# CBR Quarterly Review

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**A Review of Resource Mobilization Efforts of Central Board of Revenue**

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## The Economy

Notwithstanding the uncertainties associated with international and domestic events, Pakistan's economy continues to stay on the path of recovery. The anticipated slowdown after the September 11 events has remained rather mild. The economy has withstood the impact of falling external demand due to slowdown in developed economies, particularly in USA and the *Euro* region, and the continued recession in Japan -- one of Pakistan's leading trade partners.[2] The financial market has 'quietly' absorbed the spillover effects of shocks emerging from corporate America. Similarly, the contagion from the crisis in Argentina as experienced by other emerging markets has been almost negligible. The incessant improvement in macroeconomic fundamentals confirms that the upswing, which started in the fourth quarter of the foregoing financial year, has continued in the first quarter of FY 02-03 as well.

The provisional trade-related figures indicate that goods worth US$ 2.26 billion were exported from Pakistan during July-September 2002, showing an increase of 13.98% over 1st quarter of PFY. Similarly, goods worth US$ 2.78 billion were imported, reflecting an increase of 11.11%. Consequently, the balance of trade has reduced to US$ 201.2 million in Q1 02-03. In terms of exports, the textile sector has provided the necessary impetus to growth, as textile manufactures exports increased by 14.87% in the 1st quarter. A double-digit growth of up to 31.47% was registered for cotton

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[1] This document is prepared by the Fiscal Research Wing of CBR in collaboration with the Budget Wings of Direct & Indirect Taxes and Directorate of Research & Statistics.

[2] According to the *World Economic Outlook (April, 2002)* of International Monetary Fund, there are increasing signs that the global slowdown has bottomed out. However, the outlook for Japan remains difficult with few signs of sustained recovery in domestic demand.

cloth, bed wear, towels and readymade garments. On the other hand a declining trend continued for exports of leather garments due to high cost of production that has eroded its competitiveness in relation to other exporting countries like China. Likewise the exports of sports goods, surgical and medical instruments, and carpets also declined by 3.8%, 29.58% and 6.08%, respectively.[3]

As far as imports are concerned, there has been an increase in the imports of electrical and power generating machinery and agricultural chemicals in the 1st quarter of current fiscal year (CFY), but the same is not true for imports of petroleum crude and products, construction and mining machinery, and iron and steel. Similarly, within the food group, the imports of milk and milk food for infants, spices, and palm oil have shown an increasing trend, but soybean oil and sugar imports have declined during this period. All in all, the value of imports increased from Rs. 160.0 billion in Q1 01-02 to Rs. 172.5 billion in Q1 02-03, yielding a growth rate of 7.8%. Similarly, the value of dutiable imports has increased from Rs. 94.6 billion to Rs. 103.8 billion, showing an increase of 9.7% during the 1st quarter of CFY over past fiscal year (PFY).[4]

However, despite these favorable trends in the external trade sector, which are reinforced by improvement in foreign direct investment, firmness in the capital market, and the record level of foreign exchange reserves, the economy has not gained enough strength to register significant improvement in the overall growth. Partly due to low levels of savings and investment rates and near-stagnation in the agriculture sector, the growth of (real) GDP remains subdued. The manufacturing sector continues to exhibit mixed trend, as has been the situation with investors' confidence. The month-to-month

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[3] The analysis is based on Advance Release on External Trade Statistics by the Federal Bureau of Statistics (September, 2002).

[4] CBR is the source of data related to imports and dutiable imports.

increase in prices, especially of food, fuel and lighting, education and health sectors, is a source of escalating cost of living of low-to-medium income groups. The dreary growth and distributional aspect related to growth, therefore, remain critical areas of concern in view of the increasing incidence of poverty.

### CBR Revenue Target for FY 02-03

Assuming that the nominal GDP at market prices will grow by 9.2% during FY 02-03, non-agriculture (nominal) income and large-scale manufacturing (nominal) income by 10%, imports, dutiable imports and exports (at current prices) by 12.1%, and dollar-rupee parity will remain stabilized, the budgetary revenue target for FY 02-03 has been fixed at Rs. 460.6 billion, which is 11.4% of GDP.[5] This target envisages an increase of 14% over actual collection of Rs. 403.9 billion in FY 01-02. A comparison of the budgetary targets of major taxes with actual collection indicates that an increase of 4.08% has been anticipated for direct taxes, 23.68% for sales tax, 17.53% for customs duties and 6.56% for central excise duties *(Table 1)*.

**Table 1: A Comparison of Actual Collection and Target: FY 2002-03 over FY 2001-02**

*(Collection in Rs. Billion)*

| | Collection FY 01-02 | Target FY 02-03 | Difference (percent) |
|---|---|---|---|
| **Direct Tax** | 142.589 | 148.400 | 4.08 |
| **Sales Tax** | 166.316 | 205.700 | 23.68 |
| **Customs Duties** | 48.072 | 56.500 | 17.53 |
| **Central Excise** | 46.920 | 50.000 | 6.56 |
| **Target** | **403.897** | **460.600** | **14.04** |

It may be added that due to shifting of duties on POL products from central excise to customs, a slight readjustment in revenue targets of

[5] The following regression equation describes the tax to GDP relationship in a simplified way:

$$\log(\text{Tax Revenue}) = -1.81 + 0.974 \log(\text{GDP at market prices})$$
$$(-10.99) \quad (82.23)$$
$$R^2 = 0.997 \qquad D.W. = 1.64 \qquad F = 6761.95$$

Based on the elasticity estimate of 0.97 and the projected value of nominal GDP at market prices, the CBR revenue target for FY 02-03 is estimated to be Rs. 453.4 billion. Together with tax and special measures, this figure coincides with the budgetary target for FY 02-03.

these two categories has been made without altering the overall revenue target for the year.

Some of the major fiscal initiatives introduced at the time of the Budget 2002-03 are briefly reproduced in the following. It may be added that the net impact of all these measures is Rs. 6.99 billion.

a) *Increase in Basic Threshold of Income Tax*: In an effort to provide relief to low and low to medium income groups the minimum threshold of exemption from income tax for individuals (and association of persons) has been raised from Rs. 60 thousand to Rs. 80 thousand. The income slabs and the revised rate structure are as follows:

| S.No. | Taxable Income | Rate Structure |
|---|---|---|
| 1. | Where taxable income does not exceed Rs. 80,000. | 0% |
| 2. | Where taxable income exceeds Rs. 80,000 but does not exceed Rs. 150,000. | 7.5% of the amount exceeding Rs. 80,000. |
| 3. | Where taxable income exceeds Rs. 150,000 but does not exceed Rs. 300,000. | Rs. 5,250 plus 12.5% of the amount exceeding Rs. 150,000. |
| 4. | Where taxable income exceeds Rs. 300,000 but does not exceed Rs. 400,000. | Rs. 24,000 plus 20% of the amount exceeding Rs. 300,000. |
| 5. | Where taxable income exceeds Rs. 400,000 but does not exceed Rs. 700,000. | Rs. 44,000 plus 25% of the amount exceeding Rs. 400,000. |
| 6. | Where taxable income exceeds Rs. 700,000. | Rs. 119,000 plus 35% of the amount exceeding Rs. 700,000. |

b) *Reduction in Income Tax Rate of Banking and Private Companies*: Prior to the announcement of this fiscal measure, banks, public and private companies were taxed at the rate of 50%, 35% and 45% respectively. To create parity in income tax rates, there will be a gradual reduction in tax rates for banking companies and private companies by 3% and 2% respectively every year to bring them down to 35% in the next five years.

c) *Levy of GST on Vegetable Ghee/ Cooking Oils*: In accordance with the Government policy of minimizing the exemption regime, sales tax @ 15% has been levied on vegetable ghee/ cooking oil. Prior to the announcement of this measure, edible oils were chargeable to sales tax @ 15% on importation. Similarly, the sales tax rate on imported raw materials remains higher at 20% to favor the compliant sector against those who indulge in malpractice of direct sale.

d) *Lowering the Maximum Duty Rate and Rationalization of Tariff Structure*: Lowering of the maximum duty rate and tariff rationalization are on-going processes of tariff reforms. Besides rationalization of duty structure on many items, the maximum tariff rate was reduced from 125% to 90% in FY 91-92 as a major policy initiative. Subsequently, the maximum rate of duty was reduced gradually to 35% by FY 98-99. It has been further reduced from 30% to 25% in FY 02-03. Major items included in this reduction are 2143 tariff lines comprising items such as tea, tyres, iron and steel products, paper, plastics and articles thereof, textile and textile articles and auto parts etc. Now the four customs duty slabs are 25%, 20%, 10% and 5%.

e) *Adjustment of Duty Structure on Petroleum Products*: In order to bring operational efficiencies, the minimum 10% rate of return guaranteed for the three refineries of the country has been abolished. Instead import duty @ 10% on import of HSD and 5% on import of Kerosene, LSD and JP-4 has been introduced through tariff protection formula.

