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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Message by the Former Chairman

Surprise. Surprise. For the seventh quarter running CBR has achieved the assigned revenue target. A more welcome development has been the decreasing lack of confidence of taxpayers in the tax reform program. The self-assessment in income tax has been accepted, by and large. The model tax units are performing rather well. The age-old practice of revenue targeting has assumed a secondary role and an accommodating ambiance of service delivery has taken the driving seat. Further efforts are continuing to regain taxpayers' confidence through education and facilitation, speedy disposal of refund and rebate claims within an automated environment, amicable dispute resolution mechanism, and above all, by treating taxpayers as partners in economic development.

It is also important to highlight that CBR is actively collaborating with various government institutions to strengthen its capacity to exploit gains from information flows. This is important to accomplish the crucial objective of broadening of tax bases. The recently begun initiative of city-to-city demonstration of possession of vital information by CBR will surely enhance the quality of voluntary compliance in future. And we are committed not to allow our rapidly enhancing database to become a vexatious instrument in the hands of errant officials.

The latest issue of the CBR Quarterly Review is an analytical presentation of CBR activities during the first half of the current fiscal year. The articles in this issue have direct policy relevance. The paper on trade policy recommends careful planning and execution of reform initiatives to reap across-the-board benefits and the paper on model units provides an initial assessment of the implementation of reform agenda at the field level.

I now hope that the readers of the Quarterly will be better equipped to hold forth discussions on tax policy issues, whether at formal levels or in drawing-room settings!

Riaz A. Malik
Former Chairman, CBR.

Foreword by the Present Chairman

The present edition of the *CBR Quarterly Review* is reflective of the importance that the Government attaches to in-house analyses of the working of the various administrative organs and other important sectors of the economy. Such endeavors not only make us vigilant in the present, but also contribute towards better understanding of the future.

Ever since the publication of its first issue in June 2002, the *CBR Quarterly Review* has undergone fundamental changes and improvements. The present issue includes a concise review of the economy, detailed discussion of various tax policy and administrative reform initiatives undertaken over the past three years, a review of trade policy measures in historical perspective and their impact on the economy, and an evaluation of the model tax units at Karachi and Lahore. I believe that the multifaceted information, analysis, and its lucid presentation will be useful for wide spectrum of readers, including business community, policy planners, partners in development, and researchers.

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

M. Abdullah Yusuf
Chairman, CBR.

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

The Economy

Pakistan's economy is poised for sustained growth in the future. Thanks to careful economic management which no doubt included some painful decisions, the key macroeconomic indicators have improved immensely. The gradual recovery and strengthening of the economy is evident from the fact that it is in a better shape today than was projected at the time of Budget 03-04. There are indications that the growth of GDP may even surpass the currently anticipated rate of 5.3%. The reasons for this optimism are many and multidimensional. The analysis of the half-yearly data on leading indicators confirms that the revival of the economy is broad based. The industrial production is gaining momentum, foreign trade activities are exciting, stock market is bubbling, food security situation is satisfactory, the fiscal position has been consolidated, and most importantly, the investors' confidence is growing in response to increasing prospects of political and regional security and stability. The government on its end has ensured transparency, predictability, and consistency in its macroeconomic policies. Moreover, its resolve and commitment to wide-ranging reform agenda has not wavered.

In specific terms, the industrial sector has recorded considerable growth of 14% during the first two quarters of current fiscal year (CFY). Some of the drivers of this growth are the automobile sector, which has recorded a phenomenal growth of more than 70%; the motorcycles production has increased by 79%, tractors 50%, cotton

[1] The Research Team of Fiscal Research Wing of CBR has carried out the analysis. The collaboration of the staff of the Budget Wings of Direct and Indirect Taxes and Directorate of Research & Statistics is gratefully acknowledged.

cloth (milled) 20%, cigarettes 17%, cement 16%, iron and steel products 18%, and paper and board and fertilizers 8%. Similarly, notwithstanding the recent damage to cotton crop, the crop outlook for food grains is promising due to improved availability of water and increased area under cultivation. According to MINFAL (Crop Outlook, Dec. 2003), rice production is expected to increase by 8.9% and wheat production may also receive a positive boost from an increase in its support price and exceed last year's output of 19.2 million tons.

The external trade sector has maintained its growth momentum. The trade figures released by the Federal Bureau of Statistics (FBS) indicate that exports in rupee terms have increased by 10.3% during July-December 2003 over the corresponding period of the past fiscal year (PFY). Similarly, even though the growth in total imports has been 11.3%, dutiable imports have increased at a higher rate of 23%, which has favorable implications for domestic production and revenue receipts. As far as the performance of the components of exports and imports is concerned, even though there has been a decline in the exports of primary products by about 1.2% during the first half of CFY, the exports of textile and other manufactures have gone up by 9.3% and 1.1% respectively. Within the textile sector, a double-digit growth has been documented for cotton cloth, knitwear, canvas and tents, and made-up articles. On the imports side, there has been a decline in food group imports by 4%. However, on a brighter side, import of machinery has increased by 16.7%. The most spectacular has been the 104.4% growth in the import of iron and steel scrap.

On a careful note, while there should be no problem in highlighting the overwhelming evidence of comprehensive recovery of the economy and its stability, it is also pertinent to identify areas of concern that require continuous monitoring and high priority attention. The foremost among them is the fear that the growth momentum may be lost if not handled carefully. Many a times in the past, Pakistan's economy has reached the take-off stage, only to see it slipped away. Secondly, there are apprehensions with regard to distributional aspects of the growth process. The increasing incidence of poverty paints a gloomy picture and points towards the discomforting reality that the growth process has not been pro-poor. Similarly, the built-in rigidities in the system in the shape of low levels of savings and investment rates, proliferation of the unorganized sector contributing to higher incidence of tax evasion and low tax compliance, concentration of exports in too few commodities, lingering anti-export bias, and erosion of industrial competitiveness and increasing unemployment have the potential to derail the reform process and nullify the gains accomplished so far.

CBR Revenue Target for FY 03-04

Reliable revenue projections are important for smooth economic management. The government has to ensure that the taxes remain within the taxpaying capacity of taxpayers. On its part CBR has to ensure that the collection of federal taxes remains on track to avoid resource shortfall and related difficulties for the government. In this spirit, using information on historical collection of individual taxes, new taxation measures and key indicators of the economy, the overall target for the 2nd quarter was fixed at Rs. 125.9 billion. Of this amount, 35.7% was assigned to direct taxes, 41.4% to sales tax and the remaining 22.9% was allocated to central excise and customs duties. In view of the fact that corporate returns are filed in December, a higher target of (42.9%) was set for this month compared to 31.7% for October and 30.4% for November (Table 1).

Table 1: Monthly and 2nd Quarterly Targets of Federal Taxes

(Rs. Billion)

	Direct Taxes	Sales Tax	Customs Duties	Central Excise	ALL TAXES
October	12.3	17.1	5.8	3.6	38.8
November	11.4	17.3	5.2	3.6	37.5
December	21.3	17.7	6.9	3.7	49.6
Quarter: 2	**45.0**	**52.1**	**17.9**	**10.9**	**125.9**

CBR Revenue Position

CBR has achieved the assigned revenue target for the seventh quarter in a row. In fact, the revenue collection during the first two quarters of FY 03-04 has exceeded the revenue target by a margin of 5.6%. This success is enormously encouraging from various standpoints. Firstly, it is a welcome development that the taxpayers have reposed their confidence in the tax reform process. The self-assessment in income tax has been accepted cordially. Secondly, the model units in Karachi and Lahore have started to perform according to *a priori* expectations. It is heartening to observe that the age-old practice of revenue targeting has taken a secondary role and an accommodating and facilitating ambiance of service delivery has assumed the lead role. Thirdly, the problem of delays in sales tax refunds has been sorted out with the implementation of the computerized system of refunds 'STARR'. This facility will take a new look and improve further when the latest refund related software 'STREAMS' would be installed in the coming months. The new system would work on the principles of risk evaluation and management. Fourthly, the export rebate system has been streamlined and rebate claims are now determined on the basis of input-output coefficients. Moreover, the revised DTRE scheme is also gaining acceptance among stakeholders. Fifthly, with the successful adoption of the first generation of tax policy reforms, the reform process is now moving in the direction of improvement in tax administration. A greater importance is now laid on human resource management with special emphasis on Human Resource Information System (HRIS) and HR audit, extensive use of information technology, process re-engineering, effective audit, taxpayers' education and facilitation, and well-organized dissemination of tax policy and administrative reform measures. The initial effort in this direction has been extremely rewarding. Finally, the collaborative arrangement between various government institutions has strengthened CBR's capacity to exploit gains from information flows. The most significant developments are broadening of tax bases and simplification of procedural difficulties to address taxpayers' concerns in a cordial and prompt manner.

