# CBR Quarterly Review

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

***CENTRAL BOARD OF REVENUE***

*Government of Pakistan*

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# I

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

### The Economy

Pakistan's economy has maintained the path of recovery and growth since February 2002. The marked improvement in macro-imbalances, particularly the balance of payments position and fiscal deficit, and a sustained low inflation are signs of economic stability. The stock of debt, and debt servicing requirement is reducing after successful negotiations with the principal lenders under the debt-rescheduling program. The reduced-level of spending on interest payments due to declining interest rates and healthy growth in CBR revenue collection have provided the much needed fiscal space to boost public spending on social sectors. With an improvement in domestic and foreign demand and the promise shown by real and financial sectors, there is optimism that the overall growth targets of the current fiscal year (CFY) will be achieved.

The detailed analysis of the half-yearly information corroborates that the economic activity in the real sector is picking up. The crop outlook is encouraging due to improved availability of water and increased area under cultivation of major crops. The cotton crop is an exception where sown area has reduced by 13%.[2] However, it is expected that the loss in production and value addition of cotton will be more than compensated by gains in other major cash and food crops. The manufacturing sector is also showing signs of improvement. The July-November 2002 figures on production data indicate a double-digit growth in seven major industries including

[1] The analysis is carried out by the Research Team comprising the staff of Fiscal Research Wing of CBR, the Budget Wings of Direct & Indirect Taxes, and Directorate of Research & Statistics.

[2] According to Pakistan Cotton Ginners' Association the cotton arrival into ginneries in the beginning of December 2002 has registered an increase of 6.43% over the corresponding period of the last year.

sugar, cement, steel products, paperboard and automobiles. A single-digit growth has been recorded in cotton yarn, soda ash, glass sheets, tractors, and motor tubes.[3] The textile sector is going through a major overhaul to prepare itself for the quota-free world after 2005. During the past three years nearly one and a half billion dollars have been invested in the industry for the up-gradation and expansion of production lines. The recovery in the industrial sector is expected to strengthen in coming months, as the borrowing cost of capital is declining. Similarly, the input cost is falling due to downward adjustment of power tariffs. Furthermore, the increasing consumerism in the light of easy consumer financing is expected to reinforce domestic demand to have a positive impact on industrial growth and employment.[4]

For the second quarter, running the vibrant external trade sector is proving to be a source of economic consolidation. A 16.6% growth in exports has been contributed by nearly 20% growth in the exports of primary commodities, 16% in textile manufactures and 6% in other manufactures. On the other hand, the main sources of 18.7% growth in imports are the food group (28%), machinery group (34%), textile group (31%), and chemicals (16%) etcetera. Viewed objectively, the increasing import demands for industrial machinery and raw material are early signals of the revival of the manufacturing sector and strengthening of the economy.

On the financial side the bubbling stock market is a source of cautious optimism for two reasons. First, similar to the increasing demand for industrial inputs, the stock market performance is also a ‘lead’ variable in real business cycle analysis. A strong capital market activity based on increasing corporate profitability is usually

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[3] For further details see *Industrial Bulletin* December 2002 issued by the Expert Advisory Cell, Ministry of Industries and Production, Islamabad.

[4] The growth in automobile industry and electrical industries engaged in home appliances could in part be attributed to the consumerism phenomenon. However, this assertion needs to be substantiated further with the availability of detailed data.

followed by improvement in the overall macroeconomic activity. Second, since the present security market activity is largely driven by domestic sentiments, it also reflects an increasing confidence of domestic investors, other things being equal.

If the current trend of economic recovery continues and the overall macroeconomic environment remains conducive for real investment, the likelihood of high growth performance during CFY becomes a real possibility. However, it would be ideal if the economic growth turns pro-poor. This would, nonetheless, require that the benefits of growth be distributed equitably so that growing incidence of poverty is reduced in the country.

## CBR Revenue Target for FY 02-03

The projected monthly and quarterly targets of the four taxes are reported in *Table 1*. At the start of CFY the overall target for the 2nd quarter was fixed at Rs. 110.5 billion. The monthly targets were set on the basis of historical trends of individual taxes. For example, in view of the fact that corporate returns are filed in December, a higher target of (39.7%) was set for this month as compared to 31.5% for October and 28.8% for November. Regarding individual taxes, 38.7% of the quarterly target was assigned to direct taxes, 43% to sales tax and the remaining 18.3% was allocated to central excise and customs duties.

**Table 1: Monthly and Quarterly Targets of Federal Taxes: FY 02-03**

*(Rs. Billion)*

| | Direct Taxes | Sales Tax | Customs Duties | Central Excise | ALL TAXES |
|---|---|---|---|---|---|
| *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* |
| *Quarter: 3* | *35.1* | *48.9* | *14.0* | *11.7* | *109.6* |
| *Quarter: 4* | *47.4* | *66.8* | *22.0* | *14.3* | *150.5* |
| **Full Year** | **148.4** | **205.7** | **59.0** | **47.5** | **460.6** |

## CBR Revenue Position

*CBR has achieved the half-yearly target of revenue collection. The July-December net collection stands at Rs. 201.43 billion against the target of Rs. 200.5 billion.* This unprecedented accomplishment has been the result of a number of factors. The continuation of policy reforms and improvement in tax administration on the one side and a double-digit growth in imports, exports, and production of leading industries on the other are mainly responsible for acceleration in domestic and foreign demand and consequently the federal receipts.

### *Overall Collection and Refunds*

The revenue collection has maintained the momentum generated in the 4th quarter of the PFY and the 1st quarter of the CFY when federal revenues grew by 16.1% and 16.6%, respectively. The net collection during the 2nd quarter of CFY has increased by 14.4% over the October-December period of the PFY. In absolute terms, the gross and net collection for Q2: FY 02-03 has been Rs. 127.501 billion and Rs. 111.08 billion, respectively with refund payments of Rs. 16.421 billion. The overall growth during the first half of CFY has been 15.4%, which exceeds the projected annual growth of 14.04% for the entire FY 02-03.

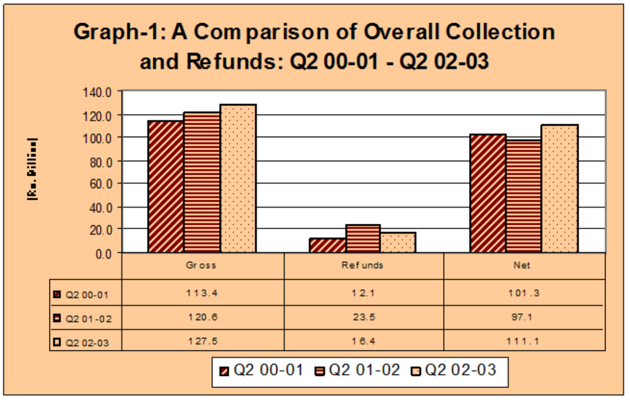
The month-to-month comparison indicates that a healthy growth in collection has been maintained during each of the first six months of the CFY *(Table 2)*. With the exception of October when the growth in revenue was 4.1%, a double-digit growth has been recorded in the remaining five months. The performance for October is not unexpected either when compared with the target set for the month. Secondly, the growth in collection has been achieved without holding back refunds. While the refunds/ rebate payment during July-December 2002 declined by 10.8% over the corresponding period of PFY, but this phenomenon needs to be evaluated in the light of the one-time policy of clearing the backlog of refunds undertaken in FY 01-02. The refunds/ rebate during the first half of the CFY when compared with the corresponding period of FY 00-01 shows an increase of 38.6%.

**Table 2: Overall Net Collection and Growth: A Monthly Comparison**

| | FY 01-02 | FY 02-03 | Growth (%) |
|---|---|---|---|
| July | 19.7 | 23.6 | 20.1 |
| August | 26.8 | 29.6 | 10.2 |
| September | 31.0 | 37.2 | 20.0 |
| October | 33.2 | 34.6 | 4.1 |
| November | 24.9 | 31.8 | 27.8 |
| December | 39.0 | 44.7 | 14.7 |
| Half-Year | 174.5 | 201.4 | 15.4 |

Note: Collection in Billion rupees.
The figures are rounded to one decimal place.

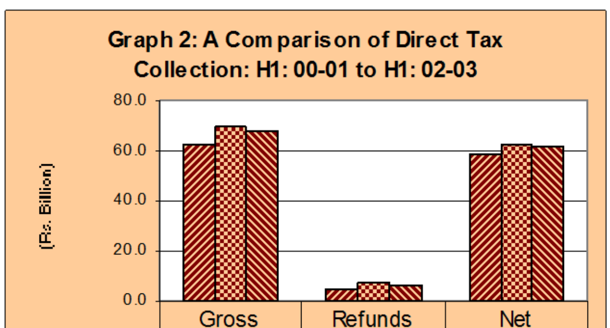
*Graph-1* is drawn to gain further insight on gross and net collection and refunds during 2nd quarter of CFY as compared with the 2nd quarter figures of past two years. Even though last year's collection and refunds were jointly influenced by the shock waves of the 9-11 event and pursuing of generous refund policy, but the economy vis-à-vis collection seem to have settled down on a steady growth path during the first half of the CFY. From a negative growth of about 4% observed during Q2 of PFY, the net collection has risen by 14.4% in Q2 of CFY. However, as compared to the 2nd quarter net collection of FY 00-01, it has gone-up by 9.7%.



***Detailed Analysis of Individual Taxes***

The collection of individual taxes has been analyzed within the broader macroeconomic perspective. While the growth in aggregate collection of the four major taxes, i.e., direct taxes, sales tax, customs duties and central excise duties, has been over 15% during the first half of the CFY, this growth has largely come from sales tax, both on domestic and import stages, and customs duties. In order to understand the determinants of growth, the detailed analysis of individual taxes is undertaken in the following.