Additionally, 1% surcharge has been levied on these items except HSD. Simultaneously, the existing central excise duty on these items has been abolished in view of the fading nature of CED.

## Monitoring CBR Revenue Collection

Given that CBR performance is measured *solely* by its revenue collection efforts, which incidentally also serves as one of the performance criteria of the IMF, CBR has projected monthly and quarterly targets of the four taxes to monitor collection on monthly basis. In this respect rather than relying on arbitrary procedures to fix the quarterly targets, the average collection of past five years (ranging between FY 97-98 and FY 01-02) has been used as the benchmark. Slight adjustment was then made to this benchmark in the light of the most recent outturn. Accordingly, the revenue target for the July-September 2002 has been fixed at Rs. 90 billion, which constitutes about 19.5% of the yearly target *(Table 2)*.

**Table 2: Monthly and Quarterly Targets of Federal Taxes: FY 02-03**

*(Rs. Billion)*

| | Direct Taxes | Sales Tax | Customs Duties | Central Excise | ALL TAXES |
|---|---|---|---|---|---|
| July | 4.8 | 12.3 | 3.9 | 2.6 | 23.6 |
| August | 7.5 | 13.5 | 4.6 | 3.9 | 29.5 |
| September | 10.9 | 16.6 | 5.3 | 4.1 | 36.9 |
| *Quarter: 1* | *23.2* | *42.4* | *13.8* | *10.6* | *90.0* |
| October | 12.8 | 15.6 | 2.8 | 3.6 | 34.8 |
| November | 9.5 | 15.8 | 2.9 | 3.6 | 31.8 |
| December | 20.5 | 16.2 | 3.5 | 3.7 | 43.9 |
| *Quarter: 2* | *42.8* | *47.6* | *9.2* | *10.9* | *110.5* |
| January | 13.5 | 16.2 | 4.1 | 3.7 | 37.5 |
| February | 8.9 | 16.3 | 4.6 | 3.8 | 33.6 |
| March | 12.7 | 16.4 | 5.3 | 4.2 | 38.6 |
| *Quarter: 3* | *35.1* | *48.9* | *14.0* | *11.7* | *109.6* |
| April | 11.1 | 17.4 | 5.9 | 4.1 | 38.5 |
| May | 12.1 | 22.8 | 7.5 | 4.5 | 46.9 |
| June | 24.3 | 26.6 | 8.6 | 5.7 | 65.2 |
| *Quarter: 4* | *47.4* | *66.8* | *22.0* | *14.3* | *150.5* |
| **Full Year** | **148.4** | **205.7** | **59.0** | **47.5** | **460.6** |

A further examination of revenue targets points out that there is an increasing emphasis on sales tax and direct taxes as the two major revenue spinners. Nearly 47% of the 1st quarter net collection comes from sales tax and 26% from direct taxes. A similar composition of federal tax receipts has been maintained for 2nd, 3rd and 4th quarters of CFY. Thus, the revenue targets for the forthcoming three quarters are fixed at Rs. 110.5 billion, Rs. 109.6 billion, and Rs. 150.5 billion, respectively.

**CBR Revenue Position**

*The revenue organization has successfully achieved the revenue collection target of Rs. 90 billion for the first quarter of FY 02-03.* This achievement becomes even more creditable when viewed in the light of withdrawal of sales tax on pharmaceuticals, whose impact worth Rs. 2.5 billion was included in the FY 02-03 revenue target. While a number of factors have contributed towards this accomplishment, nonetheless it would have been still not possible without undertaking various policy initiatives at CBR and the general improvement in the overall macroeconomic environment, essentially through vibrant external sector.

The CBR on its end has initiated wide-ranging reforms for institutional strengthening and governance capacity building. The most important step in this direction has been the redesigning and reorganizing tax administration on ‘functional’ rather than the ‘type-of-tax’ basis. Other measures include: gradual elimination of individual-specific SROs, dispute resolution – a major irritant in the eyes of stakeholders, simplification of audit and related rules and procedures, taxpayers’ education and facilitation through print and electronic media, workshops and seminars, and improvement in the quality of the work force through human resource management. The use of information technology and dissemination of fiscal initiatives under the rubric of fiscal transparency have also been introduced to improve the *status quo* without faltering in between.[6]

***Overall Collection and Refunds***

Historically the growth in federal tax receipts is somewhat slow at the start of new fiscal year but the collection picks up gradually during the year before reaching its peak in the 4th quarter. At the same time, the 1st quarter growth on year-to-year basis is usually not high. For instance, the average of the first quarter growth for the past five years has been 6.5% only, with negative growth recorded in FY 98-99 and FY 01-02. Compared to this historical profile, the 1st quarter growth for the current year has been 16.6%. The monthly data further confirms that a double-digit growth in net collection was registered in the first three months of CFY. From a high growth of 20.1% for the month of July, the growth in net collection declined to 10.2% in August but to rise again in September to reach 20%.

In absolute terms, the gross and net collection for Q1 02-03 has been Rs. 112.535 billion and Rs. 90.350 billion, respectively. The refund payments of Rs. 22.185 billion during this period show an increase of 5.2% over the 1st quarter of PFY. Thus, the improvement in collection has been achieved without restricting refunds/ rebates. Secondly, the 16.6% growth in net collection has exceeded the projected annual growth of 14.04% for the FY 02-03.

To gain further insight, a comparison of gross and net collection and refunds during 1st quarter of current and past two years is presented in *Graph-1*. It transpires that while there has been a consistent increase in gross collection but the same is not true for net collection. The dip in Q1 01-02 could be attributed to the 9-11 effect and perusal of generous refund policy in FY 01-02.

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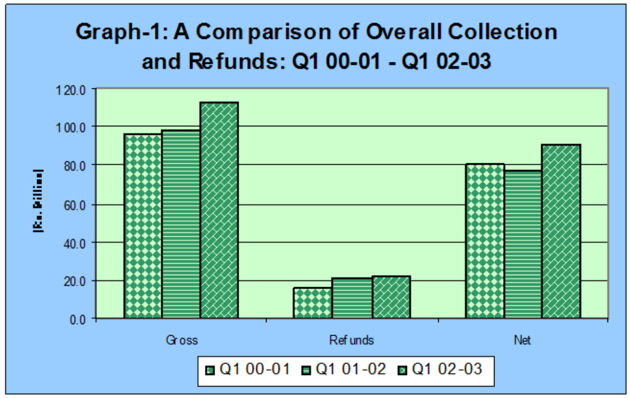
[6] CBR in collaboration with the World Bank has entered into a contract with M/s Maxwell Stamp PLC (a British based Consulting Company) to further strengthen the on-going process of tax reforms in Pakistan. The Consultants have already started work after arriving in Pakistan in September 2002. They are currently focusing on MIS, Audit, Taxpayers Education and Facilitation, and HRM.




***Detailed Analysis of Individual Taxes***

With an improvement in domestic economic activity and the external trade sector, there has been an improvement in collection as well. The 1st quarter data of CFY confirms that the healthy 'overall' growth in gross and net collection has been the result of a similar performance exhibited by major taxes, especially direct taxes, sales tax and customs duties. To explain this pattern of growth, a detailed analysis of individual taxes is carried out in the following.

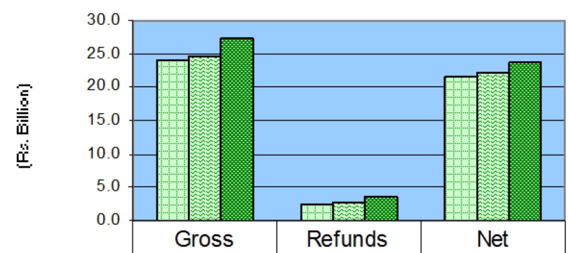
***Direct Taxes*****:** The gross direct tax collection during Q1 02-03 has increased by 10.4% over 1st quarter collection of PFY. Since refund payments increased by 39.1% during the period, the growth in net collection has been 6.9%. In absolute terms the gross collection on account of direct taxes, during the 1st quarter of CFY, was Rs. 27.3 billion, refunds Rs. 3.7 billion, and net collection Rs. 23.6 billion.

*Graph-2* illustrates that despite the intensity of various shocks experienced by the economy in FY 01-02 the gross and net collection as well as refunds related to direct taxes have followed an increasing trend in the 1st quarter during current and the last two years. The gross direct tax collection has increased from Rs. 24 billion in Q1 00-01 to Rs. 24.7 billion in Q1 01-02 to reach Rs. 27.3 billion in Q1 02-03. Similarly, the net collection has gone up from

Rs. 21.6 billion to Rs. 22.1 billion, and then to Rs. 23.6 billion during this period.