Overall Tax Collection and Refunds

CBR overall net collection has surpassed the half-yearly target. The July-December 2003 *net* collection stands at Rs. 230.4 billion against the target of Rs. 218.1 billion, showing an excess over the target by 5.6%. This is the 7th quarter running that the momentum in growth has been maintained. In absolute terms, the gross and net collection during the 1st half of FY 02-03 has been Rs. 267.5 billion and Rs. 230.4 billion, indicating an increase of 11.4% and 14.4%, respectively. The refund payments during this period were Rs. 37.1 billion against Rs. 38.6 billion during H1 of PFY (Table 2). The performance during the 2nd quarter of CFY has been remarkable. While the gross collection recorded an increase of 21.2%, the net collection also exceeded the 2nd quarter collection of PFY by 22.8%. The month-to-month comparison indicates that a double-digit growth was possible in October and December. On the other hand, with the exception of July 2003 when the growth in revenue was negative, a single-digit growth was observed in the remaining months, i.e., during August, September, and November. The three sources of this dynamic growth were: the unprecedented acceleration of direct taxes revenue, improved collection of sales tax, and the sustained higher growth of customs duties despite reduction in statutory rates in the successive three budgets and slower but sustained appreciation of Pak rupee vis-à-vis US dollar.

The broad-based growth of the leading federal taxes is indicative of the fact that CBR tax collection is closely linked with the performance of the economy, especially the level of GDP, domestic industrial production and sales, and the level of imports. It is also worth emphasizing that the growth in collection has been achieved without holding back refunds. Even though the refunds/ rebate payments during the July-December 2003 period have declined by

4% over the corresponding period of PFY, this reduction has been due to the downward revision of the DDB rates by a neutral agency, the Input Output Coefficient Organization (IOCO), in the wake of continuous reduction in rates of customs duties, enhanced use of temporary import scheme, and the DTRE scheme.

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

(Revenue Receipts in Rs. Billion)

	FY 02-03		FY 03-04		Growth (%)	
	Gross	Net	Gross	Net	Gross	Net
July	33.1	23.6	31.0	23.4	-6.3	-0.8
August	36.5	29.6	36.1	30.1	-1.1	1.7
September	43.0	37.2	45.8	40.6	6.5	9.1
October	40.4	34.6	47.9	42.0	18.6	21.4
November	37.3	31.8	39.8	33.8	6.7	6.3
December	49.8	44.7	66.9	60.6	34.3	35.6
Half-Year	240.1	201.5	267.5	230.5	11.4	14.4

Figures are rounded to one decimal place

Detailed Analysis of Individual Taxes

The historical performance of individual taxes is consistent with elasticity and buoyancy estimates presented in Table 3. Since the tax system in Pakistan has undergone drastic changes, especially during the decade of 1990s, it is relevant that beside elasticity estimates, buoyancies are also computed as they take into account past as well as planned changes in the tax system.[2] It is important to observe that income and corporate taxes have turned buoyant overtime. While sales tax has maintained its elastic nature, the responsiveness of central excise to its base has also improved during 1990s. The only exception has been customs duties where the reduction in the two estimates is due to tariff rationalization and substantial reduction in maximum duty rate from 125% in the 1980s to 25% in FY 02-03.

As indicated the main drivers of the improved tax collection during July-December 2003 were direct taxes, sales tax and customs duties.

[2] The adjusted tax revenue data have been generated through the use of 'Proportional Adjustment Method' whereby changes in each of the four federal taxes have been captured individually.

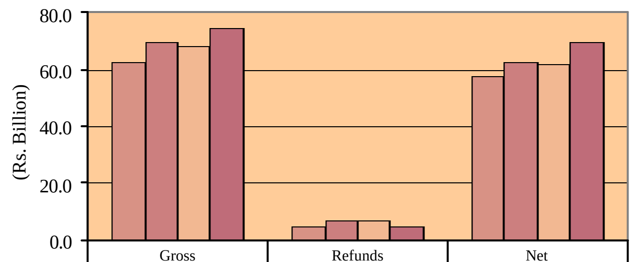
It may be relevant to state that nearly 43% of the targeted amount of direct taxes has been collected so far; and the same for sales tax, customs duties and central excise duties stands at 45%, 52%, and 41%, respectively. On the whole, slightly over 45% of the annual target of Rs. 510 billion has been achieved. Even more encouraging is the fact that most of the taxes have individually surpassed their respective half-yearly targets. The following detailed analysis has been restricted to broader macroeconomic perspective so that the linkages between federal taxes and their respective bases could be explored properly.

Table 3: Elasticity and Buoyancy Estimates of Federal Taxes

Federal Taxes	Tax Bases	Duration	Elasticity	Buoyancy
Direct Taxes	Non-Agriculture Income	1980-90	0.37	0.69
		1990-00	1.13	1.56
		1980-00	0.86	1.29
Sales Tax	Value Added in Manufacturing & Total Imports	1980-90	0.89	1.71
		1990-00	-0.17	1.55
		1980-00	0.29	1.5
Central Excise	Value Added in Manufacturing	1980-90	0.22	0.49
		1990-00	0.41	0.75
		1980-00	0.19	0.7
Customs Duties	Dutiable Imports	1980-90	0.68	0.92
		1990-00	-0.17	0.13
		1980-00	0.15	0.51

***Direct Taxes*:** The gross and net collection of direct taxes during October-December 2003 was Rs. 47.5 billion and Rs. 44.4 billion, respectively. At the same time Rs. 3.1 billion were paid back as refunds. This means that the 2nd quarter growth of gross collection was 16% and that of net collection 16.5%. In rupee terms the half-yearly gross and net collection during CFY has been Rs. 74.9 billion and Rs. 70 billion, respectively. The month-to month comparison reflects consistency in growth in direct tax collection over the corresponding period of PFY. With the exception of August 2003, a positive growth in net collection has been observed in the remaining five months with July and December being the two exceptional months. There was a phenomenal growth of 28.1% and 26.4% in net receipts during these months, which is extraordinary. A rather 'normal' growth of 7-8% was recorded in September, October and November 2003. However, notwithstanding the performance in August, the net collection has exceeded the last year's half-yearly collection by 13.4%. This consistent pattern of growth during the first half of CFY is illustrated in *Graph-1*.

Graph 1: A Comparison of Direct Tax Collection: H1 00-01 and H1 03-04



	Gross	Refunds	Net
H1:00-01	62.6	4.6	58.0
H1:01-02	69.7	6.9	62.8
H1:02-03	68.3	6.6	61.7
H1:03-04	74.9	4.9	70.0

An Analysis of Tax Returns: The preliminary analysis of income and corporate tax returns filed in September and December of CFY highlight important developments in terms of improved tax collection and broadening of the tax base. The impressive progress in tax collection – essentially the voluntary compliance – can be attributed to a number of factors including the enhanced tax effort while ensuring minimum contact with taxpayers, anticipated performance of the model tax units, and the unswerving pursuance of the reform process, particularly the adoption of the self-assessment in income tax. The salient outcomes are presented in the following (See also Table 4).[3]

[3] The analysis is based on data as of January 28, 2004. The latest figures may vary slightly as new returns are being received continuously.

- So far 1,017,465 companies and individual returns have been received. On the basis of these returns, the income and corporate tax collection shows an increase of 33.5% over PFY even though the number of returns has declined slightly by 1.1%;

- The corporate tax collection in the 'companies' category has increased by about 47% during the CFY over the PFY. This healthy growth can be attributed to increased profitability of the corporate sector as a result of stable macroeconomic environment, decreasing costs of borrowing, improvement in the law and order situation, and the promising prospects of regional security and stability;

- The number of returns as well as tax payment has increased for the 'individual other than salary' category. This is an important development as the category includes private-sector self-employed businesses where the incidence of tax evasion is usually high;

- Traditionally, the category entitled 'association of persons (AOPs)' contributes relatively small amount towards income and corporate taxes. However, notwithstanding the amount of contribution, a positive growth has been observed in terms of the number of taxpayers and the amount of tax paid;

- The share of income tax paid by companies and AOPs (i.e., other than individuals) has increased from 75% in FY 02-03 to 84% in FY03-04; and finally

- The income tax collection from 'salaried individuals' has declined by 9.4% in view of the fact that the basic threshold level was increased from Rs. 60,000 to Rs. 80,000 at the time of the announcement of the Federal Budget FY 02-03, which incidentally also explains the decline in the number of salaried taxpayers. It is also important to state that the contribution of salaried class in income tax receipts has declined from 3% in FY 02-03 to 2.1% in FY 03-04.