***Direct Taxes*****:** The gross and net collection of direct taxes during October-December 2002 has been Rs. 40.974 billion and Rs. 38.122 billion, respectively. Simultaneously, refund payment of Rs. 2.852 billion has also been made during this period. Thus, the half-yearly gross and net collection stands at Rs. 68.282 billion and Rs. 61.715 billion, respectively. While the net collection for this period is less by 1.7% the last year's half-yearly collection, but it is higher by 6.3% the net collection of H1: FY 00-01. *Graph-2* illustrates this trend quite clearly. This pattern of growth is analyzed in the following when the performance of various components of direct taxes is discussed.




| | Gross | Refunds | Net |
|---|---|---|---|
| H1: 00-01 | 62.6 | 4.6 | 58.1 |
| H1: 01-02 | 69.6 | 6.9 | 62.8 |
| H1: 02-03 | 68.3 | 6.6 | 61.7 |

The cyclical pattern of month-to month growth observed in the 1st quarter has continued in the 2nd quarter as well. The gross and net collection was lower in October-02 than October-01 by 15.9% and 5.3%, respectively. The month of November-02 registered a positive growth of 6.9% and 0.1%, but there has been a decline of around 10% in gross and net collection in December-02 over December-01.

The main factors behind this adverse growth are the decline in voluntary compliance and demand creation. Even though the voluntary compliance has registered a healthy 40.2% increase in the 1st quarter of CFY, but this important component of income tax recorded a decline of 22.9% in the 2nd quarter mainly due to less deposit by the PTCL, which incidentally is one of the major contributors in the VP category [*Table 3*]. The decline in collection on demand has continued in the 2nd quarter of CFY as well. However, the prospects on this account are bright for two reasons. First, even though LTU at Karachi has already created a demand of Rs. 2 billion, but this will be reflected in January-03 collection. Second, the assessment of returns generally picks up in the 2nd half of the financial year.

**Table 3: Quarterly and Half-Yearly Growth of Major Components of Income Tax**

| ***Tax Heads*** | ***First Quarter*** | | ***Second Quarter*** | | ***July-December*** | |
|---|---|---|---|---|---|---|
| | ***A*** | ***B*** | ***A*** | ***B*** | ***A*** | ***B*** |
| Income Tax | | | | | | |
| Collection on Demand | 10.1 | -17.7 | 8.6 | -22.3 | 9.1 | -20.6 |
| Voluntary Payments | 60.2 | 40.3 | 9.0 | -22.9 | 21.1 | -10.2 |
| Deduction at Source | 4.3 | 5.2 | 6.4 | 8.5 | 5.4 | 6.9 |
| Income Tax (Gross) | 15.4 | 11.2 | 7.6 | -8.6 | 10.6 | -1.5 |
| Refunds | 26.7 | 11.3 | 63.1 | -14.3 | 44.0 | -4.2 |
| Income Tax (Net) | 14.1 | 11.2 | 4.1 | -8.0 | 7.9 | -1.2 |

Note: **A** refers to growth over corresponding period of FY: 00-01 and **B** refers to FY: 01-02.

Withholding tax (WHT) is the 3rd major component of income tax as its share in total (net) collection continues to be above 50%. The WHT collection has increased from 6.4% in the 1st quarter of CFY to 8.2% in the 2nd quarter. The major sources of this growth are contracts, imports, salaries, electricity, and dividends. The 28.9% increase in WHT on contracts has been due to higher government spending, which has been possible due to improvement in fiscal space and economic conditions. WHT on salaries has increased by 15.4% in the 1st half the CFY mainly due to withdrawing of exemptions on perquisites and increase in rates. Finally, nearly 73% increase in dividends is consistent with increasing profitability of the corporate sector and vibrant stock market activities.

**Table 4: Quarterly and Half-Yearly Growth of Withholding Taxes**

| Major Withholding Taxes | ***First Quarter*** | | ***Second Quarter*** | | ***July-December*** | |
|---|---|---|---|---|---|---|
| | ***A*** | ***B*** | ***A*** | ***B*** | ***A*** | ***B*** |
| U/s 50(4) Contract | 29.9 | 20.4 | 6.3 | 28.9 | 15.6 | 25.0 |
| U/s 50(2) Securities | -57.4 | -5.1 | -33.4 | -39.6 | -45.8 | -29.2 |
| U/s 50(5) Imports | 8.0 | 8.0 | 7.7 | 13.8 | 7.8 | 10.7 |
| U/s 50(1) Salary | 19.9 | 17.8 | 16.3 | 13.2 | 18.0 | 15.4 |
| U/s 50(2-A) Interest | -14.5 | -7.5 | -4.2 | -2.7 | -9.8 | -5.2 |
| ***Sub-Total (Major Items)*** | 1.1 | 9.7 | 1.5 | 7.8 | 1.3 | 8.7 |
| Others | 16.7 | -7.8 | 25.9 | 11.1 | 21.5 | 1.6 |
| **Total WHT** | 4.3 | 5.2 | 6.4 | 8.5 | 5.4 | 6.9 |

Note: **A** refers to growth over corresponding period of FY: 00-01 and **B** refers to FY: 01-02.

***Sales Tax**:* Following the 1st quarter growth of 26.5%, the net sales tax collection has grown significantly in the 2nd quarter as well -- the rate of growth being 24.6%. In absolute terms, the 2nd quarter gross collection has been Rs. 56.8 billion as compared to Rs. 56.7 billion in the 1st quarter of CFY and Rs. 48.3 billion in the 2nd quarter of PFY. The net collection has similarly increased from Rs. 43.8 billion in the 1st quarter to Rs. 48.5 billion in the 2nd quarter of CFY and Rs. 38.9 billion in the 2nd quarter of PFY. The refund payments have also increased from Rs. 12.9 billion to 21.2 billion between the two quarters of CFY. Of the two components of sales tax, i.e., sales tax imports and sales tax domestic, the net collection of the former has been Rs. 25.6 billion, showing an increased of 19.9% over the 2nd quarter collection of PFY. Simultaneously, the net collection of domestic sales tax has grown by 30.2% in the 2nd quarter to reach at Rs. 22.8 billion. The half-yearly net collection of imports and domestic components of sales tax is, therefore, 15.2% and 41.3%, respectively. The overall net collection of sales tax has gone up by 25.5% during July-December of CFY over the same period of PFY. Surely, this high growth in sales tax collection has been possible due to increased demand for domestic and imported goods, some of which have been classified as raw material for consumer and capital goods. Moreover, since the refund payments during the first six months of CFY have declined by only 0.3% over the corresponding period of PFY when above-normal refunds were paid to clear the backlog, the growth in sales tax collection should be regarded as a signal of strengthening of the economy.

*Domestic Sales Tax Collection and Major Revenue Spinners*: The detailed analysis of domestic sales tax collection has been carried out on the basis of the performance of ten major revenue spinners. The relevant information is presented in *Table 5*. The ten commodity groups are selected because of their importance in terms of revenue collection, which incidentally have contributed nearly 69% of total domestic sales tax collection during the 2$^{nd}$ quarter of the current year. The data indicate that, on the whole, the collection from these revenue spinners has grown by 13.3% over the period under consideration. However, in comparison, the remaining sectors have grown at a higher pace (21.6%) to register an overall growth of 15.7% in the 2$^{nd}$ quarter.

Specifically stating, the main contributors of 13.3% growth in major revenue spinners are: POL products showing a growth of 23.7%, electrical energy 59.9%, cigarettes 22.5% and aerated waters/ beverages 19.5%. On the other hand, a decline in cotton yarn collection by 16.1% in the 2$^{nd}$ quarter of CFY and 16.5% during the first half of the year is mainly due to lower prevailing market price of cotton yarn, which is discouraging suppliers and resultantly the stocks are piling up with the manufacturers. The negative growth in collection for cement in the months of September, October, and December has been more than compensated by a positive growth in the remaining three months. Thus, despite a negative growth of 5.4% during the 2nd quarter of CFY, the sales tax collection of cement has recorded a positive growth of 5.6% for H1: FY 02-03 over the corresponding period of the PFY. A similar phenomenon has been observed for natural gas and services where month-to-month comparison has demonstrated a mixed growth pattern.

**Table 5: A Comparison of Sales Tax Collection from Ten Major Revenue Spinners October- December 00-01 to October-December 02-03**

| Revenue Heads | October-December | | | Growth (Percent) | |
|---|---|---|---|---|---|
| | 2000-01 | 2001-02 | 2002-03 | Col.4/Col.2 | Col.4/Col.3 |
| *Col. 1* | *Col. 2* | *Col. 3* | *Col.4* | *Col. 5* | *Col. 6* |
| Services | 1.54 | 2.41 | 2.08 | 34.9 | -13.9 |
| POL Products | 3.74 | 4.02 | 4.97 | 33.1 | 23.7 |
| Electrical Energy | 0.60 | 1.62 | 2.60 | 330.5 | 59.9 |
| Natural Gas | 1.82 | 2.30 | 2.06 | 13.2 | -10.4 |
| Sugar | 0.46 | 1.72 | 1.84 | 298.1 | 7.3 |
| Cement | 0.62 | 0.95 | 0.90 | 45.6 | -5.4 |
| Cotton Yarn | 0.67 | 0.48 | 0.40 | -39.6 | -16.1 |
| Cigarettes | 0.93 | 0.97 | 1.19 | 27.9 | 22.5 |
| Cotton not Carded not Combed | 6.72 | 4.33 | 5.24 | -22.1 | 21.1 |
| Aerated Waters/Beverages | 0.32 | 0.36 | 0.43 | 37.0 | 19.5 |
| *Sub Total* | 17.42 | 19.17 | 21.72 | *24.7* | *13.3* |
| Other Sectors | 5.93 | 7.68 | 9.34 | 57.6 | 21.6 |
| *Grand Total* | 23.35 | 26.85 | 31.06 | *33.0* | *15.7* |

**Value in Billion rupees*

**Customs Duties:** The collection on account of customs duties depends on a number of factors including downward revision of maximum duty rate, position of foreign exchange reserves that has a bearing on exchange rate, the rupee value of dutiable imports, and, above all, the state of the economy. The net collection during October-December 2002 indicates that the pace of revenue generation set in the preceding quarter has been maintained. In fact, the net collection of Rs.14.3 billion has surpassed the 2nd quarter target of Rs. 9.2 billion by 55.4%. This collection also exceeds the 2nd quarter collection of PFY by 98.2%. It may also be relevant to mention that this growth has been accomplished despite the removal of protective barriers on international trade transactions by slashing down the maximum duty rate on imports and the appreciation of Pak rupee vis-à-vis US dollar by about 13%.