The month-to month growth in collection exhibits a cyclical pattern. Whereas gross and net direct tax collection was higher in July 2002 over July 2001 by 9% and 12.6%, respectively, it showed a decline in August. However, the gross collection in September 2002 exceeded the September 2001 collection by 21% and the net collection did so by 9.7% in September. This growth in collection has been achieved despite a reduction of WHT on securities due to decrease in rate and less borrowings by GOP, and issuance of exemption certificates to banks, especially UBL and HBL, against refund claims. Furthermore, the revenue impact of the establishment of the Large Taxpayer Unit (LTU), at Karachi is too early to have materialized as it is still in its infancy stage.

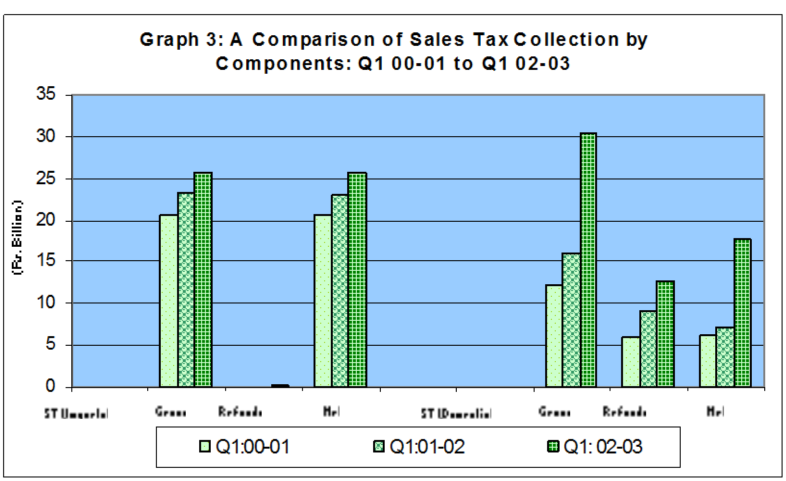
**Graph 2: A Comparison of Direct Tax Collection: Q1 00-01 to Q1 02-03**




| | Gross | Refunds | Net |
|---|---|---|---|
| Q1 00-01 | 24.0 | 2.4 | 21.6 |
| Q1 01-02 | 24.7 | 2.7 | 22.1 |
| Q1 02-03 | 27.3 | 3.7 | 23.6 |

Looking at the components of income tax it becomes obvious that the growth in collection has in fact come from 40.2% increase in voluntary payments (VP) -- an indication of an uninterrupted improvement in compliance to the taxation system, and 3.2% increase in WHT. In particular the collection through WHT on contracts has risen by 19.2%, imports 3.2%, exports 5.9% and salaries 15.1%. Contrary to this, the growth-retarding factor besides WHT on securities and interest has been collection on demand (CoD), which recorded a decrease in collection by 17.7% over July-September 2001. Whereas the growth in VP in excess of 40% is consistent with the growth pattern observed in 3rd and 4th quarters of PFY, the same does not hold true for CoD, which increased by 42.4% during FY 01-02. Finally, the favorable growth of various components of WHT, especially contracts, imports and exports is consistent with the overall improvement of the economy.

***Sales Tax:*** The sales tax collection from its two major sources, i.e., sales tax domestic, levied on domestic economic activities, and sales tax imports, levied on imports of goods, has shown significant promise during the 1st quarter of CFY. The 7.8% increase in rupee value of imports on the one hand and acceleration of domestic economy on the other have led to 26.5% growth in net sales tax collection during July-September 2002 as compared to the corresponding period of PFY *(Graph-3)*. The growth has been observed regardless of the fact that there has been 7.8% increase in refunds in the 1st quarter of CFY. In terms of value, the gross and net collections are Rs. 56.7 billion and Rs. 43.8 billion, respectively and refunds amount to Rs. 12.9 billion.



The import related net sales tax collection has increased from Rs. 23.2 billion during Q1 01-02 to Rs. 25.6 billion in Q1 02-03, showing an increase of 10.8%. Similarly, the domestic net sales tax collection has increased from Rs. 11.5 billion to Rs. 18.2 billion, presenting an increase of 58%. Given that the growth of domestic sales tax collection in the 3rd and 4th quarters of FY 01-02 was 21.1% and 25.7% respectively, it is reassuring that the momentum has been maintained.

*Domestic Sales Tax Collection and Major Revenue Spinners:* The detailed information regarding domestic sales tax collection based on major revenue spinners is presented in *(Table 3)*. The ten commodities reported here have contributed nearly 66% of the total domestic sales tax revenue in the 1st quarter of CFY. A comparison of the current quarter data with the first quarter figures of preceding two fiscal years gives an indication of how domestic sales tax collection has progressed over the years. Two points that become immediately clear are: (a) the relative significance of the ten revenue heads has changed over time. For example, revenue collection from services (including telephone/ fax etc.) has become crucial in recent years as compared to FY 00-01. (b) Positive growth in net collection has been recorded for majority of the commodities in comparison to collection in FY 01-02 and FY 00-01.

The only exception is cotton yarn where domestic sales tax collection in Q1 02-03 has been lower than the 1st quarter figures of the past two years. Similarly, the collection from cotton (not carded or combed) is not promising either when compared to the figure of last fiscal year. The sluggish performance in both these cases can be attributed to nearly 300% increase in exports of raw cotton, which incidentally is zero rated, and larger intake under DTRE scheme. Additionally, late picking of the cotton crop and speculation about higher prices has also restricted the supply of cotton. Thus, the net collection has been low. Regarding other commodities, the domestic sales tax revenue form a number of revenue heads including POL products, electrical energy, sugar, cement, and aerated water/ beverages increased by 20% and above during the 1st quarter. This pattern is consistent when current collection is compared with the 1st quarter collection of FY 00-01. The collection from cigarettes has remained stable around Rs. 900+ million in July-September period of current as well as past two years. It is also worthy to state that the share of 'other' commodities in total domestic sales tax collection was 39% in Q1 00-01, which fell to 33.2% in Q1 01-02 but recovered to 34.4% in Q1 02-03.

Since services including telephone and fax, POL products, electrical energy and natural gas are the top four revenue spinners, it follows that barring POL products, the domestic sales tax base essentially revolves around services and utilities only. This may not be a good omen when viewed in the light of excess burden of taxation and the increasing incidence of poverty in the country on the one hand, and rising cost of production and efforts to revive the industrial sector on the other.

**Table 3: A Comparison of Sales Tax Collection from Ten Major Revenue Spinners**
**July- September 00-01 to July-September 02-03**

| **Revenue Heads** | **July-September** | | | **Growth (Percent)** | |
|---|---|---|---|---|---|
| | 2000-01 | 2001-02 | 2002-03 | Col.4/Col.3 | Col.4/Col.2 |
| *Col. 1* | *Col. 2* | *Col. 3* | *Col.4* | *Col. 5* | *Col. 6* |
| Services | 0.25 | 2.49 | 4.89 | 96.2 | 1892.6 |
| POL Products | 3.41 | 3.35 | 4.09 | 22.1 | 19.8 |
| Electrical Energy | 1.22 | 1.80 | 2.71 | 50.3 | 121.8 |
| Natural Gas | 1.57 | 1.82 | 2.13 | 16.9 | 35.4 |
| Sugar | 1.17 | 1.62 | 2.03 | 25.6 | 74.0 |
| Cement | 0.01 | 0.86 | 1.04 | 20.9 | 9462.5 |
| Cotton Yarn | 1.47 | 1.17 | 1.01 | -14.3 | -31.6 |
| Cigarettes | 0.98 | 0.91 | 0.97 | 6.9 | -1.0 |
| Cotton not Carded not Combed | 0.55 | 1.05 | 0.72 | -30.9 | 30.5 |
| Aerated Waters/Beverages | 0.50 | 0.58 | 0.69 | 19.9 | 38.9 |
| *Sub Total* | 11.13 | 15.65 | 20.28 | *29.6* | *82.2* |
| Other Sectors | 7.09 | 7.78 | 10.62 | 36.5 | 49.7 |
| *Grand Total* | 18.23 | 23.43 | 30.90 | *31.9* | *69.5* |

**Value in Billion rupees*

*Risk management in Sales Tax*: With the introduction of self-assessment in sales tax, a growing emphasis is now laid on risk management by classifying taxpayers in various risk categories. The system is strengthened through effective auditing of high-risk categories, which serves as the best available tool for this purpose. Audit not only deters tax evasion, but it also brings transparency in the system. Furthermore, it helps in intensifying documentation of sales tax, which is crucial for the success of the GST regime adopted in Pakistan since 1990s.