Table 4: An Analysis of Returns and Tax Collection: 2003 and 2002

(Rs. Million)

Collection in September

	Up to October 31, 03		Up to October 31, 02		Change (%)	
	No. of Returns Received	Tax Paid	No. of Returns Received	Tax Paid	No. of Returns Received	Tax Paid
Returns Filed						
Company Cases	1223	932.67	1256	224.4	-2.6	315.6
AOPs	22133	94.1	21524	91.9	2.8	2.4
Individuals*	498690	1105.4	489244	1100.8	1.9	0.4
Salaried Individuals	431583	159.8	450624	176.4	-4.2	-9.4
Sub Total	*953629*	*2292.0*	*962648*	*1593.5*	-0.9	43.8
Statements etc.	52860	119.11	56774	188.8	-6.9	-36.9
Total	**1006489**	**2411.1**	**1019422**	**1782.3**	**-1.3**	**35.3**

Collection in December

	Up to December 31, 03		Up to December 31, 02		Change (%)	
	No. of Returns Received	Tax Paid	No. of Returns Received	Tax Paid	No. of Returns Received	Tax Paid
Companies						
Returns	9095	5381.7	8302	4057.9	9.6	32.6
Statements	1881	3.3	836	0.07	125.0	4642.9
Total	**10976**	**5385.0**	**9138**	**4057.97**	**20.1**	**32.7**

** Other than Salary*

Components of Direct Taxes

(a) Voluntary Payments (VP): The voluntary payments have increased by 9.8% during the 1st half of CFY. A slight decline in the advance payments (i.e., from Rs.18.2 billion to Rs.17.9 billion, or 1.5%) was more than compensated by payments with returns that grew by 29%. As indicated, the sizeable growth has come from both, individual taxpayers and the corporate sector. The earlier assessment that there has been a favorable response to the universal self-assessment by the taxpayers to avoid risk-based audit and high penalties has been vindicated as the initial fear that there would be revenue loss due to USAS has faded away. This may be viewed as a positive development in view of the fact that huge amount of energy and resources are being invested to transform the system from its

traditional structure to modern lines. This transition is far from complete at this juncture.

(b) Collection on Demand (CoD): There has been nearly 24% increase in income tax collection on account of CoD during July-December of CFY. The share of CoD in gross collection has also increased to 7.5%. Even though the arrears demand has declined by 39%, the current demand has shown a substantial increase of 115%. Given that the CoD usually picks up in the last quarter of the fiscal year, the realization of considerable collection from this head during first half of CFY highlights the extensive tax effort put in by the field formations of the income tax departments (Table 5).

Table 5: Collection on Demand: A Comparison

(Rs. Million)

Heads	FY:03-04	FY:02-03	Difference	
			Absolute	Percent
Arrears				
Quarter 1	701.2	789.2	-88.0	(11.2)
Quarter 2	935.8	1,880.1	-944.3	(50.2)
July- December	1,637.0	2,669.3	-1032.3	(38.7)
Current				
Quarter 1	430.9	221.5	209.4	94.5
Quarter 2	3,542.6	1,624.8	1917.8	118.0
July- December	3,973.5	1,846.3	2127.2	115.2
Total Demand				
Quarter 1	1,132.1	1,010.7	121.4	12.0
Quarter 2	4,478.4	3,504.9	973.5	27.8
July- December	5,610.5	4,515.6	1094.9	24.2
Share in Gross Collection (%)	**7.5%**	**6.6%**		

Withholding Taxes (WHT): WHT continues to remain the leading component of direct taxes. The collection on account of WHT during July-December 2003 has been Rs. 42 billion against Rs. 39 billion during PFY, showing an increase of about 8% (Table 6). Similarly, the five major withholding taxes continue to be contracts, securities, imports, salary and interest, as they have contributed nearly 76% of total WHT collection during H1: 03-04. In particular, the share of imports (28.2%) remains at top, followed by contracts (24.8%), salary (11.3%), securities (6.4%) and interest (5.1%). The collection from imports, contracts and salary has increased by 11.2%, 7.2% and 12%, respectively due to substantial increase in the value of imports and improvement in economic activity. Besides the five major WHT contributors, a double-digit growth of 15.2%, 15.7% and 31.5% has been recorded on account of exports, electricity and telephone bills, respectively. However, the WHT collection from bank accounts has gone down by around 23% initially due to declining bank rates that have now bottomed out.

Table 6: Quarterly Collection from Major Revenue Spinners Related to Withholding Taxes

(Rs. Million)

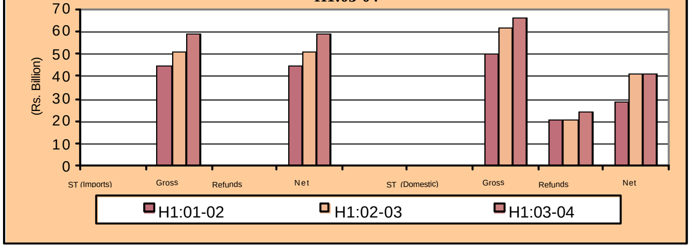
Collection Heads	FY:03-04	FY:02-03	Difference	
			Absolute	Percent
Contracts	0.25	0.25		
Q1	4609.5	4018.1	591.4	14.7
Q2	5800.1	5692.8	107.3	1.9
Securities	0.06	0.06		
Q1	1304.5	970.1	334.4	34.5
Q2	1368.2	1550.1	-181.9	-11.7
Imports	0.28	0.27		
Q1	4729.7	4760.9	-31.2	-0.7
Q2	7113.1	5886.8	1226.3	20.8
Salary	0.11	0.11		
Q1	2119.7	1925.7	194.0	10.1
Q2	2610.2	2296.2	314.0	13.7
Interest	0.05	0.07		
Q1	1038.3	1446.5	-408.2	-28.2
Q2	1120.1	1352.3	-232.2	-17.2
Sub-total (5 major items)	31813.4	29899.5	1913.9	6.4
Share in Total WHT	0.76	0.77		
Other WHT	10218.6	9118.5	1100.1	12.1
Total WHT	**42032.0**	**39018.0**	**3014.0**	**7.7**
Share in Gross I. Tax	0.56	0.57		

Sales Tax*:* Following an usual negative growth of 5% during the 1st quarter, the net sales tax collection has rebounded in the 2nd quarter with a healthy growth of 22.1%, thus registering an overall growth of 9.2% for the first half of the CFY. In rupee terms, the 2nd quarter gross collection has been Rs. 71 billion as compared to Rs. 54.6 billion in the 1st quarter of CFY and Rs. 56.8 billion in the 2nd quarter of PFY. The net collection has resultantly increased from Rs. 41.6 billion in the 1st quarter to Rs. 59.1 billion in the 2nd quarter of CFY. It was Rs. 48.5 billion during the 2nd quarter of PFY. The refund payments on the other hand have decreased slightly from Rs. 13 billion to 11.8 billion between the first two quarters of CFY.

Of the two components of sales tax, the domestic sales tax collection has shown a remarkable recovery in the 2nd quarter, as the growth in gross collection has been 25.6% as compared to (-)11.7% during the 1st quarter of CFY. Accordingly, the net collection has also recorded a sizeable growth of 19.6% during the 2nd quarter as compared to negative growth of 21.2% during the 1st quarter. The growth in domestic collection has been documented despite the fact that refund payments have increased by 42.1% during the 2nd quarter from only 2% during the 1st quarter. This growth pattern confirms that the decrease in the domestic sales tax collection during the 1st quarter was indeed a temporary phenomenon and it was correctly attributed to 'technical correction' rather than a slow down in domestic sales.

Similarly, due to considerable growth in its base, the sales tax on imports has continued its upward thrust in the 2nd quarter. Registering a growth of 24.3% in the 2nd quarter, the half-yearly net collection has been 15.4%. The monthly comparison confirms that followed by a sizeable growth of 29% in October, the net collection from imports increased by 43.7% in December, which is consistent with other indicators such as the growth in imports, collection of customs duties, and withholding tax on imports *(Graph 2)*.

Graph 2: A Comparison of Sales Tax Collection by Components: H1:01-02 to H1:03-04



Domestic Sales Tax Collection and Major Revenue Spinners: The detailed analysis of domestic sales tax collection indicate that more than 60% of gross collection is generated by ten major revenue spinners, which include POL Products, Telephone and Tele fax Services, Electrical Energy, Cotton, Natural Gas, Sugar, Cigarettes, Cement, Fertilizer, and MS Products. Unlike the 1st quarter when negative growth in collection was recorded for six out of ten major spinners, the situation has changed completely during the 2nd quarter (Table 7). Now with the exception of POL products, a healthy growth has been registered in all the remaining nine commodity groups and services. In fact a substantial increase of 154% and 99% has been documented in the case of fertilizer and services. Similarly, the growth has been 31% for cotton, 22% for natural gas, 22% for electrical energy, and 21% for MS products. This growth performance is indicative of the fact that the domestic economic activity continues to flourish within an improved overall macroeconomic environment. At the same time it is important to mention that as anticipated, the domestic sales of cotton and fertilizer have picked up in the second quarter. The crisis of the sugar industry has been amicably resolved and as a result its sale has also improved. As far as iron and steel products and cement are concerned, the improved sales tax collection is consistent with nearly 18% growth in the production of the former and 16% growth in the latter.