The monthly figures on revenue collection indicate that a sizeable growth has been recorded in each of the six months of CFY as compared to the corresponding months of the PFY. The continued buoyant pace in collection is reflected by the fact that 23.3% growth in the 1st quarter of CFY is followed by 15.6% growth in October-02, 148.1% in November-02 and a phenomenal increase of 272.1% in December-02 against corresponding months of PFY. The two main factors for this performance are the increase in rupee value of dutiable imports by 12.1% during first half of CFY and the transfer of POL products from central excise to customs duty net. Besides the net collection is favorably influenced by lesser refunds and rebates payments during CFY as compared to PFY.

Based on commodity composition of imports, a further analysis of customs duties is quite revealing. The Custom House, Karachi data indicate that the commodity composition of dutiable imports has tilted in favor of capital goods for the 2nd quarter in a row. The value of dutiable imports has increased from Rs. 25.5 billion in H1: FY 01-02 to Rs.34 billion in H1: FY 02-03, entailing an increase of 33.3%. On the other hand, the dutiable consumer goods imports have decreased from Rs.18.8 billion in July-December 2001 to Rs.12.5 billion in July-December 2002, showing a decrease of 33.5%. This phenomenon is further substantiated by the disaggregated chapter-wise data collected according to PTC Commodity Heads [*Table 6*]. The fifteen commodity heads, referred-to-as the major CD revenue spinners, have generated nearly 83% of CD revenue during July-December 2002. It is interesting to note that while the import value of these commodities in rupee terms has declined by about 18%, the value of dutiable imports has risen by more than 21%. Thus, the CD revenue has increased by 19%. This increase is even more encouraging in the light of the declining effective rate, which incidentally has fallen from 17.1% in H1: FY 01-02 to 16.7% in H1: FY02-03. The growth in imports of electrical machinery, chemicals, dyes and paints, paper and paperboard, and vehicles is a reflection of improved spending on consumer and industrial raw materials.

**Table 6: Chapter-wise Major Revenue Spinners of Customs Duties and Effective Rates**

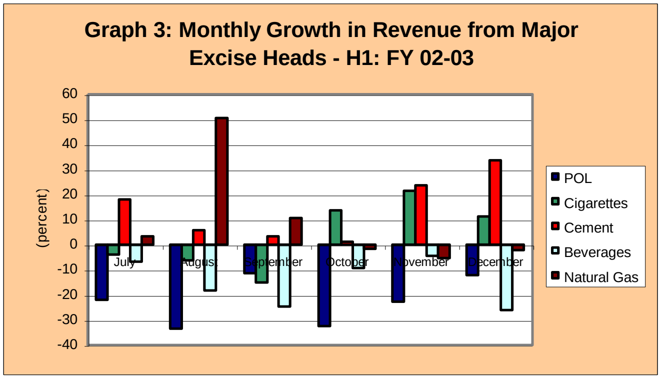
| PCT Chapter | Tariff Description | July-December Growth in | | | Effective Rate on Dutiable Imports | |
|---|---|---|---|---|---|---|
| | | Import Value | Dutiable Imports | Customs Duties | Up to Dec-02 | Up to Dec-01 |
| 15 | Edible Oil and Waxes | 22.7 | 36.1 | -5.4 | 34.7 | 49.4 |
| 87 | Vehicles | 62.8 | 59.2 | 63.0 | 33.6 | 32.8 |
| 27 | POL Products | -70.3 | 25.7 | 743.7 | 10.1 | 1.5 |
| 39 | Plastic Resins, etc. | 19.4 | 15.4 | 9.6 | 18.5 | 19.5 |
| 84 | Machinery | -5.6 | 54.2 | 15.9 | 9.1 | 12.1 |
| 29 | Chemicals | 7.4 | -11.3 | 14.9 | 10.0 | 7.7 |
| 85 | Electrical Machinery | 98.3 | 68.6 | 53.8 | 13.6 | 14.9 |
| 9 | Coffee and Tea etc. | -0.6 | -3.1 | -21.3 | 23.3 | 28.6 |
| 72 | Iron and Steel | 8.5 | 0.5 | -20.2 | 17.0 | 21.4 |
| 38 | Misc. Chemical Product | -7.3 | -10.3 | -5.9 | 13.4 | 12.7 |
| 48 | Paper and Paperboard | 10.4 | 10.1 | 1.4 | 17.9 | 19.5 |
| 32 | Dyes, Paints, etc | 11.7 | 11.5 | -0.8 | 18.3 | 20.5 |
| 12 | Oil Seeds etc. | 70.3 | 75.7 | 264.6 | 10.3 | 5.0 |
| 40 | Rubber Products | 13.7 | 13.6 | 6.9 | 14.7 | 15.6 |
| 54 | Man-made Filaments | 29.0 | 24.9 | 10.5 | 17.8 | 20.1 |
| *Sub-Total* | | *-17.9* | *21.8* | *19.0* | *16.7* | *17.1* |
| | Others | 95.2 | -3.0 | -2.0 | 12.2 | 12.1 |
| **Grand Total** | | **11.4** | **15.4** | **15.0** | **15.8** | **15.8** |

Note: Figures are in percent.

**Central Excise:** The net collection of central excise duties during Q2 02-03 was Rs. 10.2 billion, entailing a *negligible* decline of 0.6% over 2nd quarter collection of PFY. Since the decline in the 1st quarter collection was 3.3%, the overall decline during the first six months has been around 2%. The month-to-month record of collection, however, indicates an improvement in collection in November and December as compared to earlier months. In fact, the negative growth of 9.4% in September and 7.1% in October has outweighed the positive growth of 3.6% in November and 2.7% in

December and consequently a negative growth has been registered for the first half the year.

The month-to-month movement of CED collection of five major revenue spinners is depicted in *Graph-3*. It shows that with the exception of cement, which recorded positive growth in revenue during the entire first half of CFY, and POL products, which registered a negative growth in CED collection all through the first six months, the performance of other major CED heads has been mixed. The negative growth in collection from cigarettes was due to excess supply in the 1st quarter of the year. This situation has improved in the 2nd quarter as half-yearly collection shows a growth




of 3.2% over the corresponding period of PFY. However it may be added that the desired projection target could not be achieved due to increasing incidence of low and medium brands of cigarettes from neighboring markets and some reports of losing market due to increase in prices of domestic brands at the time of budget 2002-03. For aerated beverages the negative growth in CED collection has continued in the 2nd quarter as well despite the reduction in the rate of CED on retail price from 15% to 12%. Even though the 8.6% decline in collection could partially be explained by the seasonal dip in the winter months, but a consistent decline in view of the reduced duty structure remains unexplainable and requires further investigation. While the collection from cement has increased by 13.1% due to 11.73% increase in production during July-November

period, the CED collection from POL products has declined by 23.5% due to transfer of these products to CD net.

**Concluding Observations**

The success in meeting the half-yearly revenue target is by no means an ordinary accomplishment. This feat has been repeated after quite a while and that too in an objective manner. It should be reassuring that neither the refunds are withheld, nor there is any over-reporting of the revenue figures.[5] The continuation of the reform process for improving tax administration coupled with implementation of tax policy reforms; and a collaborative arrangement with inter-government institutions for consistency of polices have enabled the revenue organization to create a conducive and non-coercive atmosphere for economic expansion. Simultaneously, the revival of the economy has started to yield dividends. The improved revenue collection, especially in the areas of domestic sales tax and customs duties, is an indication of improved domestic economic activity and absorptive capacity.

The effort is now focused on translating the take-off of the economy into sustained growth and equitable distribution. The opening of model tax offices at Karachi and Lahore are the two initiatives by CBR to experiment with a new taxation system in the country. The operation of these offices is purely on functional lines where the focus is on taxpayer facilitation rather than revenue targeting. The business processes such as filing of returns, refund management, audit and enforcement are being automated to streamline the working of the organization and to minimize contact between taxpayers and tax collectors. The success of these model units will ensure whether or not the facilitating approach encourages stakeholders to join hands with the revenue organization to promote economic expansion by paying their due share in a free and friendly environment.

[5] The revenue collection figures are now reconciled regularly with the offices of AGPR and State Bank of Pakistan before their publication.

# II

# From ST to GST: The Development of Sales Tax in Pakistan[6]

## Background

Over the past fifteen years Pakistan's economy has been exposed to a number of policy reforms. With the introduction of the Structural Adjustment Program in 1980s, these policy initiatives have been diverse in nature ranging from changes in the tariff structure to industrial and commercial policies, and banking sector reforms. The continuous adjustment of the economy for correction of structural weaknesses on the one hand and increasing expenditure on account of large debt servicing and defense needs on the other hand forced the policy planners to seriously decide on fiscal discipline and consolidation. The two-prong strategy was aimed at putting restrictions on unwarranted spending and generating additional revenue. However, as has been the case with other developing countries, resource mobilization efforts have generally been marred by narrow tax base in Pakistan. Moreover, additional taxation is not an attractive policy option due to its adverse distributional consequences and unfavorable impact on industrial growth.

With the restrictive choice of additional taxation instruments, the economic managers opted for a taxation system that was efficient and equitable.[7] It ensured as much neutrality as possible from

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*Authors Note*: The authors are grateful to Mr. Riaz A Malik, Chairman CBR and Mr. M. Ramzan Bhatti, Member Sales Tax, for useful insight and comments.

[7] There are two aspects of efficiency: *allocative efficiency* is achieved when the public sector produces the level and mix of services according to the electorate demands and *X-efficiency* is achieved when the public sector produces the optimal level and mix of public services at minimum costs. Similarly, there are two aspects of equity. Equal treatment of persons with equivalent circumstances is referred to as *horizontal equity* and the desirable degree of unequal treatment of persons with unequal incomes and/or wealth is known as *vertical equity*.

individual taxpayer's standpoint and the society at large. The first generation of tax reforms focused on the value added version of sales tax with gradual phasing out of excise duties and less and less reliance on customs duties as primary sources of revenue.

The discussion in this paper, therefore, revolves around development of sales tax in the country. It is important to know how much has been achieved through various tax policy initiatives in terms of revenue enhancement, voluntary compliance, and reducing the burden of tax on poor. Similarly, the assessment of the impact of administrative reforms in the areas of registration, record keeping requirements, filing of returns, dispute resolution, audit and refund-management etcetera is also critical to design the future course of action so that the transition from ST to GST is completed in accordance with the stated objectives.