The 1st quarter data of CFY confirm that the number of audits conducted has improved considerably. From 1614 audits conducted in July 2002, the number has gone up to 1983 in August 2002. By virtue of this effort the amount detected and recovered has increased from 33.7% to 38.5% during this period. This improvement is quite significant when compared with data related to the corresponding months of PFY. For example, 1331 audits were conducted in July 2001 and 1302 in August 2001. Thus, month-to-month increase has been 21.3% and 52.3%, respectively. The data further highlights the current situation whereby the audit activity has been intensified in Faisalabad, Gujranwala, Hyderabad and Lahore Collectorates. However, it is somewhat slow in the remaining Collectorates.[7]

***Customs Duties:*** The revenue collection on account of customs duties is directly influenced by the lowering of the maximum duty rate and tariff rationalization as part of the on-going processes of tariff reforms; and the relationship between local currency and the currencies of Pakistan's major trading partners. The rupee-dollar parity, which in FY 01-02 stumbled from 67 to 60, has now stabilized around Rs. 60 to a dollar, largely due to a healthy position of foreign currency reserves.

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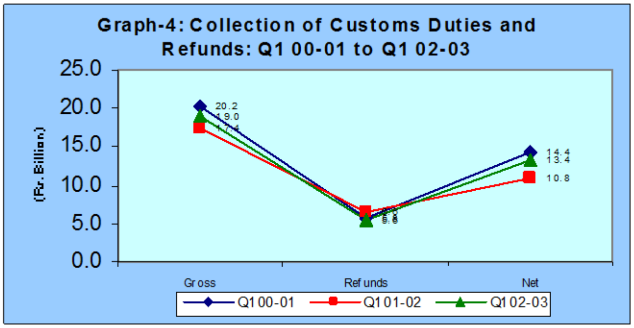
[7] No definite statement could be made for Karachi East and West for want of data for the month of September.

However, notwithstanding the aforementioned changes whose impact is captured by the effective rate of duty, the customs duties collection has increased in the 1st quarter of CFY over the corresponding period of PFY. The gross revenue collection during Q1 02-03 has been Rs. 18.96 billion as opposed to Rs. 17.41 billion in Q1 01-02. Similarly, the net collection increased to Rs. 13.36 billion from Rs. 10.83 billion *(Graph-4)*. The rate of increase of gross and net revenue collection has been 8.9% and 23.3%, respectively.[8] The difference between these rates is the consequence of refund/ rebate payments.



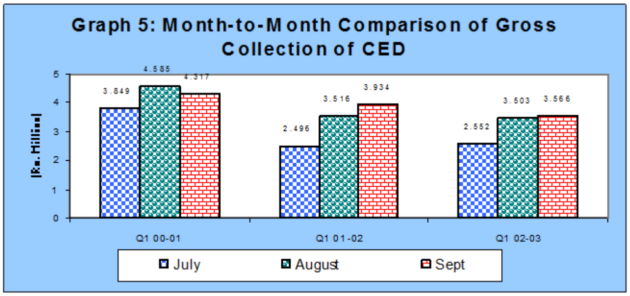

The month-to-month comparison indicates that the net collection in July 2002 was higher by 42.1% than July 2001. The same is also true for the months of August and September in which the revenue receipts from customs duties exceeded by 21.3% and 13.1%, respectively. The higher collection has been materialized due to 7.8% increase in rupee value of total imports and 9.7% increase in the value of dutiable imports. At the same time duty free imports have increased by only 5%. Secondly, this increase in net collection is the outcome of extension of CD base due to the transfer of POL products from central excise. As indicated, the revenue impact of this measure for the entire fiscal year was projected to be Rs. 2.3

[8] In sharp contrast the growth of gross and net collection during 1st quarter of PFY over Q1 00-01 was –13.9% and –24.6%, respectively.

billion. Finally, the improvement in CD collection has resulted because of the changing composition of imports. It has been observed that imports are drifting away from consumer-oriented to capital-oriented commodities. The Custom House data indicate that while imports of consumer goods have declined from Rs. 16 billion in Q1 01-02 to Rs. 9 billion in Q1 02-03 and *dutiable* consumer goods imports have declined from Rs. 10 billion to Rs. 6 billion, the imports of capital goods have increased from Rs. 22 billion to Rs. 25 billion and the imports of *dutiable* capital goods have increased from Rs. 13 billion to Rs. 18 billion during this period.

**Central Excise:** Despite its fading nature, the (net) collection of central excise duties during Q1 02-03 was Rs. 46.9 billion that shows a decline of 3.3% over 1st quarter collection of last year. The main reasons for this decline are continuation of sluggish activity in the large scale manufacturing sector and the shrinking CED base.

A cursory look at *Graph-5*, which highlights month-to-month CED collection for July-September period of CFY and past two years, would confirm a gradual increase from July onwards. However, the collection was consistently low in the 1st quarter of FY 01-02 in comparison to Q1 00-01. The situation did not improve in July-September 2002 either even though the impact of external and internal shocks has almost bottomed-out. A detailed analysis of budgetary measures is, therefore, undertaken to understand this apparent paradox.



Graph 5: Month-to-Month Comparison of Gross Collection of CED

The CED collection from major revenue spinners is presented in *Table 4*, which shows that with the exception of cement and natural gas a negative growth in collection has been recorded in the remaining major revenue heads. Similarly, a negative growth of 12.3% has also been registered for 'all other commodities' as well. The reason for the overall shortfall has been the withdrawal of CED from a number of items in the Budget 2002-03. These include: POL products, automotive batteries, metal containers, filament yarn and services like advertising, travel and shipping agents. For aerated beverages, the rate of CED on retail price was slashed from 15% to 12%. However, since the benefit of this reduction was not passed on to consumers, at least in the first two month of Q1 02-03, the expected increase in sales may have not materialized. Consequently, clearance as well as revenue collection has been adversely affected. As far as 10.4% decline in collection from cigarettes is concerned, there was an excess supply in July and August as manufacturers in anticipation of an increase in CED rates on cigarettes at the time of Budget 2002-03 made larger than usual clearance. However, the normal level of clearance is expected to initiate soon, which would improve CED collection in coming months.

**Table 4: A Comparison of CED Collection from Major Revenue Spinners**
**July- September 00-01 to July-September 02-03**

| **Revenue Heads** | **July-September** | | | **Growth (Percent)** | |
|---|---|---|---|---|---|
| | 2000-01 | 2001-02 | 2002-03 | Col.4/Col.3 | Col.4/Col.2 |
| *Col. 1* | *Col. 2* | *Col. 3* | *Col.4* | *Col. 5* | *Col. 6* |
| Beverages | 653.46 | 732.78 | 613.02 | -16.3 | -6.2 |
| Beverages Concentrates | 275.40 | 305.96 | 286.41 | -6.4 | 4.0 |
| Cigarettes & Tobacco | 3420.40 | 2993.41 | 2681.12 | -10.4 | -21.6 |
| Cement | 3203.38 | 2408.60 | 2617.95 | 8.7 | -18.3 |
| Natural Gas | 925.29 | 914.77 | 1086.18 | 18.7 | 17.4 |
| POL Products | 1109.04 | 1119.48 | 865.60 | -22.7 | -22.0 |
| *Sub Total* | 9586.97 | 8474.99 | 8150.28 | *-3.8* | *-15.0* |
| All Others | 3219.87 | 1473.88 | 1292.17 | -12.3 | -59.9 |
| *Grand Total* | 12806.84 | 9948.87 | 9442.46 | *-5.1* | *-26.3* |

**Value in Million rupees*

## Concluding Observations

The CBR revenue position has been analyzed within the overall macroeconomic perspective. One of the important conclusions of preceding discussion is that the performance of the revenue organization depends not only on its own institutional strength, but also on how well the economy performs. The impact of economic recovery summarized by leading macroeconomic fundamentals and ‘near’ correction of structural weaknesses is fully reflected in improved CBR revenue collection. From a position of weakness where the revenue target was consistently missed and waiver was sought repeatedly, the revenue organization is entering into an era of reassurance and certainty with a modern taxation system and efficient workforce. An unremitting effort continues to further simplify the system to make it taxpayer friendly, to minimize disenchantment between CBR and its stakeholders, and to achieve its targets in the most professional manner. The collaborative effort between CBR and its various stakeholders, including GoP, holds the key to further successes.

It has been demonstrated that the reorganized taxation system of Pakistan revolves around two major taxes, i.e., direct taxes and sales tax. Fortunately, these taxes are very close to be regarded as base-elastic as far as up-to-date elasticity and buoyancy estimates are concerned. This finding is very significant from policy perspective. Additionally, the value-added version of GST despite its apparent regressivity needs to be viewed as neutral so far as exemptions, full credit on investment and full rebate to exporters are concerned. Similarly, the justification of WHT within the direct tax regime should be explained in the light of the large size of the undocumented economy. The customized versions of direct and sales tax are expected to play pivotal roles in the taxation system of the country. Thus, with a careful persuasion of various fiscal initiatives, especially related to these two taxes and a healthy growth of the economy, a steady growth in revenue should be anticipated with a greater conviction of achieving the targets.