Table 7: A Comparison of Gross Collection of Domestic Sales Tax

(Rs. Million)

	July-December		Difference	
	FY:03-04	FY:02-03	Absolute	Percent
Ten Major Commodities				
July	4065.8	5843.6	(1,777.8)	-30.4
August	3929.9	6501.1	(2,571.2)	-39.6
September	7255	8301.6	(1,046.6)	-12.6
October	7,646.0	5,866.0	1,780.0	30.3
November	8,333.0	7,240.1	1,092.9	15.1
December	11,028	8,362.2	2,666.2	31.9
Sub-Total	42,258.1	42,114.6	143.5	0.3
% Share in Total	*63.6%*	*67.6%*		
Total All Commodities	66,406.2	62,277.9	4,128.3	6.6

Customs Duties: The CD collection has surpassed the assigned target for the July-December 2003 period by a wide margin of 18.4%. The continued buoyant pace in collection is reflected by the fact that 33.9% growth in the 1st quarter of CFY is followed by 56.1% growth in the 2nd quarter. The monthly performance indicates that net CD collection increased by 47.8% in October-03, 28.7% in November-03 and 86.1% in December-03 against the corresponding months of PFY. While part of this growth is attributable to substantial increase in the base of customs duties – the dutiable imports have increased by 23.2% during July-December 2003, and partly to lesser amount of refund/ rebate claims due to the application of revised DDB rates. The gross and net collection during the 2nd quarter has been Rs. 25.5 billion and 22.4 billion, respectively and the refund/ rebate payments were Rs. 3.1 billion.

The composition of imports, dutiable imports and effective (average) tariff rates presented in Table 8 is according to the PCT Commodity heads. The information confirms that while the import value of 15 major commodity groups has increased from Rs. 195.4 billion during H1: FY 02-03 to Rs. 237.3 billion, showing an increase of 21.5%, the value of dutiable imports has increased from Rs. 159.8 billion to Rs. 198.7 billion during this period entailing an increase of 24.3%. Secondly, nearly 84% of imports of 15 leading revenue spinners are dutiable. Thirdly, the CD collection from these commodities has increased at a faster rate of 26.4% as compared to all commodities in which case the revenue has increased by 23.7%. Finally, the effective rate (ER) of tariff for the sub-group of 15 commodities has been higher for dutiable and total imports – 17% and 14.2% – as against 15.9% and 10.3% when all commodities are considered. However, the higher side dispersion, i.e., the dispersion between the maximum ER and the maximum rate of statutory duty is significant only in three cases, i.e., iron and steel products, vehicles, and edible oil. Besides increase in the international prices of these items, their volume has also increased significantly to keep pace with the robust growth in industrial production.

Table 8: Major Revenue Spinners of Customs Duties and Effective Rates

(Growth and Effective Rates in percent)

PCT Chapter	Tariff Description	July-December Growth			Effective Rates on Dutiable Imports	
		Import Value	Dutiable Imports	Customs Duties	Up to Dec-03	Up to Dec-02
15	Edible oil and Waxes	31.2	32.7	23.9	32.5	34.8
87	Vehicles	48.3	53.6	65.3	35.9	33.4
84	Machinery	2.7	23.9	24.3	9.8	9.8
39	Plastic Resins, etc.	20.0	20.4	20.7	18.6	18.5
27	POL Products	13.2	5.3	6.3	10.2	10.1
29	Chemicals	28.4	22.7	20.5	9.9	10.0
85	Electrical Machinery	28.6	24.5	28.3	13.9	13.5
72	Iron and Steel	48.5	53.7	53.8	16.0	16.0
9	Coffee and Tea etc.	16.9	11.5	-8.4	19.1	23.3
48	Paper and Paperboard	22.9	23.3	27.3	18.7	18.1
38	Misc. Chemical Prod.	25.2	25.8	10.3	11.7	13.3
32	Dyes, Paints etc.	5.8	4.6	2.9	18	18.3
40	Rubber Products	25.8	26.8	16.9	13.8	14.9
54	Man-made Filaments	23.1	19.8	6.7	16.1	18.1
30	Pharmaceutical Products	18.2	19.4	18.3	10.2	10.3
Sub-total		*21.5*	*24.3*	*26.4*	*17*	*16.7*
Others		-1.9	19.2	11.7	11.9	12.7
Grand Total		**11.0**	**23.2**	**23.7**	**15.9**	**15.8**

Note: The Data pertains to Custom House, Karachi and Dry ports constituting nearly 96% of total CD Collection.

Regarding individual commodities, the most significant growth in CD collection has been observed in the case of vehicles (Chapter 87) and iron and steel products (Chapter 72). Incidentally, in both these cases the rate of duty was slashed on the pretext of reducing tariff peaks, albeit at different rates and for different categories within each of the two commodity groups.[4] Similarly, even though the ER for edible oils has declined due to reduction in duty, nevertheless, the CD collection has increased by 24% due to 32% growth in the value imports.[5] It may also be pointed out that 96% of total imports

[4] See Budget Document 2003-04 of Ministry of Finance.

[5] Edible oil is subjected to specific rate of customs duty therefore the effective rate declines with the increase in value per ton of this product.

of PCT Chapter 15 (edible oils etc.) were dutiable during the 1st half of the CFY. Contrary to this, the duty from Chapter 9 (coffee, tea etc.) has declined during the July-December 2003 period even though the value of total imports and dutiable imports has increased by 16.9% and 11.5%, respectively. This has happened because of reduction of CD rate on tea in the last budget.

Central Excise: The net collection of central excise duties during the 1st two quarters of CFY was Rs. 19.4 billion, showing a decline of 1.8% over the corresponding period of PFY. Since, the CED base is being reduced gradually as a deliberate policy change, its share in total federal receipts has further reduced to 8.6% during the first half of CFY from 19.6% in FY 96-97. However, notwithstanding these changes, CED revenue has increased during the 2nd quarter by 2.5%. The month-to-month record further confirms that the collection was higher by 13.3% in October and 4.3% in December, which is noteworthy. The main sources of the movement in CED receipts are fluctuations in five commodities, including cigarettes, cement, natural gas, POL products, and beverages and concentrates. These commodity groups have constituted nearly 91% of CED revenue during July-December 2003 (Table 9).

The commodity-wise analysis of CED provides the following insight. Firstly, the collection from cigarettes has gone up by 13.3% on account of higher production and clearance. The data confirms that the production of cigarettes has increased by 17% during July-November 2003. Moreover, the recent measure to seize the machinery used for the manufacturing of counterfeit products has certainly added to the performance of this sector. Secondly, the collection from cement has declined by 19% during H1: FY 03-04 over PFY due to reduction of the rate of duty. The negative impact of this measure has been supplemented by a substantial increase in export of cement to Afghanistan, which is without payment of CED. Thirdly, the collection from natural gas has increased by 9.2% even though the CED duty structure was changed from Rs. 17.18/HCM – a volume based rate to Rs. 5.09/mmBTU – a heat content-based rate. Essentially, the improved supply condition of natural gas has been instrumental in increasing CED collection. Fourthly, notwithstanding the substantial share of POL products in CED revenue, its amount has declined during the 1st two quarters of CFY as compared to PFY due to revision of rates on lubricating oil and mineral gas. Finally, for aerated beverages the growth has turned positive for the last two consecutive quarters. The data indicates that the clearance of beverages was higher by 21% during July-November 2003.

Table 9: A Comparative Analysis of CED Collection

(Rs. Million)

5 Major Revenue Spinners	FY:03-04	FY:02-03	Difference	
	July-December		Absolute	Percent
Cigarettes				
Q1	2,964.3	2,681.1	283.2	10.6
Q2	4,543.3	3,947.7	595.6	15.1
Total	7,507.6	6,628.8	878.8	13.3
Cement				
Q1	2,167.8	2,617.9	-450.1	-17.2
Q2	2,157.1	2,724.6	-567.5	-20.8
Total	4,324.9	5,342.5	-1017.6	-19.0
Natural Gas				
Q1	1,161.7	1,086.2	75.5	7.0
Q2	1,157.8	1,038.0	119.8	11.5
Total	2,319.5	2,124.2	195.3	9.2
POL Products				
Q1	789.3	865.6	-76.3	-8.8
Q2	849.7	827.5	22.2	2.7
Total	1,639.0	1,693.1	-54.1	-3.2
Beverages				
Q1	648.1	613.0	35.1	5.7
Q2	408.4	384.4	24.0	6.3
Total	1,056.5	997.4	59.1	5.9
Sub Total				
Q1	7,731.2	7,863.8	-132.6	-1.7
Q2	9,116.3	8,922.2	194.1	2.2
All Commodities	16,847.5	16,786.0	61.5	0.4
% Share in Gross	90.9	84.7		

Concluding Observations

CBR has accomplished significant progress in such diverse areas as revenue receipts, interaction with stakeholders, HRM of its workforce, automation, facilitation and prompt dissemination of tax related information. Notwithstanding the initial slow progress due to inherent rigidities in maintaining the *status quo*, the firm commitment and resolve for change has prevailed thus far. This change required sweeping revisions in direct and indirect tax rates to change its tax-mix in the light of the overall macroeconomic requirements of the country and its international commitments and far-ranging administrative reforms to improve CBR's interface with taxpayers. The model units to pilot-test various reform-related initiatives have shown remarkable progress. The re-prioritization of objectives from revenue targeting to cooperative and facilitating ambiance of service delivery has been an enriching experience. It has received widespread appreciation of stakeholders.