**The Progress of Sales Tax in Pakistan**

*Legal Aspects and Coverage*: Sales tax, essentially levied on sales of goods, was categorized as federal tax through enactment of the Sales Tax Act, 1948.[8] It was a cascade type tax levied at each stage with few exceptions. The Sales Tax Act, 1951 replaced the earlier version when it became operational in 1952. It was introduced as a single stage tax levied both at the import stage and on domestic sale of goods by manufacturers or licensed wholesalers. The rate structure was heterogeneous for indigenous products and imports. The tax was administered by the Income Tax Department although at import stage it was collected by Customs and tax on excisable goods was collected by the Central Excise Department. However, the administration of sales tax was transferred from income tax to central excise in 1981 as its collection was started in the excise tax mode. The idea was to separate the administration of one of the

[8] Prior to this sales tax was administered on the basis of the 1935 Act.

major indirect taxes from direct taxes and to bring the collection of all three federal indirect taxes under one administrative structure.

With the emergence of value added tax (VAT) and its unparallel rise and success all across the world, efforts were also started in Pakistan to adopt the new sales tax structure. It was believed that the proposed tax will be neutral as far as consumption choices, methods of production and distribution and international trade transactions are concerned [Bhatti (1984)] and it will be revenue buoyant, broad based, and difficult to evade [Burgess and Stern (1993)].[9] In this pursuit a major milestone was accomplished when the Sales Tax Act 1990 was passed by the Parliament, which paved the way for the introduction of the comprehensive value added version of sales tax, commonly known as General Sales Tax (GST), in the country in November 1990. To start with the value added tax at each stage of business transaction was restricted to import stage and manufacturing sector. However, with the introduction of revolutionary changes in the Sales Tax Act 1990, the GST was enforced in true letter and spirit of VAT mode in FY 95-96. It was organized on the functional lines including the functions of assessment, audit, enforcement, monitoring and adjudication rather than the traditional administrative structure. To make the sales tax system more equitable and just, emphasis was shifted from production to consumption, which required phasing out of central excise and less emphasis on customs duties. Additionally, the system was developed on self-assessment basis with enforcement of effective audit parameters. On the administrative front, the collection of domestic sales tax was transferred from Central Excise Collectorates to newly established Sales Tax Collectorates. The detailed assessment of the whole process corroborates that the zeal

[9] Bhatti, M. R. (1984) 'Need for Reform of the Federal Indirect Tax System – A Proposal for Introduction of Value Added Tax in Pakistan.' Dissertation submitted to School of Humanities and Social Sciences, University of Bath, the United Kingdom, and Burgess, R. and N. Stern (1993) 'Taxation and Development', *Journal of Economic Literature*, June, pp: 762-830.

and labor of past twelve years is bearing fruit, as the outcome is quite promising. There is significant achievement in terms of enhanced revenue collection and improved level of compliance while maintaining the neutrality of the tax.

**Sales Tax Compliance**

The main objective of transition from ST to GST was to achieve the target of improved compliance efficiently and equitably. The tax administration is efficient when the cost of collection is low and where non-compliance is detected through a transparent system of audit and appropriate penalties. From taxpayers' perspective, the tax is efficient when the cost of compliance is low. In this respect, a number of policy initiatives have been taken since early 1990s with regard to registration of taxpayers, record keeping requirements, effective auditing, amicable resolution of disputes, and promptness in refund payment. The procedural guidelines with brief details are described in the following.

*Registration, Record Keeping and Filing of Returns*

Registration is the entry point in the sales tax domain. An entity (a person or establishment) that makes a taxable supply in Pakistan including zero-rated supplies is required to apply for registration under the Sales Tax Act, 1990. These include manufacturers (threshold exceeding Rs. 2.5 million), retailers (exceeding Rs. 5 million), importers, wholesalers (including dealers) and distributors. All commercial exporters who want to claim the refund of sales tax as a result of zero-rated export of the goods are required to register as well. However, those manufacturers and retailers whose annual supply of taxable goods is less than the sales tax registration threshold are exempt from registration. In this case they are required to enroll with the concerned collectorate of sales tax to pay the turnover tax at the rate of 2% if the annual turnover is 0.5 million for manufacturers and Rs. one million for retailers.[10]

The historical growth of sales tax registrants presented in *Table 1* shows that the GST base is expanding at respectable rates for both, domestic as well as import categories. Within the domestic category, the number of registered manufacturers has grown, on average, by about 4% per annum between FY 96-97 and FY 01-02. While the number of registered wholesale and retail traders has exceeded sixty thousand, the number of service providers has also surpassed six thousand when GST was extended to services in FY 00-01. On the whole, the number of taxpayers has increased by 23% in FY 01-02.

**Table 1: Number and Growth of Registered Persons under Sales Tax**

| | Domestic | | Importers | | Overall | |
|---|---|---|---|---|---|---|
| | Number | Growth | Number | Growth | Number | Growth |
| 1996-97 | 31046 | | 1651 | | 32697 | |
| 1997-98 | 33166 | 6.8 | 8841 | 435.5 | 42007 | 28.5 |
| 1998-99 | 47014 | 41.8 | 13197 | 49.3 | 60211 | 43.3 |
| 1999-00 | 57621 | 22.6 | 17917 | 35.8 | 75538 | 25.5 |
| 2000-01 | 96359 | 67.2 | 21057 | 17.5 | 117416 | 55.4 |
| 2001-02 | 122175 | 26.8 | 22362 | 6.2 | 144537 | 23.1 |

Record Keeping Requirement: From exclusive reliance on the exhaustive excise record and supervised clearance in the early stages of development, greater emphasis is now laid on record keeping activities with the introduction of self-assessment in sales tax.[11] A registered person making taxable supplies is required to maintain and keep records of goods purchased and supplied (including zero-rated and exempt supplies) for ascertainment of tax liability, if and when required. The types of records include:

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[10] To facilitate aspiring registrants, the detailed procedure of registration is available on CBR website.

[11] In fact, keeping of record and invoices by registered persons is one of the core activities of VAT, which should be viewed and analyzed in the light of the benefits of documentation of the economy and good business practices as has been the case in the developed world rather than adopting the naïve approach which focuses on increasing cost of book-keeping only.

i) The record of supplies indicating description, quantity and volume of goods, name and address of the person to whom supplies were made and the amount of tax charged;

ii) The record of goods purchased reflecting description, quantity and value of goods, name, address and registration number of supplier and amount of the tax on purchases;

iii) The record of zero-rated and exempt supplies; and

iv) Invoices, credit notes, debit notes, bank statements, inventory records, utility bills, salary and labor bills, rental agreement, sales purchase agreement and lease agreement.

Filing of Tax Return: A registered person is required to furnish a tax return on prescribed form on 15th of the following month and quarterly return for turnover tax on 15th of the month following the quarter [Section 26(A) of the Sales Tax Act, 1990]. The non-filers, short-filers and late-filers are identified and separated through computer records at the collectorate level for further action. *Table 2* indicates that while there is no definite pattern in growth of non- and short-filers, the growth of nil filers is declining overtime, especially after FY 99-00 due to various tax measures taken in recent years.

**Table 2: Number and Growth of Nil-, Non- and Short-Filers**

| | Nil Filers | | Average Non-Filers | | Short-Filers | |
|---|---|---|---|---|---|---|
| | Number | Growth | Number | Growth | Number | Growth |
| 1996-97 | 6432 | | 13723 | | 1649 | |
| 1997-98 | 10420 | 62.0 | 9954 | -27.5 | 1569 | -4.9 |
| 1998-99 | 17729 | 70.1 | 13356 | 34.2 | 3007 | 91.7 |
| 1999-00 | 23649 | 33.4 | 18767 | 40.5 | 2701 | -10.2 |
| 2000-01 | 30588 | 29.3 | 8537 | -54.5 | 3209 | 18.8 |
| 2001-02 | 34067 | 11.4 | 16216 | 89.9 | 3521 | 9.7 |

Note 1: The figures of non-filers for FY 00-01 and FY 01-02 do not include 12918 persistent non-filers. Their cases are being dealt individually as enforcement issue.

Note 2: Growth is in percent.

Audits and Penalties: The theoretical and empirical literature on tax evasion demonstrates that increased tax compliance is ensured through a transparent system of audits and appropriate penalties. A rational taxpayer under uncertainty maximizes utility by declaring income after taking into consideration the probability of audit and the penalty, if evasion is detected. Thus, higher is the probability of detection and more effective are the prescribed penalties, the lower is the probability of tax evasion. However, notwithstanding the significance an effective audit strategy to ensure compliance in VAT, this usually remains the weakest component of VAT administration. There are various reasons for this including lack of sufficient skills for audit, especially of large units and improper monitoring. In the absence of the required information, there are problems with the selection of appropriate audit parameters.[12] In this situation penalties turn out to be a preferred choice in view of its low administrative costs than audit. However, for penalties to be effective, they must be applied quickly.[13] A penalty that is delayed for years because of appeals or non-recovery becomes ineffective.

During the transition period from sales tax to GST, a system of penalties along with audit has been evolved to make the tax more effective and rigorous. Along with the penalties provided in the law, especially those related to late-filling, non-filling, non-registration and tax fraud, additional tax at the rate of two and a half percent is another form of penalty used to deter tax evasion. To encourage documentation and registration, a further tax of 3% is levied as a penalty on sales by a registered person to a non- registered person. Beside penalties, changes have also been carried out in the law at regular intervals to implement these penalties. Separation of adjudication from administration, suspension of amnesty schemes by the government and speedy disposal of the pending cases are some of the steps towards making the penalties more effective.

Promptness in Refund Payments: Payment of refunds has always remained an irritating issue between taxpayers and the tax

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[12] The issue of sales tax audit is taken-up in greater detail in a separate article appearing in the same issue of the *CBR Quarterly Review*.

[13] See Tanzi, V. and P. Shome (1993) ‘A Primer on Tax Evasion’, *IMF Staff Paper,* Vol. 40, No. 4: pp. 807-828.

administration. Delays in payment of refund to the registered person amount to implicit taxing of the inputs. In face of inflation, the real value of refunds carried forward declines rapidly, becoming equivalent in effect to a tax on fixed asset. However, in the presence of fake, flying, and fictitious invoices, overstatement of inputs and understatement of sales by the taxpayers, refund payments cannot be made promptly. CBR has already taken various initiatives including issuance of detailed rules and regulations for sanctioning refunds, setting up of a refund repository and availability of an option to the taxpayers to verify their refund status through computer to resolve the issue of refunds and rebates.[14]

**Sales Tax Collection in a Historical Perspective**

Whether or not GST is buoyant could be judged from its revenue generating potential. The historical growth of sale tax revenue has been evaluated in this section to understand how various tax policy initiatives have contributed towards the goal of generating the targeted revenue for the government.