# II

# Addressing the Refunds and Rebates Conundrum[9]

## Introduction

The issue of refunds and rebates has gained increasing importance in recent years. The refund-rebate payments have augmented from a measly sum of Rs. 3.2 billion in 1984-85 to 79.3 billion in 2001-2002. Within a short span of 18 years the ratio of refunds to gross collection has increased from 5.7% to 16.4% *(Table 1)*. This share crossed into the double digit in the year 1990-91 to reach 15% in 1998-99. The significance of the issue becomes even more revealing when the volume of refund-rebate payments is compared with key indicators of the economy such as the output of the manufacturing sector, imports and exports of goods and GDP. The refund payments comprised only 8.3% of exports and 3.5% imports in the year 1984-85, but this proportion increased to 14% and 12.2% respectively, by the year 2001-02. While the ratio constituted only 7.4% of manufacturing output and 0.6% of GDP (at market prices) in 1984-85, by the year 2001-02, these shares have gone up to 14.8% and 2.1%, respectively.

Regardless of the peculiar growth in refund-rebate payments in recent years, the two major points that require immediate attention are: (a) there is the 'complaint' from the taxpayers that their refund/ rebate claims are not processed on time and thus they continuously exert pressure for a 'timely' release of funds; and (b) in view of flying and fictitious invoices, CBR has an equally justified concern about the legitimacy of refund claims. The cross verification of these

[9] The Fiscal Research Wing of CBR has prepared this document. The authors (Dr. Ather Maqsood Ahmed and Robina Ather) are grateful to Mr. Riaz A. Malik, Chairman CBR, for useful insight and valuable comments. Thanks are also due to Mr. Vakil A. Khan, Member (Direct Taxes) and Mr. Mumtaz Rizvi, Member (Exports) for helpful suggestion and clarifications.

invoices is undoubtedly time consuming which means that some delay in refund clearance is inevitable.

In view of this apparent confliction of concerns it is necessary to have a thorough understanding of the issue and its root cause. The objective of this research is not only to provide an overview of the refund/ rebate problem, but also examine the justification of various refund/rebate schemes in the light of rules and procedures. Additionally, there is an effort to sift the main concerns of taxpayers and the CBR besides highlighting CBR initiatives to resolve these concerns.

**Table 1: Refund/ Rebate Payments in Relation to Key Indicators : 1984 – 2002**

| | 1984-85 | 1990-91 | 1995-96 | 1998-99 | 2001-02 |
|---|---|---|---|---|---|
| Refunds/ Rebates* | 3.2 | 14.2 | 30.7 | 48.1 | 79.3 |
| Gross Collection* | 55.6 | 124.6 | 298.8 | 356.6 | 483.2 |
| Exports of Goods* | 38.0 | 138.3 | 294.7 | 390.3 | 567.2 |
| Imports of Goods* | 89.8 | 171.1 | 397.6 | 466.0 | 650.0 |
| Manufacturing Output* | 67.6 | 158.8 | 309.7 | 423.5 | 537.0 |
| GDP (at market prices)* | 510.5 | 1,044.5 | 2,120.2 | 2,938.4 | 3,726.6 |
| *Overall Refunds/ Rebates as % of* | | | | | |
| Gross Collection | 5.7 | 11.4 | 10.3 | 13.5 | 16.4 |
| Exports of Goods | 8.3 | 10.2 | 10.4 | 12.3 | 14.0 |
| Imports of Goods | 3.5 | 8.3 | 7.7 | 10.3 | 12.2 |
| Manufacturing Output | 4.7 | 8.9 | 9.9 | 11.3 | 14.8 |
| GDP (at market prices) | 0.6 | 1.4 | 1.4 | 1.6 | 2.1 |

** nominal values in billion rupees.*

**Justification for Refund/ Rebate Claims**

The primary objective of all the refunds and rebates schemes is to facilitate taxpayers by paying back the amount of tax paid in excess of liability or as advance payment by them or, in case of exports, the taxes paid at the import stage or at stages of local manufacture. Whereas the duty draw back regime with the sole objective of export facilitation and promotion has been in operation since 1970s, entertaining significant refund payments on account of sales tax has been a relatively recent phenomenon, which is linked with the introduction of VAT type of sales tax since mid 1990s. The expansion of quantum of refunds has a linkage with the ever-expanding scope of sales tax through removal of item-wise, sector-wise and area-wise exemptions. Similarly, wide variations in refund claims against various sub heads of direct taxes have been an ongoing experience.

With an ever increasing volume of refunds and rebates, proper understanding of the basis of refund claims under the rules on the one hand and procedural requirements for timely clearance on the other are essential to avoid misapprehensions between taxpayers and tax administrators. This section, thus, discusses the justification of refund claims under the rules of direct taxes, sales tax and customs duties and provides the historical trends of refund/ rebate claims relative to gross collection.

***Direct Taxes***:[10] In terms of section 170 of the Income Tax Ordinance 2001, a taxpayer who has paid tax in excess of the amount due (i.e., properly chargeable) is entitled to refund of the overpaid amount. Refund usually occurs in respect of:

- Advance Tax u/s 147;
- WHT that are not presumptive in nature; and
- Others (court and tribunal orders/ adjudication orders etc.).

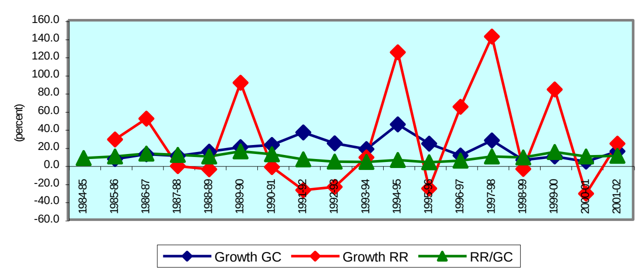
In order to claim refund based on any of the above entries, the taxpayer completes a prescribed claim form and submits it to the concerned Commissioner Income Tax within the specified time. After necessary verification and deducting any outstanding liability against the claimant under any of the federal tax laws, the refund amount is sanctioned. The time limit for sanctioning the refund

[10] The authors have benefited greatly from useful discussions with Mr. Nadir Mumtaz Warraich, Secretary Budget (Direct Tax).

amount or refusal to the same is within forty-five days of the receipt of the refund application.

The historical data indicates that refund payments mainly on account of income tax have increased from Rs. 0.8 billion in 1984-85 to Rs. 16.5 billion in 2001-02. The refund payments relative to gross (direct tax) collection have varied between 3.4% and 15.3% during the last 18 years with three distinct peaks appearing in FY 86-87, FY 89-90 and FY 99-00. The refund payments consumed 10.4% of gross collection in 2001-02 due to the deliberate perusal of generous refund policy *(Graph 1)*.

**Graph 1: Direct Taxes: Growth of Gross Collection (GC), Refunds (RR) and RR/GC Ratio**




It is interesting to note that despite wide fluctuations in the line graph of growth of gross collection and growth of refunds, the line graph depicting refund to gross-collection ratio (RR/GC) remains relatively smooth. This has been due to the fact that exceptional growth in both gross-collection (numerator) has generally been cancelled by a similar growth in refunds (denominator). For example, even though refunds increased by 124.6% in FY 94-95 and 142.1% in FY 97-98, but since gross collection also increased by 44.9% and 27.5% in these years, the increase in relative terms was rather small. This phenomenon therefore suggests that refunds and gross collection have generally been moving in the similar direction. However, the three aforementioned spikes in RR/GC ratio could be explained in the light of three considerations: (a) Issuance of exemption certificates to banks and multinational as well as non-resident companies against refund claims (taxpayers convenience); (b) Adjustment of refunds against demand created during the year mostly from corporate sector (departmental convenience); (c) Remission due to appeal effect for corporate sector[11]; and (d) Refund adjustment for advances u/s 147.

Further to elaborate on the issue of exemption certificates and its connection with remission due to appeal effect, it may be worthwhile to mention that these certificates are issued to taxpayers, especially banks, to reduce the extent of refund claims and to maintain transparency of the financial position of the banking sector for privatization.[12] To clarify further, consider one of the following legal issues that has significant revenue implications. Even though banks charge interest (on suspense accounts) as well as there is disallowance of bad debts/ loans but since interest income is not received but accrues, it is accounted for separately. However, legal procedures are adopted and appeals are filed due to differences in perceptions about taxability of the interest income within the sphere of influence of banks. As a result refund is created if and when remission is granted. Viewed within this perspective, it appears that the system generates a process where no interest is generated but accrues and no deductions are made and yet bonds are issued for an amount that remains totally outside tax collection. So far CBR has issued income tax refund bonds to banks worth Rs. 22 billion.[13]

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[11] In legal issues, which are usually common in big cases, refund is created as a consequence of appeal effect. This has been an annual phenomenon where refund was withheld u/s 103 of Income Tax Ordinance, 1979 as a prelude to further appellate action by the department. However, refund can no longer be withheld with effect from July 1, 2002, which would dampen the intensity of spikes in the RR/GC ratio.