It is also encouraging that the revenue generating effort of CBR has received strength from improved macroeconomic environment. The significant growth in various tax bases including value-added in the manufacturing sector, dutiable and total imports, and non-agriculture income has improved tax compliance. It is anticipated that CBR's performance will maintain its steady course in future as well through the combined impact of efficiency gains emanating from fiscal reforms and the healthy growth of the economy.

II

Vying for An Accelerated Growth: Lessons from Trade Policy Initiatives in Pakistan[6]

Background

The course of economic development in a country is largely shaped by trade regime pursued over an extended period of time. One of the most agreeable conclusions of the international economics literature is that *Openness is superior to autarky*. Needless to add that while unrestricted trade flows are favored on efficiency, productivity gains, and economies of scale arguments, effective management of foreign trade transactions is equally desired to maintain equilibrium in balance of payments, attaining favorable terms of trade, protecting domestic industry, creating employment opportunities, generating revenue for the government and ensuring food security.

Historically the developing economies have concentrated either on import substitution policy of industrialization to promote growth or export-led growth has been exercised as the alternative option. However, it is now well known that a large majority of the countries had opted for export pessimism after the 2nd World War. A highly protective environment was created through exchange rate and commercial policies. Imports were restricted through tariff and non-tariff barriers and by maintaining overvalued currency to subsidize imports into priority area. The general understanding was that indigenous capacity building and industrialization were essential for faster technological growth and employment. It was believed that full exploitation of backward and forward linkages would result in improvement of terms of trade in favor of the manufacturing sector and resultantly there would be stable export earnings.

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However, the empirical evidence did not support the policy of export pessimism as the world trade grew rapidly during 1950s and 1960s. Even more astonishing was the fact that this growth was faster than the growth in the world income. Secondly, some of the countries such as Korea, Taiwan, Singapore, and Hong Kong that quickly shifted to export optimism experienced substantial improvements in their export performance and overall growth as compared to India, Brazil, and Pakistan who persisted with inward looking import substitution policies. The situation has reversed almost completely during the past two decades as more and more countries are now favoring trade liberalization and deregulation as compared to the regime of barriers to trade and protectionism of 1950s and 1960s. The 'openness hypothesis' interprets liberal regimes of international transactions as a major cause of higher rates of economic growth and poverty reduction. However, notwithstanding the controversies concerning the relevance of import substitution industrialization and export-led growth, the world as a whole has already endorsed the free trade environment under the umbrella of the World Trade Organization (WTO). [7]

The present study investigates the strengths of trade regimes in Pakistan in historical perspective. In the first part of the study the nature of trade flows has been analyzed to verify the claims that Pakistan's foreign trade sector suffers from narrow concentration in terms of goods and destinations. The second part provides a comprehensive review of trade policy initiatives since early 1950s to understand shifts in policy regimes. Based on this review, lessons are drawn in the third part to explain how outward orientation could be rewarding in the shape of economic growth and export earnings.

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[7] The initial discussion on the controversy can be found in Bhagwati, J. N. (1988) 'Export promoting Trade Strategy: Issues and Evidence', The World Bank Research Observer, 3: 27-57. For more recent studies see Sachs, J. and A. S. Warner (1995) 'Economic Reform and the Process of Global Integration' Brookings Paper on Economic Activity 1: pp 1-118; and Kappel, R. (2004) 'Openness, Institutions, and Policies: Determinants of Globalization on Economic Growth in Developing Countries' Paper presented at the 19th AGM of PSDE in Isalmabad.

Pakistan's Trade Transactions

Pakistan's trade flows had registered two remarkable changes during the past 56 years. The first major shift occurred soon after the independence when India's position as one of the leading export partner declined sharply from 56% to 4% during the decade of the fifties and the authorities had to search for new markets. The second similar change occurred in 1971 when East Pakistan became Bangladesh and as a result, (West) Pakistan lost more than half of its export market. On both these occasions drastic measures enabled the country to find alternative export markets. For instance, the sharp devaluation of the currency in 1972 was instrumental in doubling the transactional value of international trade between FY 71-72 and FY 75-76. Barring these surgical measures, the rupee value of exports and imports have historically increased steadily on account of a number of trade facilitation measures and the built-in momentum. The share of exports in GDP has improved from less than 3% in FY 60-61 to over 16% in FY 02-03 even though the unit value of exports has declined in recent years. Similarly, the share of imports has now reached in the vicinity of 17-18% for the last many years (Table1).

Table 1:Pakistan's Trade Transactions and Openness

(Rs. Billion)

Years	GDP	Exports	Imports	Balance of Trade (BoT)	Share in GDP (%) of			Openness (%)
					Exports	Imports	BoT	
1960-61	20.06	0.5	2.2	-1.6	2.7	10.8	-8.1	13.5
1971-72	55.3	3.4	3.5	-0.1	6.2	6.3	-0.1	12.5
1975-76	131.3	11.4	20.5	-9.1	8.7	15.6	-6.9	24.3
1980-81	278.2	29.6	53.5	-24.0	10.6	19.2	-8.6	29.9
1985-86	514.5	50.4	91.0	-40.6	9.8	17.7	-7.9	27.5
1990-91	1020.6	139.4	171.2	-31.7	13.7	16.8	-3.1	30.4
1995-96	2170.2	296.1	397.7	-101.7	13.6	18.3	-4.7	32.0
2000-01	3423.1	542.8	627.7	-85.0	15.9	18.3	-2.5	34.2
2001-02	3628.7	565.3	635.3	-70.1	15.6	17.5	-1.9	33.1
2002-03	4018.1	655.2	714.7	-59.5	16.3	17.8	-1.5	34.1

Source: Economic Survey 2002-03 and FBS Monthly Bulletin of Statistics, December 2003.

The important milestones of recent trade flows are the increasing level of openness, measured as the ratio of total value of exports and imports to GDP, and the reduction of balance of trade relative to GDP, and the turning of the current account into surplus due to sharp increases in current transfers.

Another area of substantial progress has been the changing commodity composition of exports. Starting as a producer and exporter of primary products, major proportion of Pakistan's export earnings is now generated by manufactured and semi-manufactured products. The share of primary products in total imports has declined from 45% in FY 71-72 to 11% in FY 02-03 (Table 2). However, this change could be deceptive, as the industrial structure remains heavily dependent on the agriculture sector and there is limited diversification of exports, both in terms of geographical regions and products. Nearly 80% of Pakistan's export earnings continue to originate from five commodities with textile sector at the top of the rank with 60% share. Similarly, nearly 50% of Pakistan's exports end up in only seven counties.

Table 2: Exports and their Share by Economic Categories: 1972-2003

(Rs. Billion)

Years	Total Exports	Primary Commodities		Semi-manufactures		Manufactured Goods	
		Value	% Share	Value	% Share	Value	% Share
1971-72	3.4	1.5	44.8	0.9	27.1	0.9	28.1
1975-76	11.3	4.9	43.6	2.1	18.4	4.3	38.1
1980-81	29.3	12.8	43.8	3.3	11.3	13.1	44.9
1985-86	49.6	17.1	34.6	7.9	15.9	24.6	49.5
1990-91	138.3	25.8	18.7	33.8	24.4	78.7	56.9
1995-96	294.7	47.9	16.2	63.8	21.6	183.1	62.1
2000-01	539.1	67.8	12.6	81.3	15.1	390.0	72.3
2001-02	560.9	60.3	10.8	80.4	14.3	420.2	74.9
2002-03	652.3	71.2	10.9	71.3	10.9	509.8	78.2

Source: Economic Survey 2002-03 and FBS Monthly Bulletin of Statistics, December 2003.

This extraordinary level of concentration of exports in traditional commodities and markets has always been a cause of concern for policy planners for the following reasons: (a) the export earnings have become unstable as they not only depend on weather conditions at home, they also depend on the economic conditions, recession or boom, in the importing countries, (b) revenue instability is encountered frequently which in turn becomes a source of economic mismanagement, and (c) many pressure groups have emerged (e.g., the textile group) whose actions and demands are often inconsistent with the objectives of the State.

The composition of imports has also seen significant changes overtime. While the share of consumer goods has declined steadily, the share of raw material for consumer goods has grown rapidly, which is a reflection of increasing industrial concentration in the consumer goods sector dependent on the imported raw material. The capital goods imports on the other hand have remained stable during the past three decades except for the beginning of the millennium years when trade transactions were at their lowest levels mainly because of international events and also due to trade sanctions imposed by Pakistan's leading trade partners. However, things have improved from FY 02-03 onwards as total imports have registered a healthy growth of 12.6% during the past financial year (Table 3).