The average annual sales tax collection was Rs. 180 million in 1950s, which increased to Rs. 2,893 million in FY 80-81 and Rs. 17,008 million in FY 90-91. With the extension of GST, the sales tax collection further increased to Rs. 166,561 million in FY 01-02. The average annual rate of increase was 12.2% during 1950s, which declined to 8.9% in 1960s. Ever since the rate of growth in sales tax collection has been around 20% with the exception of 1980s when it was 24% *[Table 3]*. Notwithstanding this consistent growth in the overall sales tax collection, wide fluctuations have been observed in the growth of its two components, i.e., sales tax domestic and sales tax on imports. The reasons for this change in the behavior include: frequent changes in the standard rate, withdrawal of exemptions, broadening of sales tax base and transition from sales tax to value

[14] Further details can be found in Ahmed, A. M. and Robina A. Ahmed (2002) 'Addressing the Refunds and Rebates Conundrum', *CBR Quarterly Review*, Vol. 2, No. 1, July-September: pp 19-34.

added version of GST. These developments are briefly discussed in the following.

Due to weak and dilapidated manufacturing sector in early 1950s, sales tax on imports was the major contributor (85.3%) of total sales tax collection. However, towards the end of the decade, this share came down to only 39.3%. While the collection of sales tax picked up significantly in 1960s, its share remained small in total federal receipts. Even the repeated increases in the standard rate from 10% to 12.5% in 1960-61 and to 15% in 1963-64 could not yield improvement in revenue due to various distortions in the taxation system, especially the presence of large number of exemptions. The standard rate kept on fluctuating in the early 1970s as well. For example, the rate of sales tax on imports was reduced to 10% when the currency was devalued by 131% in 1972, but the rate on domestic sales was maintained at 20%. In 1973-74, both the rates were increased with few exceptions. Particularly, the rate for selected imported goods was fixed at 30% vide SRO No. 819(I)/73 issued on June 9, 1973.

**Table 3: Collection and Growth of Sales Tax and its Components**

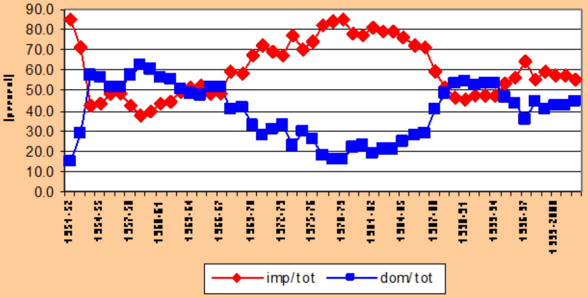
| | Average Annual Collection[1] | | | Average Annual Growth[2] | | |
|---|---|---|---|---|---|---|
| | Domestic | Imports | Total | Domestic | Imports | Total |
| 1950s | 93 | 87 | 180 | 37.5 | 4.9 | 12.2 |
| 1960s | 236 | 261 | 497 | 3.7 | 14.6 | 8.9 |
| 1970s | 257 | 924 | 1181 | 16.9 | 20.8 | 18.5 |
| 1980s | 2797 | 4432 | 7229 | 37.8 | 17.2 | 24.0 |
| 1990s | 21322 | 27033 | 48355 | 19.1 | 25.4 | 21.8 |
| 2000s | 69397 | 90667 | 160064 | 22.5 | 18.2 | 20.0 |

[1] Collection in Rs. Million
[2] Growth in percent

The decade of the eighties started with a number of amendments in the Sales Tax Act, 1951 to make excise mode of collection applicable to sales tax. The standard rate on domestically produced goods was reduced from 20% to 12.5%. A uniform rate of 12.5% was introduced in FY 86-87 for imported as well as locally manufactured and sold goods. The sales tax exemptions on cigarettes and beverages were withdrawn in FY 87-88 similarly to provide protection to the local industry and encourage private investment exemptions on 172 items of imports were withdrawn in FY 88-89. These goods were made liable to standard rate of sales tax at 12.5% and at the same time the standard rate on goods taxed at reduced rates was restored.

As indicated earlier, Sales Tax Act, 1990 was a significant departure from the old system of sales tax. In the first phase spanning over FY 90-91 to FY 95-96, the collection registered an increase of 193%. From this period onwards, the increase in collection was at a much higher rate because of the broadening of GST base by inclusion of retail sales in FY 98-99 and services in FY 99-00. The most encouraging aspect in revenue collection was the increasing share of domestic component as compared to sales tax on imports, which highlights the significance of ever increasing role of domestic economic activity *[Graph-1]*.

**Graph 1: Composition of Sales Tax: 1951/52 to 2001/02**




## VAT in Pakistan in Relation to Rest of the World

The rapid and irresistible adoption of VAT for its greater efficiency and potential as a major revenue spinner is probably the most important tax development in the recent history of taxation in the world.[15] Even though it remained confined to a limited number of countries in 1960s, but with the passage of time and especially in 1990s its acceptance has been overwhelming.

Presently, over 120 countries of the world have adopted VAT covering 75% of the population of world contributing 25% of the world's revenues. The cross-country evidence suggests that the standard VAT rate varies drastically around the world. It is as high as 25% in Denmark and Sweden, but as low as 3% in Singapore and 5% in Japan and Taiwan. On average, the standard rate around the VAT-world is 16% *[Table 4]*. The buoyant nature of the tax is evident from the fact that in terms of GDP, the contribution of VAT revenue ranges between 3.3% in countries of Asia and the Pacific to 7% for the EU region including Norway and Switzerland.

**Table 4: VAT Features by Regions**

| | Sub-Saharan Africa | Asia and Pacific | EU (plus Norway and Switzerland) | Central Europe and BRO | North Africa and Middle East | Americas | Average |
|---|---|---|---|---|---|---|---|
| Standard Rate[1] | 16 | 10.4 | 18.8 | 20.1 | 15.7 | 13.5 | 16 |
| Number of Rates[2] | 1.3 | 1.7 | 2.9 | 1.5 | 3.2 | 1.7 | 1.8 |
| VAT Revenue as percent of[3] | | | | | | | |
| Tax Revenue | 28.4 | 21.7 | 20.7 | 27.8 | 28.1 | 33 | 26.5 |
| GDP | 3.9 | 3.3 | 7 | 6.4 | 5.7 | 4.9 | 5.1 |

*Source: Ebrill et. al (2001)*

[1] Average, in percent.

[2] Average number of rates (including standard rate and excluding zero rate on exports).

[3] Figures are unweighted averages over those countries for which data on VAT revenues are available.

*GST in Pakistan in terms of International Standards*

Sales tax has now emerged as the leading source of revenue in the country. Its share in indirect taxes has increased from 27.6% in 1990s to over 60% in the first two years of current decade *[Table 5]*. Similarly, its contribution in federal tax receipts and GDP have

[15] *The Modern VAT* by Liam Ebrill, Michael Keen, Jean-Paul Bodin and Victoria Summers. Washington, DC: International Monetary Fund (2001).

almost doubled in 2000s as compared to 1990s. Specifically stating, the share of GST in indirect taxes was 19% in FY 90-91 that increased to 28% in FY 96-97. It has further gone up to 64% in FY 01-02. Similarly, its share in total federal receipts and GDP has increased to 41% and 4.5% in FY 01-02 from 19.7% and 2.3% in FY 96-97 and from 15.4% and 1.7% in FY 90-91, respectively. Comparing this progress with the VAT-world it is clear that Pakistan's performance is better than many developing countries of Asia and the Pacific, it is comparable to many of South American countries but lags behind the developed world.

**Table 5: Importance of Sales Tax**

| | Share of ST in Indirect Taxes | | | Share of ST in Federal Taxes | | | Share of ST in GDP | | |
|---|---|---|---|---|---|---|---|---|---|
| | Domestic | Imports | Total | Domestic | Imports | Total | Domestic | Imports | Total |
| 1950s | 12.6 | 11.7 | 24.3 | 9.5 | 9.1 | 18.6 | na | na | Na |
| 1960s | 13.0 | 13.0 | 26.0 | 10.0 | 10.2 | 20.2 | 0.9 | 0.9 | 1.8 |
| 1970s | 2.6 | 8.1 | 10.7 | 2.2 | 6.7 | 8.9 | 0.2 | 0.7 | 0.9 |
| 1980s | 4.4 | 8.5 | 12.9 | 3.7 | 7.0 | 10.7 | 0.4 | 0.8 | 1.2 |
| 1990s | 12.5 | 15.1 | 27.6 | 9.0 | 10.7 | 19.7 | 1.0 | 1.2 | 2.2 |
| 2000s | 34.3 | 26.2 | 60.5 | 17.4 | 22.8 | 40.2 | 1.9 | 2.5 | 4.4 |

Note: (1) Share in percent; (2) na means data not available on some components.