[12] The refund claims associated with appeal effect as compared to excess/advance payments are fairly small in magnitude. In fact they constitute no more than 10% of yearly refund payments.

[13] Besides the issue mentioned in the text, WHT on account of interest paid on securities is deducted @ 30% whereas the tax turnover ratio of banks works out to 2-3%. This also accounts for accumulation of refunds.

***Sales Tax:*** Under section 10 of the Sales Tax Act 1990, the taxpayer can adjust tax paid on inputs and can claim refund if her/his input tax exceeds output tax. Similarly, since exports are zero rated u/s 4 of the Sales Tax Act 1990, it entitles exporters to claim refunds. Finally, refund claims are also entertained on the basis of stocks, u/s 66 and court orders etc.[14]

Concerning the refund procedure, the monthly sales tax return filed by a claimant is treated as refund claim once all the supportive documents including invoices, bills of entry are received. The processing officer, usually an Auditor carries out the initial examination and scrutiny. A comprehensive refund report is forwarded within seven days to the Senior Auditor. The Senior Auditor/ Superintendent after giving his/her recommendations forwards it to the concerned Assistant Collector/ Deputy Collector within three days. The refund amount is then sanctioned if the claim is found genuine and admissible.[15]

As a consequence of shift within indirect taxes towards sales tax and away from customs duties as visualized in the first generation of tax reforms (started in the 1990's), sales tax was extended to include major sectors of the economy. The value-added nature of the tax and zero rating of the exports resulted into parallel increase in input adjustments and refunds. In the last eighteen years (i.e., between 1984-85 and 2001-02) the amount of sales tax refund has increased from Rs. 0.2 billion to Rs. 36.0 billion. In percentage terms, the refund/ gross collection ratio has increased from 4.4% to 17.8% while attaining its peak (27.5%) in 1996-97 *(Table 2)*. The reason for this increase is that with the extension of GST to services like electricity, gas and telephone and other sectors of the economy, the

[14] Further details on the subject could be found in 'A Study on Sales Tax Refund' prepared by the Sales Tax Wing (Textile Sector), Lahore (February, 2002).

[15] The procedural guidelines on Sales Tax Refund originally explained through SRO 417(1)/2000 have been revised in August 2002. The Sales Tax Refund Rules, 2002 could be found in SRO 575(1)/2002.

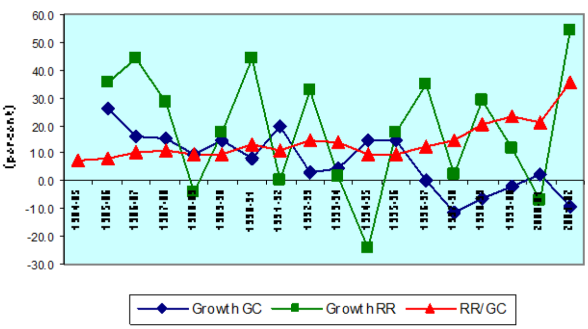
gross collection has increased but lack of diversification in the exports has confined refunds to the traditional sectors only thereby, decreasing the proportion of refunds to the gross collection.

**Table 2: Sales Tax Gross Collection and Refunds for Selected Years**

| | Gross Collection | Growth in Gross Collection | Refunds | Growth in Refunds | Refunds/ Gross Collection |
|---|---|---|---|---|---|
| | (Rs. Million) | (%) | (Rs. Million) | (%) | (%) |
| 1985-86 | 5,230 | 7.0 | 302 | 41.1 | 5.8 |
| 1991-92 | 26,783 | 41.0 | 5,984 | 201.5 | 23.3 |
| 1994-95 | 54,967 | 40.9 | 11,393 | 31.9 | 20.7 |
| 1996-97 | 76,769 | 14.8 | 21,101 | 24.0 | 27.5 |
| 1999-00 | 139,552 | 50.6 | 22,841 | 11.1 | 16.4 |
| 2001-02 | 202,274 | 10.3 | 35,958 | 20.3 | 17.8 |

***Customs Duties****:* Section 21(c) of the Customs Act, 1969 allows repayment, in whole or in part of the customs duties paid on the importation of any goods which have been used in the production, manufacturing and processing of goods meant for export. Similarly, central excise duty paid on any imported material or components or excisable material used in the production, manufacture and processing of exported goods is also refundable. The exporter files the rebate claim in the respective Customs or Export Collectorate along with all the supporting documents including calculation sheet, bank credit advice, airways bill, and bill of lading. The receiving officer after determining that the claims is within time, is legitimate and the calculation sheet is correct, places it before the sanctioning authority. The sanctioning authority, Assistant Collector/ Deputy Collector/ Additional Collector/ Collector (depending upon the amount to be sanctioned) ensures that the claim is genuine in all respects and there are no recoveries outstanding against the claimant. The refund claim is then sanctioned.

The data pertaining to 1984-85 to 2001-02 show an unusual increase in the volume as well as proportion of customs duty rebates to gross collection. Whereas the gross customs duties collection during this period increased from Rs. 25.3 billion to Rs. 74.9 billion, the rebate amount has increased from Rs.1.9 billion to Rs. 26.8 billion. The appalling aspect of the pattern of growth is that while gross collection reached its peak in FY 96-97 before the descend started, the refund/ rebate payments have increased continuously since FY 95-96 with the exception of FY 00-01 when a slight decrease has been observed. Thus, as a proportion of gross collection the increase in rebates during the past eighteen years is from 7.5% to 35.8% *(Graph 2)*. One plausible explanation for this huge increase is that DDB (duty drawback) rates have mostly been much higher than the actual incidence of the duty.



Graph 2: Customs Duties: Gross Collection (GC), Refund-Rebate (RR) & RR/GC Ratio

**Concerns of the Taxpayers and CBR**

From time to time CBR has introduced various schemes to facilitate the claimants as well as safeguard the interests of the CBR. However, delays and governance issues concerning processing of refunds and rebate claims continue to be problem areas. Ever since the introduction of *Sales Tax Refund Rules* in 1996, that allow adjustment/refund of input tax to the registered persons, the refund rules and procedures have undergone many changes according to the requirements of the claimants and the CBR. Time limit for processing of refund claims and sanctioning of refund has been reduced from no-limit to forty days. Similarly, gold and silver categories are created to facilitate exporters. But there are certain limitations of the existing system that hinders the expeditious disposal of the claim and proper handling of the problem of fake and flying invoices. The processing of the refund claim is manual. The refund applications are subject to a comprehensive manual pre-audit of all the documents, which obviously consumes substantial time. Moreover, the tax profiles of the refund claimants are not complete, as these are restricted to reporting in the sales tax return. Thus, there is informal and inadequate use of information about the taxpayer available with other collectorates or CBR. The biggest problem is that of verification of invoices. In the absence of any formal mechanism, fake/ flying invoices are only informally and sometimes accidentally detected. Also, as it is nearly impossible to consolidate all invoices of one supplier at one point of time and get them verified in one go, verification of invoices does not take place in forty days for a good majority of cases. Detection of malafied variation in the description contained in the original and counter-foil of invoices kept with the supplier is also a time taking process. Thus, in many cases the refund is sanctioned without verification of invoices.

As far as the *Duty Drawback Scheme* is concerned, based on surveys, the rebate wing of the CBR used to prescribe standard (non company specific) and individual (company specific) duty drawbacks rates. It allowed refund of import duty, central excise duty and sales tax paid on import of goods used in the production, manufacture and processing of good exported from Pakistan. However, with the passage of time it was realized that the scheme has failed to produce the desired results. The systematic estimate or update of IOC (input-output coefficients) was not carried out and the process of rate fixation and its administration lacked transparency. The DDB rates were often higher than the incidence of taxes actually incurred. The exporters were, understandably content and confined their complaints mainly to the payment process (delays etc.). The last eighteen years data manifests that the DDB rates had been much higher than what they should have been.

The input output coefficient organization (IOCO) was established in 2001 with the objective to devise a systematic method of determining IOC and DDB rates in consultation with the trade bodies and to review and revise these rates periodically. It was believed that with the systematic calculation of IOC and resulting DDB rates reflecting the incidence of duty actually paid would strengthen free trade policy by increasing the take up of DTRE procedures, as setting of accurate DDB rates would remove the current attraction towards drawback. Now, IOCO determines the quantity of imported material required to be used in a given quantity of manufactured end product and notify standard or specific DDB rates. Based on these notifications, the Export/ Customs Collectorates issue rebates to the exporters.

**CBR Initiatives**

Given the importance of the issues, CBR has taken an increasingly professional, methodological, dedicated and systematic approach to secure revenues involved and to remove irritants of the business and industry. The two major initiatives, one each for sales tax and customs duty are briefly outlined in the following.

