system had sent second and third copies of returns. This teething problem is being rectified.

Conclusion

The level of sophistication reached by the developed countries shows that technological improvement is an ongoing process, which requires significant amount of planning, commitment, experience and resources. While the service provided would be beneficial to the taxpayers, CBR needs to create an environment wherein the users feel secured about filing returns on line. With a population that is largely not tech savvy, the success of the entire exercise hinges on whether CBR could create a sense of comfort in users' minds. There is need to provide a system including laws and procedures along with technology that is cost effective, secure and easy to use. There is further need to substantiate the services with other related facilities like e-refund payment, e-delivery of certificates etc. It is also important to note that all the benefits cannot be reaped in the very first year. The system will take some time to mature and give desired results.