*GST and Regressivity*

VAT is often criticized for its regressivity emanating from uniformity of rate especially when there are no exemptions. The rationale for this assertion lies in the argument that under a uniform (single) rate structure poor segments of the society are taxed more than the higher-income households as they spend larger proportion of their budget on food and items of basic need. VAT becomes even more regressive when it is levied only on the manufacturing sectors and commodities and services like electricity, telephone, professional and financial services, hotels, and restaurants are not taxed. Accepting that in a neutral environment, this could very well be the case, but this disapproval requires careful evaluation in the light of the available alternatives for VAT. Furthermore, the existing cross-country evidence confirms that the tax has been made less regressive by introducing such parallel measures as increases in 'luxury' excises, effective income tax administration with information from VAT records, and expenditure 'safety-nets' for vulnerable groups [Tait (1991)] and the use of other tax instruments to offset VAT effects [Ebrill *et. al* (2001)]. [16]

The regressivity of GST has been a core concern in Pakistan as well. Going with the dictates of the taxation literature, exemptions have largely been withdrawn, consumer items consumed by higher-income groups face higher rates of central excise and customs duties and the government expenditure strategy for vulnerable groups is operational ever since early 1990s.[17] Moreover, the income tax structure under the Income Tax Ordinance 2001 would remain progressive, as was the case with the earlier ordinance of 1979. All these steps have been designed and initiated to mitigate the regressive impact of GST.[18]

*Tax Rate and Collection*

Concerning GST rate, Pakistan during the last decade, has experimented with three rates. During the initial stages, i.e., between FY 92-93 and FY 94-95 the GST rate was 12.5%, which was raised to 18% in FY 95-96 and remained operational until FY 97-98. However, the standard rate was reduced to 15% in FY 98-99 and it remains applicable to-date.[19] The relationship between GST rate and domestic sales tax collection presented in *Graph-2* shows the impact of rate changes on tax collection -- a Laffer curve phenomenon. It is

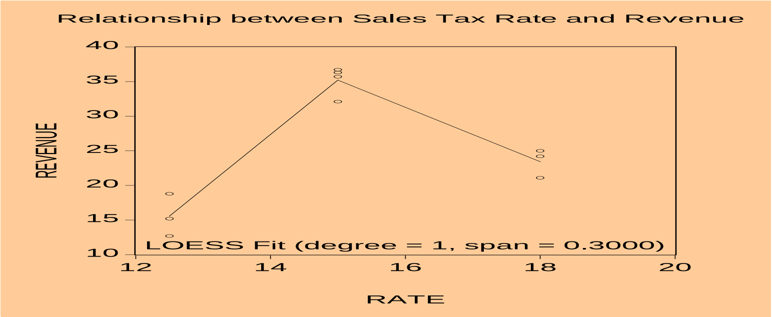
[16] See Allen Tait (1991) 'Value-Added Tax: Administrative and Policy Issues' Occasional Paper 88. Washington DC: International Monetary Fund.

[17] This includes funds released under the Social Action Program and the PRGF. It may be added that the impact assessment of these programs is beyond the scope of the present study.

[18] Regressivity of a tax has been determined in the literature in much more comprehensive ways either through Computable General Equilibrium (CGE) models or through complete demand system of equations such as AIDS. With accumulation of necessary human resources, CBR plans to initiate work on these important projects in the near future.

[19] The sales tax rate on some of the raw material was raised from 15% to 20% in FY 01-02 while keeping it at 15% on finished goods essentially to arrest tax evasion and encourage registration besides providing protection to the organized sector.

evident that the maximum amount of revenue has been generated when the rate has been set at 15%, which is consistent with the average standard rate prevailing in the VAT-world. While a higher rate seems to have encouraged prohibition (evasion), a lower rate has clearly been sub-optimal.

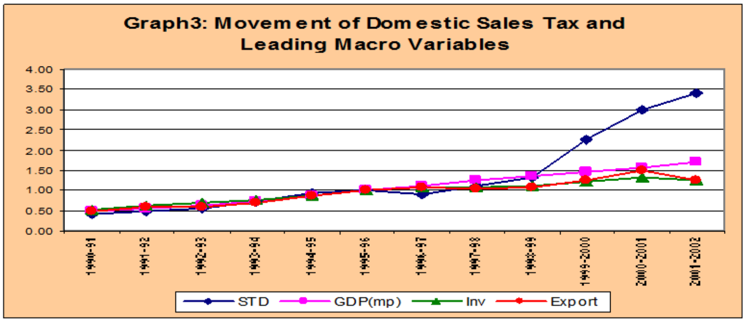



On methodological point, it may be clarified that while establishing the relationship between GST rate and sales tax collection, the revenue figures for the decade have been adjusted for base and abnormal shocks to separate the rate effect on revenue collection from other possible sources that have contributed in raising GST collection.

*Neutrality of GST*

The incidence of VAT on key macroeconomic variables is debatable even though its superiority over cascaded sales tax structure is well recognized. VAT is considered neutral as far as its impact on investment, exports and inflation is concerned. The availability of tax-credit or immediate refund on capital purchases and full rebate (zero-rating) makes VAT desirable for raising investment and exports. Similarly, VAT is non-inflationary by itself if other policies such as money growth over and above the stated rule and indexation are not operative simultaneously.

While an in-depth impact analysis of VAT on macro variables requires an elaborate framework as has been suggested earlier, but based on anecdotal evidence it appears that GST in Pakistan has neither discouraged investment nor exports over the last 10-12 years. Similarly, the overall growth of the economy has not been restrained. *Graph-3* depicts the movement of domestic sales tax revenue since FY 90-91 along with investment, exports and GDP. For comparison purposes, the data on these variables has been converted into indices with FY 95-96 used as base year. It is clear that both investment and GDP have maintained a steady path, notwithstanding the year-to-year fluctuations in growth. Similarly, except for the dip in FY 01-02 due to the 9-11 events, exports have also maintained an upward trend even though the sales tax was extended to services in FY 99-00.




## Going Forward

The preceding analysis confirms that the introduction of GST in place of the traditional sales tax has made a significant difference, both in terms of tax collection and compliance. However, despite this improvement there are various aspects of policy and administration where more effort is required. The issues related to tax policy involve extension of base, determination of optimum threshold level, uniqueness versus multiplicity of rate structure, and most importantly the cost of collection and tax compliance. At the same time extra effort and political commitment is also required to make the ongoing tax administration reform process a success.

As far as the optimum threshold limit is concerned, its provision may be a reasonable safeguard against taxation of small businesses;

however, it is not free from distortionary effects on efficiency, competition, and revenue. Exemption of small traders below threshold not only introduces cascading, but it also encourages artificial splitting of enterprises to avoid taxation. The experience of developing countries indicates that whereas higher threshold minimizes revenue, the lower threshold increases cost of administration. Given these difficulties, the determination of optimum threshold level remains an unresolved area under VAT.

The broad basing of VAT is another major concern in Pakistan due to the presence of hard-to-tax areas like agriculture and a large informal sector. Concerns are also raised against the validity of the current consensus that favors exclusive reliance on VAT for increasing revenues in developing countries and lowering of trade taxes. The welfare implications of this move have recently been challenged by Emran and Stiglitz (2001).[20] Similarly, even though a single rate VAT is always preferred for convenience and low administration cost, but a uniform GST rate on food and items consumed by low-income groups may not be justifiable on equity grounds. There is a growing realization for a thorough understanding of the incidence of GST on the different income groups, industries and the pattern of imports and exports in the economy.

However, despite these concerns, Pakistan's experience with the introduction of GST has been rewarding partly because of its gradual implementation. Its coverage has been extended only after a careful understanding of ground realities. The time has now come to move into areas that are more difficult to tax-administer. Venturing into these areas would not only require thorough knowledge of the issues, but also the lessons learnt from cross-country experiences so that the objective of revenue maximization is achieved without sacrificing equity and efficiency considerations.

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[20] See M.Shahe Emran and Joseph E. Stiglitz (2001), "On selective indirect tax reforms in developing countries". Paper presented in the Cornell-ISPE conference.

# III

# Sales Tax Audit and CBR Initiatives[21]

*'The age of Chivalry has gone, that of sophisters, economists and calculators has succeeded…'*

**Edmund Burke:** *Reflections on the Revolution in France*

## Background

Historians believe that record keeping originated about 4000 BC when the ancient civilizations in the Near East began to establish organized government with full accounting of receipts and disbursement of taxes. In the modern sense of the word the earliest reference dates back to exchequers of England and Wales 1130 AD. But it was not until the emergence of Insurance Companies, Banks and Joint Stock Companies in the 19th century, when auditors formally assumed the role of professionals and hiring of professional auditors became an economic and corporate necessity. These days the subject matter of most audits including financial audits is concerned with accounting data that are contained in the books of records and financial statements of the audited entity. The auditor is supposed to gather and evaluate information that is quantifiable and verifiable, as long as the auditor and the auditee agree on the criteria to be used as the basis of determining the degree of correspondence. The assertions are after about accounting transactions. The established criteria are generally the accepted accounting principles.

## Sales Tax Audit

The main feature of the value-added version of the General Sales Tax (GST) in Pakistan is self-assessment. Even though it has a strong element of self-policing, but as with other taxes, GST can

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also be avoided and evaded. The most common sources of GST evasion are non-registration of businesses, underreporting of gross receipts, frivolous and incorrect claims of inputs, and non-remittance of taxes collected from customers to tax authorities. This requires that a mechanism of audit be put in place to serve as a deterrent to tax avoidance and tax evasion. An effective audit not only increases the probability of detection, but it also enables tax authorities to educate taxpayers about the laws and regulations besides the deterrence of imposition of penalties on those who 'deliberately' fail to comply with their obligations.

*Legal Provisions for Sales Tax Audit*

The sales tax audit functions are performed under the Sales Act 1990. This provision exists on the basis of a number of sections pertaining to record keeping, access to premises, stocks checking, and recovery. The taxpayers are required to maintain Books of Accounts and Records of business transactions and imports under Section 22 of the Act so that auditing of accounts could take place, if and when required. The sales tax liabilities are assessed according to law and regulations. In this case Sections 11, 36 and 48 are concerned with recovery of short paid/ evaded amount by taking cognizance of non-payment, non-filing and/ or late filing of returns. Similarly, Sections 25, 36, 37 and 38 are concerned with evasion detected through post audit, providing access to premises, record, stock, and to summon and interrogate registered persons. Finally, Section 32A is related with special audit by Chartered and Cost Accountants.

*Historical Profile of Audit, Amount Detected and Recovered*

The theoretical literature argues that tax evasion could be reduced by increasing the probability of detection. In this case 'number of audits' is often used as the relevant proxy variable. It is contended that in a regime where an effective system of audit and enforcement prevails, a higher incidence of audit has significant but opposite effects on amount detected and revenue collection. Audit as an effective deterrence forces taxpayers to reveal their true income and therefore the possibility of detecting unreported income through audit falls with the passage of time. On the other hand, taxpayers' cooperation for fear of audit and subsequent penalties also results in increased revenue collection.

While it would have been interesting to validate the proposed relationship between revenue collections, number of audits conducted in a particular year, and the amount detected, but the available aggregate data are too limited to either confirm or refute such claim. The reason is that the full-fledged audit-based sales tax system has been in place only from 1996 onwards when domestic sales tax was separated from the customs collectorates. The recruitment of auditors was also initiated at that time. Thus, the information presented in Table 1 is somewhat restricted and may be treated as indicative in nature as it only explores the pattern of growth in the three audit indicators. How far audit has been effective in raising the overall sales tax revenue and whether it has served as an effective deterrence could be established with the help of detailed data, not only at the aggregate level but also at individual level, i.e., at the level of registered persons who would be visited rather frequently over a longer time horizon.