***A. Sales Tax Automated Refund Repository (STARR)***

As the efforts to address the problems from within the existing formations and organizational structure of CBR were insufficient to bring about the desired improvement, a dedicated organization has been raised to address and resolve this Achilles heel.[16] This organization has introduced systemic corrections through establishment of Sales Tax Automated Refund Repository

[16] This part of the document is extracted from the Concept Paper on STARR prepared by the Sales Tax Wing (Textile Sector), Lahore (July, 2002).

(STARR). The establishment of the Repository and standardization of the processes and the documents in all the ten collectorates from 1st October, 2002 is expected to bring in transparency and efficiency and would lessen human involvement in the processing and sanctioning of refunds.

*Resolving the Problem of Verification of Invoices*

Through a phased program there will be an attempt as part of the STARR to ensure maximum convenience to the claimant, gradual reduction and ultimately elimination of spurious refunds and establish a Decision Support System (DSS) for the management. The idea is to gradually evolve and supervise a Management Information System (MIS) of verification of invoices. Initially, invoices submitted with the refund claims (issued by suppliers of refund claimants) would be stored in the STARR and shared with all Collectorates. At the latter stage, the Repository will endeavor to capture all the invoices generated in the system. Immediately after the data concerning invoices submitted with the refund claims is uploaded in the system, details of invoices would automatically become available to concerned Collectorate. Therefore, complete 40 days would be available to the Collectorates for verification of invoices. Supplier-wise details of all invoices relating to different claimants of various Collectorates would also be segregated saving substantial time. The potential benefit of the scheme would be that reliability of verification of description of goods would increase, as data of invoices of refund claimants would contain description of goods. Availability of all invoices in the system would also help in undertaking audit and building risk profiles.

*Monitoring the Process of Refund Claims*

Monitoring of the refund process would be carried out through automated report generation as well as through obtaining specific information about a particular transaction or set of transactions. Software is being developed to generate 'reports' and 'alerts' for detection of undue refund payments through use of nation-wide data. Reports like non-conformity with the data in tax return, out of tax period adjustment, purchases from suspected sources, abnormally low or high transactions, and abnormality in sales pattern would be generated automatically. These 'alerts' and 'reports' would be available to sanctioning officers for processing of refund claims. The system would also generate reports regarding pendency of the refund claims. The ultimate objective would be to refine the existing system to such an extent that it is able to handle lingering issues related to pending applications for categorization under Gold/ Silver category, references from any organization for down grading of rating or category of any exporter, reference from any exporter for up gradation of his/ her category, or cases rated or categorized six months earlier.

Future endeavor includes sharing the Repository database with data available with the Income tax and Customs departments, and NADRA, WAPDA, PTCL, etc. for enrichment of analysis.

***B. Addressing the Issue of Customs Duties Refunds/ Rebates***

As indicated, the unprecedented growth in export rebates has been a constant source of agitation between the tax authority and manufacturers/ exporters. As of now CBR and GOP have gained significant mileage in addressing this issue as a result of various initiatives. So far nearly 85% of rebate-able exports, mostly related to textile and leather sectors, have been corrected. The only exception has been the engineering sector including portions of cutlery and surgical goods. At the same time an effort is continuing to rescind individual-based SROs and put greater emphasis on standardization. Nonetheless, there are certain undesirable aberrations such as the issue related to PSF (Polyester Staple Fibre) whose local purchases are being deemed imports costing GOP Rs. 2.5 billion annually at the current export base. However, if the promotional compensatory DDB rates yield the desired results, the component of the PSF based export will go up, resulting in an equivalent revenue erosion.

Finally, the gradual reduction in DDB rates initiated in FY 01-02 was put on hold after the 9-11 events. Even though the freeze on the reduction of DDB rates has been lifted since 1st July 2002, its real revenue impact will start materializing midway through the second quarter of CFY. Besides CBR staff has designed a comprehensive restructuring plan for the customs department to improve the existing set-up of the customs administration. A brief review of how export rebates will be handled in the new environment is presented in the following.

***DDB within CARP***[17]

The VISION envisaged by the customs department, though not implemented yet, is a paradigm shift in perception as well procedures so that a more efficient system is evolved. In case of customs the basic impediment in processing and disposal of rebate claims is that there is lack of sufficient knowledge about the claims filed. At present there is no specified dedicated input point for filing the rebate claim. There is no unique reference number (e.g., a machine number), which makes it difficult to keep track of what has been filed, when it is filed and to whom it pertains? Furthermore. it is not possible to know while processing the claim, whether it was filed in time or whether somebody has just stamped it in the back date.

*The Proposed process*

Since application for refund is a prescribed customs document as per section 33 of the Customs Act 1969, it may be entered into the system in the manner as is done for Bill of Entry (BOE). The procedure of filing this document would be at the front office and as

[17] This part of the document is extracted from the Customs Administration Reform Plan (CARP) developed by a team comprising Ashir Azeem Gill, M. Irfan Sarfraz, Iftikhar Ahmad, Fawad Ali Shah and Amir Thaheem (August, 2002).

a single administrative document (SAD). This will resolve the issue concerning proper identity of the document.

In a computerized environment, the refund application will appear as a job in hand at the concerned AC’s terminal the moment it is filed at the front office. The documents submitted along with the application will also be forwarded. Elaborate mechanism will be written in the software to handle these documents. With this step the putting up mechanism will be eliminated and will become instantaneous. The process would leave 30 days for the sanctioning authority to decide the issue, unless there is delay on the part of the claimant in responding to any hearing memo, filing of any missing documents etc.

The system will be developed in a manner to resolve the issue of priority automatically. Once the job in hand is approached the refund/ rebate claim is presented on the Assistant Collector’s terminal in a Refund Processing Menu that will assist the officer in the following areas in the manner described:

*Claim is within time*: The system will compute from the date of filing (recorded when the claim is lodged in front office) and date of payment (available in system against the IGM/ EGM-Index) by comparing it with Cash Number. The claimant in his/ her application will specify the date of payment in cases not relating to IGM/ EGM-index.

*Confirmation of payment*: The system will confirm the payment of the amount claimed from the Cash Number.

*Confirmation of no-duplication*: The system will indicate the details of any refund claimed/granted against the same IGM / EGM-index has been earlier claimed.

*Recovery Outstanding*: The system will indicate if any amount is recoverable from the claimant so that the same may be adjusted. Any notices for recovery against the claimant received from other Collectorates /department will also be reflected, so that the same can be legally adjusted from the amount sanctioned.

All notifications, SROs, CGOs, Public Notices and Standing Orders will be available to the officer. If more documents from the claimant are needed, system generated Document Calling Memo or Hearing Notice will be issued. The references of such correspondence will be recorded in the system against the Refund Application's Record. Refund Sanction Order will be computer generated which will be communicated to the claimant and to the Accounts Section.

**Concluding Observations**

Notwithstanding the elaborate nature of refund/ rebate procedures and their continuous revision in the interest of taxpayers, the two concerns that have emerged from the preceding analysis are worth repeating. These are the problem of flying/ fake invoices within the ambit of sales tax and the unprecedented growth of export rebates since 1995-96 within the customs duties regime. Besides, the time delay in clearance of refund claims due to manual verification of various documents and the related governance problems continue to remain a constant source of disenchantment between taxpayers and the revenue organization.

While considerable progress has been made so far, which includes the reengineering of Sales Tax Wing under the overarching reform program of CBR. Similarly, the redesigning of procedures for sanctioning rebate under customs duties is under active consideration. Both these measures are expected to resolve the time delay problem through effective utilization of information technology. Likewise, the problem of invoice verification is being addressed through a fully automated system. However, despite various attempts in recent years by CBR and GOP the problem of ever-increasing export rebates remains a contentious issue, which requires unremitting government intervention due to various technicalities involved.

It has been demonstrated in this study that the prevailing DDB rates are still higher than the actual incidence of customs duty and the argument of export non-competitiveness does not appear to be valid. It may be recalled that a similar argument of export expansion through competitiveness was continuously put forward when devaluation of the currency was sought. Contrary to this assertion, the latest research findings have made obvious the insensitivity of exports to exchange rate fluctuations. In fact exports have increased while the currency is appreciating!

The historical review of the data has further confirmed that the upward revision of DDB rates in 1997 was done on the pretext of widening gap between ‘official’ and ‘equilibrium’ exchange rate of rupee vis-à-vis dollar. Now that the difference between the two rates has almost vanished and the currency has gain stability, there is a need to implement a market based DDB rate structure to restrict wasteful drainage of revenue receipts. The implicit subsidy on exports at the expense of taxpayers has no justification in a competitive environment where market forces rather than arbitrariness take the central position. The on-going correction of DDB rates based on a fair analysis of data will not only improve the revenue position of the government, which in turn is necessary to meet its additional expenditure needs to addresses the core concern of poverty, but it will also be instrumental in correcting market imperfection.

# III

# CBR Reform Program
## The Human Resource Management and CBR Initiatives[18]

### Background

Human Resources Management (HRM) is about managing people, the most vital of all resources of any organization. Within the human capital framework it focuses on recruitment, staffing, remuneration and incentives, training, performance management and career planning and so as to raise efficiency and productivity of the human resources and transform them into a motivated, dedicated and target-oriented work force.