Table 3: Imports and their Share by Economic Classification: 1971-2003

(Rs. Billion)

Years	Total Imports	Consumer Goods		Raw Materials				Capital Goods	
				Consumer Goods		Capital Goods			
		Value	% Share	Value	% Share	Value	% Share	Value	% Share
1971-72	3.5	0.8	22.8	0.9	24.4	0.4	10.5	1.5	42.4
1975-76	20.5	4.3	21.2	7.7	37.7	1.3	6.2	7.2	35.0
1980-81	53.5	7.8	14.5	26.8	50.1	4.1	7.6	14.9	27.8
1985-86	90.9	16.4	18.1	36.4	40.0	5.0	5.5	33.2	36.5
1990-91	171.1	26.9	15.7	76.3	44.6	11.6	6.8	56.3	32.9
1995-96	397.6	54.1	13.6	180.5	45.4	22.5	5.7	140.4	35.3
2000-01	627.0	89.8	14.3	345.8	55.1	34.4	5.5	157.1	25.1
2001-02	634.6	72.0	11.3	346.9	54.7	39.0	6.2	176.7	27.8
2002-03	714.4	72.2	10.1	380.0	53.2	41.2	5.8	220.9	30.9

Source: Economic Survey 2002-03 and FBS Monthly Bulletin of Statistics, December 2003.

Trade Policy Initiatives in Historical Perspective[8]

It is interesting to observe that barring few exceptional years the economy of Pakistan has been growing at respectable annual rate of around 6% when import substitution policies were in vogue. However, this growth fell sharply with the initiation of the liberalization program. The deceleration observed during the decade of the 1990s has been the worst since past many years. This outcome, which some may regard contradictory to economic wisdom, requires careful evaluation and proper explanation. A historical recount of events is therefore necessary.

(i) Humble Beginning and the Era of Increasing Controls (1947-59): At the time of independence in 1947 the economy of Pakistan witnessed discernible disparity between availability of huge natural base but very few industrial units to process primary products. While, it was producing nearly 75% of jute in the world but there was not a single jute mill; the good-quality cotton production was as high as 1.5 million bales but the 'infant' textile industry was not ready to play a meaningful role, and same was true for other agro based primary products including sugarcane, tobacco, wool, and hides and skins. The trade policy at this juncture had to be designed to improve the macroeconomic environment and to promote economic growth.

Although many economies of the world operating within sterling area decided to devalue their respective currencies after pound sterling was devalued by 31% in 1949, Pakistan in a rather bold attempt chose not to do so even though it meant apparent loss of comparative advantage as exports became expensive. There was an

[8] For comprehensive review of trade policies see also Ahmed Viqar and Rashid Amjad (1984) *The Management of Pakistan's Economy, 1947-82*, Karachi: Oxford University Press; Dorosh, Paul and Alberto Valdes (1990) *Effects of Exchange Rate and Trade Policies on Agriculture in Pakistan*, Research Report No. 84, International Food Policy Research Institute; Zaidi, S. Akbar (1999) *Issues in Pakistan's Economy*, Karachi: Oxford University Press; and Hussain, Ishrat (1999) *Pakistan: The Economy of an Elitist State*, Karachi: Oxford University Press.

initial difficulty as India being one of the leading trade partners at that time refused to recognize new exchange rate and the trade between the two countries virtually stopped. However, the problem was short lived as the Korean War brought with it unprecedented commodity boom. There was a record increase in the demand for cotton and jute. With an enhanced level of exports and a stable level of imports the balance of payments position improved substantially and there was a strong buildup in foreign exchange reserves.[9] As a consequence Pakistan was once again able to pursue a liberal import policy. According to Zaidi (1996), nearly 85% of its imports in 1951 were virtually without license.

Since the demand for Pakistani products collapsed and foreign exchange earnings declined sharply after the Korean War, the government resorted to import controls but delayed the decision to devalue the rupee until 1956. However, strict controls had serious consequences in the shape of emergence of a black market in licenses as the demand for both consumer and intermediate goods far exceeded their supplies. Simultaneously, the real value of total exports also declined sharply due to inadequacy of price incentives; export duty on cotton and jute exports, and the ban on the exports of many agricultural products.

(ii) An Era of Multiple Exchange Rates (1959-72): Throughout 1950s the government maintained a highly restrictive import regime to promote import substitution policy, nevertheless Export Bonus Scheme (EBS) was introduced in 1959 to promote exports. Under this scheme exporters of manufactured products were awarded export bonus vouchers at rates depending on the stage of processing which were then used to purchase otherwise restricted items from the import bonus list. This move introduced a multiple exchange rate system in the country. The Open General Licensing (OGL) system

[9] See Hussain, I (1999) *op. cit.*

practiced during the 1950s was reintroduced in 1961 with the hope that it would break the monopoly on imports by established traders. Similarly, further steps towards import liberalization were undertaken in 1964 when a free list of goods was introduced that allowed importer to import otherwise restricted goods without an import license. However, despite these measures to reduce anti-export bias, the degree of trade liberalization was fairly marginal. The trade liberalization efforts received a serious set back after the 1965 war when the number of commodities on the free list was drastically reduced. However, the EBS continued to be rewarding as the share of manufactured exports in total exports increased from 43% in 1960 to 67% in 1970.

(iii) Re-emergence of Controls and Nationalization (1972-76): By 1971 bonus vouchers issued against exports were as high as 35% of the export proceeds, and goods imported under bonus voucher schemes accounted for almost 40% of total imports [Dorosh & Valdes (1990)]. However, after the loss of nearly half of the export market in 1971, frantic efforts were made to enhance exports. As a first step rupee was devalued in May 1972, and secondly the EBS was abolished. Furthermore, the restrictive import licensing system was largely dismantled and all the permissible imports were placed either on the free list or tied list. Goods not on either of the two lists were banned. At the same time as a move towards trade liberalization, import duties were also reduced on intermediate and capital goods. However, despite all these measures, anti-export bias was dominating as the import substitution bias increased in the 1970s [Khan (1998)].[10] The reason for this paradox was the implementation of a two-prong strategy whereby all export subsidies except tax rebates and export financing were withdrawn, and at the same time export duties were imposed on a number of products including raw cotton, cotton yarn, and cotton fabrics. However, the

[10] The import substitution bias has been computed on the basis of the ratio of effective exchange rate for imports and exports (EER_m/EER_x) [Khan (1998)].

exchange rate for exports was unified later in the decade, initially by reducing and ultimately eliminating of export duties on various products.

(iv) Escalating Balance-of-Trade Problem (1978-82): The balance of payments problem started to deteriorate towards the 2nd half of 1970s for two reasons: firstly, the imported raw material became expensive as a result of devaluation, and secondly, despite a sharp rise in prices of imported goods after the two oil price shocks, Pakistan maintained constancy of its nominal exchange rate. All this was happening when the domestic inflation and the rupee were continuously appreciating in real terms. Besides maintaining an over-valued currency, the government kept on relying on export subsidies and compensatory rebates for the exporters of traditional exports on the grounds that capital goods were facing duties at the import stage and input costs were also rising. At the same time the licensing procedures were tightened and further quantitative restrictions on imports were imposed to manage the balance of trade problem. However, Pakistan's trade regime reached its most restrictive stage in 1980 as 41% of the domestic industrial value added was protected by import bans, and another 22% by various forms of import restrictions [World Bank (1988)].[11]

(v) The Onset of the Trade Liberalization Regime (1982-88): As an important policy to enhance exports the Pak Rupee was de-linked from US dollar in January 1982 and the government adopted a managed float exchange rate policy. Many of the non-tariff barriers were also removed and import bans were lifted from 122 products in 1983. Even though a 'negative list' of banned import items was in vogue during this period, it was regularly trimmed with the passage of time. The initial work on tariff rationalization was also started in 1987 whereby tariff rates were reduced and the number of slabs

[11] See World Bank (1988) *Pakistan: Growth Through Adjustment*, Report No. 7118-Pak, Washington, DC: The World Bank.

decreased from17 to 10. Another important step in 1987 was the introduction of the system of International Trade Prices (ITP) for customs clearance to tackle the problem of under invoicing.

An *ex post* review of trade and exchange rate policies on exports indicates that nothing substantial was gained at least immediately after the change in policy environment. The share of exports in GDP declined initially from 9.4% in FY 82-83 to 8% in FY 84-85. However, it increased slowly afterwards to reach 11.7% by FY 88-89. Similarly, the growth of exports remained erratic between FY 81-82 and FY 84-85, only to register a double-digit growth in the 2nd half of the decade of the eighties. Thus, a strong case cannot be made for a significant relationship between devaluation and exports.

(vi) Outward Orientation: The Real Beginning (1988-1995): In the light of the stagnation in the balance of trade and payments position Pakistan embarked upon an ambitious structural adjustment program towards the end of 1980s. Since then widespread reforms in diverse areas have taken place and trade liberalization measures are among them. Specifically, the trade reforms include continuous rationalization and reduction of tariff rates, elimination of para-tariffs such as import license fee, *iqra* and flood relief surcharges, and cascading of nominal tariffs with rates increasing progressively with stages of manufacturing.[12] A policy of managed float exchange rate was maintained. Further concessions were granted to exporters to reduce anti-export bias and promote competition. These included availability of full drawback for all surcharges and import license fees on raw material imported at international prices, encouraging trade houses whose exports exceeded US$ 20 million to sell their goods under their brand names, and the availability of export

[12] The gradual reduction of tariff rates and issues related to tariff peaks and escalation are under active research at CBR. The analysis on this important area will be included in one of the forthcoming issues of the *CBR Quarterly Review.*

development funds for the promotion of Pakistani exports abroad.[13] Similarly, re-exports were allowed under certain restricted conditions and higher income tax relief of more than 55% was allowed on the income from exports of machinery and engineering goods. The involvement of the private sector was encouraged in the exports of basmati rice and raw cotton.