The evidence confirms that with the recruitment of additional staff and improvement in efficiency, the number of audits has grown steadily since FY 98-99. Even though the average annual rate of growth between FY 98-99 and FY 01-02 has been 86.4%, but this high growth has largely come from 158% growth in the most recent years. The average annual growth in 'amount detected' was strong (above 68%) until FY 00-01, but it has turned negative in FY 01-02. This growth pattern clearly suggests that the audit activity has been aggressive in FY 01-02 as far as the number of audits is concerned. This phenomenon is expected to level off in the CFY as 10018 audits have been completed so far in the first quarter. On the recovery front, the pursuit has slowed considerably in recent years. The two factors that have severely constrained effective enforcement are: the institutional strength of the field offices to carryout the job and the issue of harassment by taxpayers.

**Table 1: A Historical Profile of Sales Tax Audits and the Amount Involved**

*(Amount in Rs. Million)*

| | Number of Audits | Growth (%) | Amount Detected | Growth (%) | Amount Collected | Growth (%) |
|---|---|---|---|---|---|---|
| 1998-1999 | 3896.0 | | 4835.0 | | 921.0 | |
| 1999-2000 | 4977.0 | 27.7 | 7076.5 | 46.4 | 2304.5 | 150.2 |
| 2000-2001 | 8627.0 | 73.3 | 13541.7 | 91.4 | 1390.4 | -39.7 |
| 2001-2002 | 22267.0 | 158.1 | 10673.0 | -21.2 | 1375.3 | -1.1 |
| Average | | 86.4 | | 38.9 | | 36.5 |

### Sales Tax Audit: An Appraisal

While the available information may not be sufficient to carry out sophisticated statistical tests for policy analyses, nevertheless it would be safe to conclude that the system of effective auditing of taxpayers is gradually picking up. The initial years of the GST implementation in the country could truly be regarded as formative years when rules and regulations were designed, parameters for effective auditing were considered, the required human resource skills were developed and the idea of audit was being floated among taxpayers to prepare them for their tax liabilities. Relatively more attention was paid on the revenue generating capacity of GST and its administration. Now that besides income tax, sales tax has emerged as one of the major revenue spinners in the country, efforts are on the way to make it more and more taxpayer friendly. Development of an audit program purely on scientific grounds is, therefore, an important endeavor in this direction.

To start with different sets of specific audit parameters have been laid down for sales tax payers including importers, manufacturers, commercial exporters, and manufacturers-cum-exporters. Broadly stating, the taxpayers are selected for auditing on the basis of such internationally accepted factors as: non-registration, high claim on input tax, output tax unusually low, large units with high revenue, exaggerated refund claims, erratic and questionable behavior, random selection, consistent nil filing, and aggrieved competitors etc. With a proper risk profiling of taxpayers, the cases for audit are selected through computer to minimize the possibility of human error and staff discretion.

In order to monitor the success and to improve upon the existing situation, CBR undertakes evaluation of the system at regular intervals. Within the first five-years of its implementation, the system of sales tax audit was thoroughly evaluated in FY 00-01 by the Task Force on Tax Administration, headed by Syed Shahid Hussain in 2001.[22] The key parameters for the situation analysis were: audit performance, audit productivity, coverage, and efficiency of the workforce and the possibility of collusion.[23] The authors of the report found a number of weak areas that required strengthening. In particular they observed that the audit performance was poor because the average real revenue per taxpayer had barely grown during 1997-2000 despite buoyant growth in real domestic sales tax revenue. During 1999-2000 audit raised only 2.7% additional revenue. The auditors' productivity was low. The average number of audits per auditor per month was 1.2, which was far short of 5 audits per month achieved by modern VAT administrations. Similarly, the audit coverage was also low as during 1999-2000 only 7% registered persons were audited. International practices in the developing world suggest a coverage ratio of 20%. The most disturbing aspect was the inefficient utilization of audit manpower as 29% of audit staff was found delegated to functions outside audit

[22] For details see 'Reform of Tax Administration in Pakistan'. Report of the Task Force on Reform of Tax Administration, April (2001).

[23] It may be added that the Report of the Task Force is much more elaborate as it covers the entire taxation system and its administration in Pakistan. The evaluation of the sales tax audit system was only a minor component of the entire exercise.

and refund activities. The average time to complete an audit was as high as 75 days.

It was encouraging to find that the report of the Task Force acknowledged various measures initiated by the revenue organization to address these issues and to make auditing more effective. The following initiatives were particularly highlighted.

- The development of an audit manual and audit planning and execution instruments, with the help of Price-Waterhouse-Cooper.[24] The Sales Tax Audit Manual has been prepared to standardize the audit process in the country. It provide detailed instructions for the users, elaborates on power of officers, performance of audit visits, use of references, assessment, closing review, reports and management of audit. It has been written with the following purpose and use:

    a) The Manual sets out the requirements for the performance of audit work. It has instructions for each and every step of the audit process. For example, starting with an audit visit and working through performance of work, the Manual provides specifications for the final report.

    b) For ease of reference, the main text is confined to the general procedures, which are applicable in every case. Further elaborations/ instructions and specifics are given in relevant annexes, which also have layouts of the forms to be used by the audit processing officers.

- Audit selection has been successfully automated. The units are now selected for sales tax audit on the basis of specific criteria.
- The establishment of an Audit Review Committee at the CBR level, to streamline audit selection and to monitor audit work.

[24] The Audit Handbook for the Sales Tax Wing has been prepared by E. Mouat, Consultant, Price-Waterhouse-Coopers (March, 1999).

- A proposal to establish Audit Review Cells at the Collectorate level, in order to conduct audit review work.
- Significant progress has been made in hiring trained professionals for audit. For example, 75% of the employed auditors possess B-Com, ACMA or MBA degrees and 65% Senior Auditors have M-Com or MBA qualification.
- Networking between PRAL import-export database and a centralized database of information on sales tax shipping/ airway bills and bills of entry will allow spurious audit selection to be eliminated at the CBR level.
- Sales Tax General Order No.09 of 1999 stipulates that an auditee cannot be audited more than once in a financial year, except in exceptional circumstances to be recorded in writing.

**Recent CBR Initiatives and their Significance**

Under restructuring program of CBR, a comprehensive program has been chalked out to further improve and strengthen audit functions pertaining to federal taxes.[25] Given the strength of the workforce and rather lackluster track record, the following improvements to the audit procedures have been designed and enforced.

1) The audit period has been standardized through out the country as of 12 months.[26] This corresponds to the year and accounting period of the registered person. Earlier on the period was varying and it was left to the discretion of the auditors to decide. The main benefit of this change is in the shape of its reconciliation with the Income Tax returns. This was not possible with the earlier arrangement.

2) One of the shortcomings of the earlier setup was that the audit report format was dependent upon the writer of the report. This is now standardized in the shape of a '<u>one</u> page plus annexure format' report applicable universally in the sale tax audits. This

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[25] This work was initiated soon after the appointment of Functional Member (Audit) in March 2002.

[26] Currently, the 12-month period pertains to the financial year. However, a transition from financial year to company's accounting year is in progress.

in itself is a major improvement. It is expected that the quality of audit, the follow up of audit, management of audit and taxpayer convenience shall improve with the introduction of standardized report format.

3) The audit report submission to the registered person has been made mandatory. The registered person now gets a chance to clear the detections before these are converted into contraventions. This is a step towards reducing frivolous litigation and clears a long outstanding irritant faced by the taxpayers.

4) A checklist for the audit review has been introduced. The reviewer of the audit report now will have to complete the checklist before accepting the report. This will ensure quality of audit, which is desired in the sales tax regime.

5) An approval checklist is also put into place, which is a further improvement in the audit reporting set up.

6) The completed audit reports at each Collectorate are now sent to the office of Member (Audit) for review and categorization as, fair, average, and below acceptable level (BAL). The BAL reports will go through further scrutiny to improve the competence of the field staff.

7) A channel of continuous discussions between Member (Audit) and the Adjudication Collectorates has been opened to improve the working of audit reporting.

8) The recovery of audit-detected amounts have been streamlined. The following are being implemented.

    - The period of show cause notice and order-in-original is being looked into and reasons for delays shall be identified and overcome.
    - The legal side in each Collectorate is being re-enforced to ensure proper representation of auditors. Orders-in-original shall be monitored for appeals and follow through.

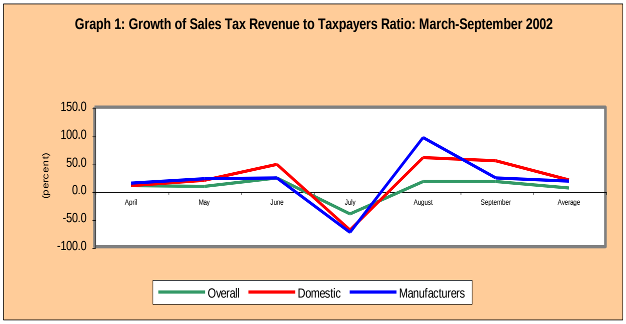
- The recovery of detected amounts is being monitored and the registered person is encouraged to settle the amount to save additional taxes and penalties.
- The duplications and complication being faced for dual audits, RRA and sales tax are under discussion at an appropriate levels and shall be resolved to achieve better understanding and working between RRA and sales tax audits.

9) An alternate setup of dispute resolution under section 47 has been put in place, legal cells with representation from private sector have been established to check harassment, input-output ratios have been fixed and the extent of 'wastage' specified for ease of calculations of value added by the commodity producing sectors.

*Performance of Audit Indicators in Recent Months*

The continued effort has been rewarding in the sense that significant improvements in the entire audit process could easily be noticed. The overall average sales tax revenue per taxpayer has grown by 5.53% between March and December 2002. However, a better picture of voluntary tax compliance emerges when taxpayers are segregated into various categories. For example, the domestic sales tax revenue to taxpayers' ratio increased by 13.5% during March-December 2002 period and the same for manufacturers has increased by 15.9%. It is important to mention that the revenue to taxpayer ratio as an indicator of audit efficiency gets diluted by the inclusion of the turnover taxpayers, whose number is incidentally much higher and revenue contribution much smaller, in fact fairly insignificant.