Within this perspective, CBR is in the process of its organizational restructuring on functional lines through effective use of human resource endowment and raising the existing level of human capital. The newly established HRM wing is entrusted to serve as an advisor, developer, change agent, strategist and a facilitator with the responsibility of building CBR into an efficient and trustworthy organization that protects the interests of its stakeholders -- taxpayers and the Government of Pakistan. It is working on a plan of designing a comprehensive change management program to prepare the CBR employees to successfully execute the reform process that entails improvement in revenue collection and the image of the organization.

### HRM Strategy Elements

To achieve these straightforward yet challenging objectives, HRM is working on a strategy of setting up of a sophisticated HRM system,

[18] The Human Resource Management Wing of CBR has prepared this text.

which will essentially be reviewing, improving and implementing the following core concerns:

1. On going evaluation of staffing needs based on the new process reengineering initiatives and use of automation in the tax collection process;

2. Streamlining the induction process to ensure that people with required skills and competencies needed for the specific responsibilities are hired purely on merit basis;

3. Building technical skills through ambitious training programs including Masters in Tax Administration, in coordination with leading national and/ or international academic institutions. Qualifying in this program will be considered as a prerequisite for induction at officer level positions;

4. Introduction of Performance Management System for unbiased evaluation of the work force that would include such performance indicators as efficiency, promptness, strategic planning and execution of work, and leadership competencies etc., to facilitate CBR to distinguish between top, middle and poor performers;

5. Introduction of new promotion criteria, which, in addition to seniority, will also take into consideration the track record of performance, leadership skills and matching of specific competencies needed for the new senior position. The system would ensure placement of right people at right jobs;

6. Review and implementation of new compensation strategy, which will strive to compensate the CBR employees in line with the market as specialists in tax administration; and

7. Based on the development of core competencies for various revenue and support functions, HRM would undertake skills gap analysis to serve as base for evolving training and development strategies.

In addition to the core human resources elements of the strategy stated above, HRM will also take ownership of designing of a comprehensive anti-corruption strategy and provide a new code of conduct. It will also design integrity-training modules.

**HRM Initiatives at CBR**

Pursuing the recommendations of several committees, task forces and strategy sessions on reform and restructuring of the CBR the HRM team initiated formulation of a new recruitment, compensation, promotion and work force planning process for CBR employees in consultation with the field formations of Income Tax, Customs, Sales Tax and Central Excise.

The task forces, consisting of cross sectional representatives from field formations of all services made their recommendations, which have been evaluated and incorporated in the proposed new recruitment, compensation/ promotion policies. The details of these initiatives are offered in the following.

***Recruitment Policy***

The recruitment policy has been designed to adopt a transparent and effective recruitment process for induction of employees in CBR at all levels where the incumbents match the core competencies of various specialist and general assignment positions. The recruitment process for different categories of employees will be as under:

- The present system of direct recruitment for Grade-17 officers through the Federal Public Service Commission (FPSC) based on all Pakistan open competitive examination in accordance with the FPSC Rules 1978 will continue. However, in order to build consistency in the level of professionalism and specific technical skills for various assignments among officers to be inducted in CBR services, a pre-induction training program has been envisaged. This program will be conducted in association with recognized business / law school / university leading to a degree of Masters in Tax Administration. The proposed degree program, which is likely to run between 18 to 24 months, will cover subjects on Business, Commerce, Economics, Accounting, Mathematics, Computer Science and specialized training on Tax and Customs laws and regulations. Officers successfully passing and attaining the master's degree will qualify for induction into services;

- FPSC would be requested to advertise, short list, test and select incumbents for the positions in BPS 15 and 16 in line with the rules already in place. Employees recruited by FPSC will undergo special training on subjects like accountancy, legal orientation, book keeping, IT/ Customs laws & procedures, industrial notes, information technology and other modules specific to the position. The successful candidates will also undergo one month structured on-the-job training with the filed officers. Based on the final evaluation of the performance of the incumbents in written examination as well as field assignments, successful candidates will be inducted in services;

- In order to maintain transparency in recruitment process as well as effectively manage the external influences, the recruitment for all positions in grade 11 to 14 will be done strictly through FPSC as per rules. Professional training for up to six months will follow depending upon the nature of the job after which the employees will be tested in core competencies specific to the positions. Successful candidates will be eventually inducted in service; and

- Within the reorganized CBR, the lower level non-technical positions of grade 1 to 10 is likely to be reduced and gradually replaced by technical positions. For non technical junior level positions in these grades recruitment will continue under the present system which recognizes the geographical coverage and provides equal opportunities of employment to people of different areas. However, in order to maintain complete transparency in the process, such recruitments will be based on defined criteria including education, age and experience requirements, which will be tested by independent sources to be specified by the CBR. For technical positions falling in Grades 1–10, the recruitment criteria will also be consistent with the specific technical skills needed at CBR and its field offices to perform these duties. The skills of the incumbents will also be tested independently. Necessary training and subsequent testing of the successful candidates will be mandatory to complete the induction process for the technical positions.

***Compensation and Promotion Strategy***

To adopt a new compensation and promotion mechanism in CBR that will change the work culture and encourage a high level of commitment, creativity, dedication and performance, significant headway will be achieved through following initiatives:

- Providing the management the ability to pay "living wages" in the form of additional compensation to those employees who will play a substantial role in the accomplishment of CBR objectives; and

- Introducing a promotion mechanism that will shift the current emphasis from seniority criterion to a broad based approach that takes into consideration factors like competencies for the new senior position, knowledge, skills, demonstrated performance and behavior.

Based on the extensive situation analysis and evaluation of recommendations of the task force, HRM is recommending transformation of policies in three stages that are:

1. Identification of specialized functions that are playing key role in the CBR modernization process with a restructured organization setup. This includes staff posted at LTU, SMTU, Tax Reform, IT, Audit, Fiscal Research, Tax Payer Education and Facilitation and HRM etc.;

2. Extending the concept to include CBR staff working in other critical functions by adopting a similar approach of placing good performers in specialized functions. These functions will include entire CBR, departmental representatives of direct and indirect taxes, departmental appellate positions, training directorates at all locations and other core positions in the field formations; and

3. Setting up specific goals for each function and cascade it down to individual levels with defined measures of success which should be monitored and evaluated at the end of the year to rate the performance and determine the rewards for each individual.

With the implementation of business process reengineering, the possibility of reduction of surplus positions and employees could not be ruled out. Rationalizing of CBR staff structure and size would provide the necessary fiscal space to gradually extend the concept of paying living wages to all the employees of line and support functions. This initiative will be extended after selecting/ retaining productive and efficient employees whose performance and suitability will be exclusively judged through a professionally conducted HR audit on predetermined parameters. There will be a process of goal setting for line and support functions. Performance evaluation will be based on accomplishment of goals as well as demonstrated leadership competencies by individuals during each year under review.

***New Promotion Mechanism***

The present promotion policy, predominantly based on seniority, is not capable for getting the right people for the specialized jobs, as it does not take into consideration the competencies and skills required for performing well in the new position. Accordingly, there is a strong case for a shift in the promotion policy with immediate effect. New promotion criteria should provide the CBR management the ability to link the job specific requirements with individual competencies and skills giving it the flexibility to get the best-suited person for the job irrespective of seniority. The new promotion policy will accordingly take into consideration other factors like competencies, skills, performance etc in addition to the seniority.

***Work Force Planning***

HRM with the help of independent consultants is identifying all critical positions in the organization, both in line as well support functions where value addition to CBR is meaningful. The consultants will identify core competencies for all such benchmark positions and conduct HR audit for the whole organization, identifying people with right competencies and match these with the job requirements. Based on the HR audit evaluation, adjustments would be made wherever needed leading to redeployment of staff over and above the needs of CBR.

## Going Forward

The HRM strategy will play a key role, on a continuous basis, in transforming the quality of human capital at CBR in its pursuits of achieving excellence and accomplishing the vision of becoming a modern and progressive arm of the Government of Pakistan.

In the next phase HRM, in partnership with the field formation will be developing revised and updated job descriptions for all benchmark positions. It is also initiating development of a new performance management system, which will give CBR the ability to objectively distinguish between leaders with potential, good performance and those who need improvement. Similarly, HRM is now examining the options of identifying the state of the art Human Resource Information System (HRIS) so that the human resource strategies are successfully implemented. With the continued support of the Government of Pakistan and commitment towards reforms, the CBR management is confident of its success.

*A man asks his gardner how long it would take for a certain seed to grow into a tree.*
*The gardner said it would take 100 years, to which the man replied,*
*"Then plant the seed this morning. There is no time to lose".*

A story often told by John F. Kennedy,
recollected by Lawrence H. Summers in his paper
**"Investing in *All* the People" (1992).**

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