(vii) Globalization of Merchandised Trade under the WTO (1995-2004): The most audacious step of the trade reform process was the adoption of the WTO Agreements under which all protective arrangements had to be dismantled according to an agreed time frame. The trade policy framed at the time of the establishment of WTO envisaged an outward looking approach and included further steps towards liberalization of trade. The policy endeavors included simplification of the existing rules and procedures for boosting exports, incentives for the diversification of exports, both commodity-wise as well as country-wise, continued revision of applied tariff rates and their binding structure, and involving private sector in the exports of additional manufactured products, particularly cement. The trade policy for the most recent year (2003-04) is also guided by market driven forces and aims at liberalization and deregulation of the economy. The main focus has been placed on macroeconomic stability. The maximum tariff rate has been brought down to 25% and the numbers of tariff slabs reduced from 5 to 4. Additional measures to further reduce anti-export bias have been outlined. Simultaneously, incentives have also been announced for manufacturers and exporters with an objective to reduce their cost of doing business in Pakistan.[14]

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[13] Specifically the import of yarn wool, silk, viscose & acrylic and dyed yarn of cotton / wool required by manufacturers for subsequent exports was allowed free of duty, sales tax and *iqra* surcharge against indemnity bond. In the same way the import of parts and components required for the manufacturing of capital goods and the import of straightening machines and vibratory bowls, used in cutlery industry, were allowed free of duty, sales tax, *iqra* surcharge and import license fee under BMR.

[14] A brief review of the recent initiatives and future strategies related to trade liberalization and export promotion has been carried out in recently released Poverty Reduction and Growth Strategy Paper. See Government of Pakistan (2003) 'Accelerating Economic Growth and Reducing Poverty: The Road Ahead' Poverty Reduction Strategy Paper, Islamabad: Ministry of Finance.

Lessons Learnt from Trade Policies

The debate is far from over on the relevance of import substitution (IS) industrialization and the export-led growth (ELG) hypotheses for economic development. However, over the years the perspective has changed slightly. The IS policies are now analyzed within the broader framework of deficient or weakly enforced non-market institutions and hence carries a new label 'corruption pathology.' On the other hand, the ELG hypothesis is now viewed within the context of 'openness' whereby policy changes aim at eliminating large government deficits, curtailing inflationary monetary policies, maintaining market-oriented exchange rates, increasing domestic competition, improving governance problem, strengthening the legal and civil-service systems, and expanding the health and education facilities, provision of basic needs and so forth.

The discussion in this paper has revolved around two questions, firstly, how trade policy has evolved overtime, and secondly, what lessons could be learnt from various initiatives to design future course of action. It has been confirmed that the IS policies pursued soon after the independence were growth promoting but this gain was materialized only in the short run. These policy initiatives were not helpful in the long run as they failed to expand output and generate exportable surpluses, especially of value added manufactured products because of allocative and distributional inefficiencies. The deliberate inclination towards import substitution also resulted into anti-export bias. On the contrary, export-promoting policies pursued initially during the 1960s and then in the 1980s were somewhat rewarding, notwithstanding the fact that the momentum was lost during the 1970s (Table 4). However, despite being a late starter in the 1980s, the incentive driven program of liberalization faced tough challenges in the shape of the worsening economic conditions. This was the time when the twin deficit problem had worsened to an extent that there were concerns about economic survival, as the economy was not generating enough resources for its sustenance. The reform process at this stage was tantamount to a major surgery that resulted into further bleeding and weakness. Surprisingly, some of the critics have ‘wrongly’ linked the initial growth retardation with the removal of protectionist barriers. According to them the root cause of the declining investment and exports activities during much of the 1990s could be found in the opening-up of the economy to foreign competition after the liberalization program. This outcome has encouraged them to suggest that protectionism had been a better option as it was at least growth promoting! This assertion requires correction in the light of the success of the trade liberalization phenomenon in various countries.[15] It should not be a surprise that even the most inward looking countries like India and China have gained considerably through the process of deregulation and liberalization. The only concern in the case of Pakistan could be that the pace at which these reform measures have been undertaken is probably too fast. Also the initial setbacks may have been due to the wrong sequencing of the reform process, especially the financial sector reforms.

Table 4:Growth of GDP, Exports and Investment in Nominal and Real Terms during Policy Regimes Since 1950 (%)

	Growth (in Real Terms)*			Growth (in Nominal Terms)		
	GDPmp	Exports	Investment	GDPmp	Exports	Investment
1951/52 - 1958/59	NA	NA	NA	NA	-5.8	NA
1959/60 - 1971/72	6.6	8.9	6.5	8.2	21.2	10.8
1972/73 - 1977/78	5.1	1.4	7.2	21.6	33.0	37.4
1978/79 - 1987/88	6.6	10.0	4.8	14.3	20.5	13.5
1988/89 - 1994/95	4.7	9.1	4.8	15.7	18.2	16.2
1995/96 - 2002/03	3.4	7.2	2.0	10.1	12.8	7.8
Overall	5.5	7.8	5.2	11.2	17.0	15.8

** Base Year 1980-81*
NA = Not Available

[15] See for example Frankel, J. and D. Romer (1999) ‘Does Trade Cause Growth?’ *American Economic Review*, 89:3, pp. 379-399 and Baldwin, R. (2003) ‘Openness and Growth: What’s the Empirical Relationship’ NBER Working Paper 9578.

Concluding Remarks

The purpose of the present study has been to clarify some of the paradoxical conclusions emanating from trade and exchange rate policies. It has been demonstrated that there are short run costs of every reform process. These costs take various forms and shapes including the closure of inefficient manufacturing units, increasing unemployment of previously employed workforce in unproductive industries, decrease in export earnings, reduction in industrial output, and most importantly the decrease in the incomes of rent seekers. Unfortunately, various vulnerable groups are also exposed to difficulties of life when subsidy programs are rolled back. However, this is the time when the role of the reform team becomes critical, as they have to ensure that the short-term costs are not stretched far too long. In fact, the transition phase requires careful monitoring. A prompt government intervention is required when distributive consequences become too difficult for the general public. Otherwise the growing incidence of unemployment and poverty takes over and there are further damaging consequences for the society at large. Incidentally, Pakistan is passing through the critical phase of transition that requires careful handling.

III

Performance of Model Tax Units: An Initial Assessment[16]

Aims and Objectives

As part of the reform process, CBR undertook the initiative of developing model tax units to run its business transactions on modern lines. In this respect, the first such unit, popularly known the Large Taxpayers Unit (LTU) started functioning from 1st July 2002. Similarly, the Medium Taxpayers Unit (MTU) was inaugurated on 1st October 2002 in Lahore. The objectives of setting up of these units were fairly diverse and included the following: to pilot test tax administration on functional rather than cylindrical lines; to test the growing integration of the two future taxes, i.e., sales tax and income tax and assess the nature and magnitude of benefits that could be derived from co-location and the availability of information flows across taxes; to create a taxpayer friendly office environment; to exercise focus over all the tax matters of the largest taxpayers at Karachi and small and medium taxpayers at Lahore; to minimize contact between taxpayers and collectors; and eventually to maximize revenue collection for the government. Business process reengineering, management of human resources and automation as part of administrative reforms have been the major driving forces towards achievement of these objectives. Now that the model units have completed more than one year of successful functioning, it is relevant to analyze the outcome on the basis of performance measures including revenue receipts. The following initial assessment is somewhat restricted in nature as subjective assessment on the basis of structured questionnaires has not been included. The effort towards impact and evaluation will be undertaken in coming months.

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[16] The paper is written by Mr. M. S. Lal Member (Policy and Tax Reforms), CBR. Useful input from Ms. Raana Ahmed, Commissioner MTU, and Mr. Shahid Jamal DG LTU is thankfully acknowledged.

Large Taxpayer Unit (LTU) at Karachi

Many countries in the world have established large taxpayer units to secure revenue, improve management of arrears, enforce audit and introduce new systems and procedures. Generally the largest 2% of taxpayers contribute around 70% of revenue. Similar is the situation in Pakistan where:

a. Top 100 income tax payers paid 28% of total income tax revenue in the year 2001;

b. Top 100 domestic taxpayers paid 32% of total GST revenue; and

c. Top 100 Custom payers paid 40% of total Customs collections.

Keeping in view the large revenue potential and to address the issue of high level of risk to revenue, CBR decided to establish LTU with the following specific objectives:

- to facilitate large taxpayers
- to reduce compliance cost of large taxpayers
- to secure revenue
- to improve audit capacity
- to monitor arrears
- to integrate taxes

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. 80 billion (45.5% of Karachi's tax revenue) to be collected from around 600 Karachi-based large taxpayers. On account of the success achieved, another LTU at Lahore is being established which will commence working by mid-2004.