The audit coverage ratio of registered persons has also increased from 7% in FY 99-00 to 13% in FY 00-01. It has further gone up to 15% in FY 01-02 and expected to stay around 15% in the CFY. The audit performance has improved significantly from 20.4 audits per senior auditor per year in FY 97-98 to slightly above 80 in FY 01-02. Consequently, the average audit time has reduced to only four days. Finally, to ensure efficient utilization of audit workforce, their activities have been restricted to audit work only.




## Road Ahead

Besides continuous effort to further strengthen the audit system, CBR is focusing on two important initiatives that would have long-term implications. These initiatives relate to human resource development and improved audit performance at LTU, which is being run as a model setup to be replicated in the rest of the country.

Regarding the first initiative, given the specialized nature of the audit work and lack of competence of the staff to engage into effective audit of large units, a greater emphasis is laid on the training of the audit staff. In this respect, on-the-job training of Assistant Collectors and Deputy Collectors has been started in disciplines of accounting and auditing. The first such course was administered in Lahore for 12 officers, which has given good results as per feed back from the participants. Such courses shall now be held at other major centers including Karachi, Islamabad and Peshawar. There are plans to encourage senior officers including Additional Collectors and Collectors to attend short evening courses on accounting and auditing.

Towards streamlining the sales tax audit process at the LTU Karachi, a number of audit goals are set and action plans devised for their achievement. These goals include: efficient realization of due taxes, enhanced efficiency of audit and transparency, establishing a two-way communication between taxpayers and tax collectors, improved taxpayers facilitation, and efficient and effective dispute resolution mechanism. The action plans include: notification of quarterly audit schedule, auditors to taxpayers ratio to increase from 1:200 to 1:25, joint audit of sales tax and central excise, full access to income tax data, a two-member audit team for each unit, introduction of comment card, introduction of post audit meeting with taxpayers, and communication of audit observations to registered persons.

In the end it may be useful to re-emphasize that the overarching objective of audit is to bring discipline in the taxation system. A system where taxpayers pay taxes on self-assessed basis and maintain records of their commercial and industrial activities for official verification, if and when it is required. And where the system of audit is designed to minimize the possibility of tax avoidance and evasion. However, despite all the efforts to bring transparency in the system, episodes of grievances between taxpayers and tax collectors are expected to exist. The effort at CBR is to minimize these frictions by designing the audit system on scientific and systematic grounds so that the element of human error and discretion is reduced. Nevertheless, the success of this effort also hinges on how well these efforts are received by its stakeholders, especially those who are selected for complete audit.

# IV

# Reform of Tax Administration and Restructuring of CBR: An Update[27]

## Introduction

There is a general perception that the tax administration is inefficient, vexatious and corrupt. Political and financial leaders often complain of static tax base, inelastic revenues, arbitrariness of policies and procedures, lack of measurable performance indicators, excessive administrative tiers and absence of connectivity of information. Tax Collectors also complain of low salary, lack of resources and political will.

In order to reform these weaknesses and to create a model and efficient client responsive tax administration, government in June 2000, appointed a Task Force on Reform of Tax Administration. This Task Force presented its report to the government in May 2001. Consequently, IMF also carried out its own study and presented its findings in August 2001. These reports and various other studies recommend a tax system, which has simpler laws, procedures, promotes self-assessment, reduces physical controls and creates reliance on audit and risk assessment.

The recommendations of these reports were discussed by top management team of CBR in a 3-day workshop held in October 2001. In this workshop the reasons of failure of previous tax reform efforts were also identified. The overwhelming opinion was that beside other reasons, the previous efforts also failed to create ownership of the reform process within the organisation. It was also considered that to develop the Vision and Mission of future CBR the entire organisation should be involved. Therefore, CBR started a process of consultation by holding workshops for its employees.

[27] This update is prepared by Khawaja Tanveer Ahmed, Chief (Policy and tax Reforms) CBR.

Accordingly, thirty-six daylong workshops were held. In these workshops Vision, Mission, and Values were adopted and an outline of the strategy for reform was developed.

VISION

To be a modern, progressive, effective, autonomous and credible organization for optimizing revenue by providing quality service and promoting compliance with tax and related laws.

MISSION

Enhance the capability of the tax system to collect due taxes through application of modern techniques, providing taxpayer assistance and by creating a motivated, satisfied, dedicated and professional workforce.

VALUES

These include: Integrity, Professionalism, Teamwork, Courtesy, Fairness, Transparency, and Responsiveness.

**Reform Strategy for CBR**

In November 2001, Government approved the broad outline of the reform strategy of CBR. The reform strategy aims at increasing effectiveness of CBR, reduce corruption opportunities and raise the buoyancy of the tax system through organizational re-structuring, self-assessment, reduction of personal contact between taxpayers and tax collectors, simplified processes, revised terms and conditions for employment of CBR officials and improved IT management.

**Cabinet Committee for Federal Revenues**

An important development in the reform process is the formation of the Cabinet Committee for Federal Revenues (CCFR) to oversee the reform process of CBR. The Committee is headed by Minister for Finance and includes Minister for Commerce, Minister for Privatization, Deputy Chairman Planning Commission, Secretary General Finance, Secretary Establishment and Secretary Revenue Division as members.

**Restructuring at CBR**

CBR has re-structured its headquarters. With a view to supplement the level of skills in CBR, government has appointed professional Members from private sector for Human Resource Management (HRM), Information Management System (IMS), Audit, Taxpayers' Education and Facilitation (TPE&F), and Fiscal Research and Statistics (FR&S). The CBR has prepared a recruitment policy, that puts greater emphasis on skills that match CBR needs, incentive and merit based remuneration and promotion mechanism and extensive training. CBR through its reform program is strengthening sales tax audit and enforcement activities.

**Important Initiatives under Reform Process**

The following milestones in the reform project have been achieved.

*i. Large Taxpayers Unit (LTU)*

In its reform project CBR with effect from July 01, 2002 has established a pilot Large Taxpayer Unit (LTU) at Karachi. The Unit is based on functional organization encompassing all the three domestic taxes i.e., sales tax, central excise duty and income tax. It has an open-floor layout with a large reception and facilitation area for the taxpayers. The Unit has revenue target of Rs. 55 billion to be collected from around 300 Karachi-based large taxpayers.

Expected Benefits: The LTU is expected to be major facilitating unit with minimum contact between taxpayers and tax collectors. The closely monitored performance of the tax collectors is expected to improve revenue collection and check corruption. The incentive based remuneration for the employees of CBR working at LTU will cultivate a new culture within the organization.

*ii. Medium Taxpayers Unit (MTU)*

A model Medium Taxpayers Unit has started working in Lahore with effect from October 01, 2002. The Unit will test the re-engineered income tax system based on functional organizational structure. The total taxpayer population of this Unit is around 10,000.

Expected Benefits: In the reform project of CBR, this Unit has a pivotal role for determining the future organizational structure of income tax. The present system of collection of income tax is circle based. In this system all functions of collection, assessment, appeal, recovery, enforcement, survey etc are performed by the circle staff headed by Income Tax Officer. There is a close contact between taxpayers and tax collectors. However, the re-engineered system based on functional organization is expected to overcome the deficiencies of the existing system. Once tested, the new system will be replicated at different locations throughout the country under the reform project of CBR.

*iii. Universal Self-Assessment System*

The obsolete income tax system has been abandoned and replaced by Universal Self-Assessment System (USAS) from July 01, 2002. Under USAS all taxpayers would automatically qualify for self-assessment. The detailed examination of returns will not undertaken at the time these are received. Even at a later date only a certain percentage of cases would be selected for audit based on risk assessment for various classes of taxpayers.

Expected Benefits: The USAS will not only minimize the direct contact between tax officers and taxpayers, thus reducing the adversarial relationship between the two, but it will enhance voluntary compliance through an effective mechanism of audit and enforcement of penalties for willful evasion.

**Measures to Ensure Continuity of Reforms**

CBR has taken necessary steps to institutionalize the reform process. The basic outline of the Reform Strategy Document was developed in consultation with all stakeholders. This has helped to create ownership of the reform process within the organization. However, to ensure continuity, the reform project of CBR needs continuous support of the government. There is requirement of further investment in IT and other infrastructure improvement during the next 3-4 years. While CBR will remain a Division of the Government of Pakistan but it will need enhanced legal powers, capabilities and autonomy in order to:

- Formulate its own expenditure budget and administrative policies (government to meet budget needs);
- Spend (within its budget) as it deems appropriate;
- Decide its own structure for monetary rewards and allowances;
- Formulate and enforce its own operational rules;
- Adopt its own human resource recruitment and development strategy;
- Protect itself against undue intrusion from outside influence.

**Implementation/ Monitoring Mechanism**

The Cabinet Committee for Federal Revenues (CCFR) is monitoring the reform process of Central Board of Revenue. The Committee meets regularly and reviews the progress of the reform process. Besides Government of Pakistan is committed with donor agencies for the reform of tax administration. The IMF and the World Bank have provided certain timelines for the reform process. These are also required to be met. The mechanism of regular monitoring by the Cabinet Committee and donor agencies is ensuring the smooth implementation of the project.

**Policy Directions for the Future**

The detailed reform strategy document of CBR with timelines will be ready by February-March 2003. This document will provide re-design of business processes, information technology architecture, human resource management, and strategy to combat corruption and infrastructure development strategy. The extensive use of IT will help to minimize contact between officials and taxpayers. The reformed CBR will heavily depend on modern, effective and efficient IT function. Databases will be created for management reporting, audit selection and analysis. Eventual objective is to shift from paper based processes to electronic interactive service.

**Concluding Remarks**

The reform process has already been initiated at CBR. A fundamental change is envisaged. A sense of urgency for change is now visible. It is encouraging that all stakeholders, including government, donor agencies, and tax practitioners, are committed to the reform process. The response of the taxpayers is also favorable to the changes introduced so far. It is anticipated that on the completion of the reform program in the next 2-3 years, an effective tax system will be in place with enhanced community participation and voluntary compliance.

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*Chapter IV: Reform of Tax Administration and Restructuring of CBR*

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