The LTU has enabled CBR to divert its best available resources to largest taxpayers. This on the one hand has facilitated the taxpayers in resolution of their problems; on other hand allowed handling of complex legal issues involved in large cases by persons having adequate technical skills. The professional approach and know how of the personnel working in LTU will have better chances to identify any tax avoidance techniques employed by the largest taxpayers. Already the close monitoring of performance of the tax collectors and other related factors has helped to improve revenue collection and check corruption. The incentive based remuneration for the employees of CBR working in LTU have also helped to develop a new culture within the organization.

Box 1: Some Comments/ Expressions of the LTU Visitors

The mission considers that the LTU fully meets all of the requirements envisaged and indeed sets a standard that very few other countries are achieving.	IMF/FAD Mission 2003
"Astounding unit. Makes one feel like paying taxes"	John Wall, World Bank
"A clear example of a successful reform effort"	Michael Engelshalk, World Bank
"A great step forward"	Richard Highfield, IMF/FAD
An exemplary institution created by the Government to change the tax culture. It will create confidence and trust amongst the assesses. Such offices should be created at all levels. I must congratulate the DG and his officers for the yeomen service.	Justice Saleem Akhtar, Federal Tax Ombudsman
I am extremely delighted to see the LTU working as a cohesive and focused team of facilitators and collectors. I wish their attitudes and skills are spilled over to the rest of the tax administration.	Dr. Ishrat Hussain, Governor, State Bank of Pakistan
Simply great. It was a pleasure to visit and meet with LTU staff. I hope they are successful in their efforts of providing the desired services to the taxpayers and at the same time increasing revenues for the country.	Mudassir Khan, Sr. Financial Sector Specialist, World Bank
Very useful procedures	Milan Zavadjil, IMF
Excellent facility	Axel Schimmelpfennig, IMF
Impressive performance,	Ron Van Rooden, IMF
Very impressive! You have few things to teach us also.	Am Remie, Director HR, World Bank
?	Ms. Mieko Nishimizu, Vice President World Bank

Revenue Performance

As indicated, LTU handles all the three domestic taxes of Karachi based units that include largest designated corporate taxpayers, banks, insurance companies and non-resident corporate taxpayers.

The initial assessment confirms that there are efficiency gains and modern setup of tax administration has enabled tax collectors to improve revenue collection. The LTU has contributed around 23% of federal tax receipts in respect of domestic taxes during CFY. The tax-wise performance is as follows.

Direct Taxes: For a meaningful analysis, the half-yearly direct tax collection of LTU for CFY is compared with the outcome of PFY and FY 01-02, the time prior to the establishment of LTU. Secondly, even though 300 additional cases have been transferred to LTU during CFY, the comparison is restricted to original cases only. It is encouraging to note that after an initial decline, the total direct tax collection has increased by 89.8% during H1: FY 03-04 over H1: FY 02-03. In absolute terms net collection of Rs. 12 billion has been materialized during July-Dec 2003 against Rs. 6.3 billion during the corresponding period of PFY and Rs. 8.6 billion in H1: FY 01-02. The share of LTU collection in total direct taxes has increased from 10.4% in July-Dec 02 to 17.9% in July-Dec 03.

Sales Tax (Domestic): Similar to direct taxes, the half-yearly domestic sales tax collection of LTU is compared with the outcome prior to its establishment. It has been observed that the collection increased by 49% between H1: FY 02-03 and H1: FY 01-02 and a further increase of around 6% has been recorded during the 1st half of CFY. The gross receipts have increased from Rs.14.4 billion in H1: FY 02-03 to Rs.15.2 in H1: FY 03-04. The LTU has emerged as the leading revenue collecting source among the Sales Tax Collectorates. Even though sales tax is being collected from 129 commodities, the true nature of economic activity is not properly reflected because of deficient sales tax registration system. However, the leading commodities have the following share in ST (domestic) collection: natural gas 20.6%, petroleum oils & lubricants (15.7%), lubricating oils & oil additives (10.4%), M.S. Products (7.8%), cigarettes (5.6%) and automobiles (3.6%).

Central Excise: Presently 68 manufacturing units within the jurisdiction of LTU are liable to pay central excise duties. With this CED tax base, the share of LTU in total CED collection has increased to 14% during CFY from 11% during PFY. Similarly, the collection during the first half of CFY has also increased by 27.4% over H1: FY 02-03. The important sources of revenue are cigarettes, soap & detergents, paint & varnishes, POL products, and beverages. The collection from cigarettes has increased by 7.7% during the first half of the year, paint & varnishes is 22.6% and beverages 7.4%. On the other hand, the collection from POL products and soaps and detergents has declined by 23.5% and 8.7%, respectively.

The overall revenue performance of LTU has been compared with the National data in Table 1. The data relating to first half of FY 02-03 and FY 03-04 confirms a favorable outcome for the model unit. While, LTU has recorded a remarkable growth of 30.5% in revenue collection, the growth at the national level is 14.4%. It is interesting to observe that the difference between these growth rates is even more startling for individual taxes.

Table 1: Half Yearly Comparison of Revenue Collection

(Revenue in Rs. Billion)

	LTU			National
Revenue Heads	H1: 02-03	H1: 03-04	Growth (%)	Growth (%)
Income Tax	6.3	12.0	89.8	13.4
Sales Tax	14.4	15.2	5.5	1.5
Central Excise	2.1	2.7	27.4	-1.8
Total	23.2	30.5	31.5	14.4

Reforms Related to Tax Administration

A number of steps have been undertaken to improve tax administration at LTU. A brief description of these measures is provided in the following.

Electronic Compliance Mechanism: In order to facilitate the taxpayers, by enabling them to prepare and furnish various statutory source documents, through electronic media, Large Taxpayers Unit, Karachi has developed soft wares for the taxpayers that would accomplish the electronic transfer of data.

As a first step towards Electronic Compliance Mechanism, filing of statements of withholding taxes has been routed through electronic media. Various types of statutory statements are furnished by the withholding agents to the department on quarterly, half yearly and annual basis. Owing to the bulk of data involved in these statements, this activity bears substantial compliance cost. The department has developed a software of Withholding Taxes Management, that will not only facilitate the taxpayers in easy preparation of such statements, but will also enable them to electronically transfer the data to the department. This has reduced the frequency of contact between the taxpayers and the tax officials. Furthermore, the department intends to effectively use the data for analysis of collection.

Human Resource Management: At present there are 84 officers and 52 staff working in the LTU. The general officer staff ratio in the tax organization is $1:10^{+}$. The number of technical persons has been enhanced and that of non-technical personnel drastically reduced. Computerization of duly empowered personal files of all LTU employees has been completed for future performance evaluation. CBR has developed 142 generic positions in job descriptions. LTU has prepared customized job description and the future performance evaluation will be made on specifically designed performance parameters.

Automation: The LTU has prepared taxpayers profiles for the last five years due to which issuance of exemption certificates, auditing of taxpayers, enforcement and collection of arrears and arrear management has become easier. The databank for all sales taxpayers and central excise collections has been completed. Linkages have also been developed with the Custom House database through radio connectivity. With the installation of necessary hardware, including 77 PCs, the data sharing across the taxes has commenced which will further strengthen the audit capacity of the unit.

Box-2: Visitors who were bowled over by LTU

Mr. Shaukat Aziz, Finance Minister
Ms. Mieko Nishimizu, Vice President, World Bank
Dr. Ishrat Hussain, Governor, State Bank of Pakistan
Justice Saleem Akhtar, Federal Tax Ombudsman
Mr. Henri Ghesquire, Sr. Resident Representative, IMF
IMF/ FAD Income Tax and Sales Tax Technical Mission
Internal Revenue Officers, Nepal

Taxpayers Facilitation: All applications of exemptions from various provisions of withholding taxes are now responded within 24-48 hours as against 72 hours prescribed and 7++ days national average. The response time of taxpayer queries has greatly improved due to posting of tax managers at taxpayer's assistance centers. Moreover, the officials of LTU are regularly attending the tribunal and the appellate hearings in almost all cases in order to expedite the dispute resolution process on urgent basis.

Medium Taxpayer Unit (MTU) at Lahore

The MTU is a big leap forward towards implementation of the reform program of CBR. The Unit became operational in October 2002 with initial taxpayers population of 12,000. This number increased to 110,000 in December 2003 and includes 45,000 commercial and 65,000 salary cases. Even though MTU has made significant progress in diverse areas, the most notable contribution is towards computerization of records, taxpayers' facilitation, and improvement in tax culture. Incidentally, tax collection has also enhanced as a by-product of the introduction of the modern system of tax administration. Currently, the MTU is testing a homegrown Tax Management System. The software of this reengineered system incorporates the future needs of the functional organization of income tax. The system has been designed and developed by a team of mid level tax and IT functionaries at CBR and has parameterized approach, standardized outputs, globally accepted layouts and friendly interface.

In MTU as against the present system of collection of income tax where all functions of collection, assessment, appeal, recovery are performed by the circle staff headed by Income Tax Officer, the re-engineered system based on functional organization has overcome the deficiencies of the existing system. The unit has helped to identify appropriate level of staffing, skills and training needs for future income tax organizational structure. It has also assisted in understanding of stakeholders' mindset in relation to new income tax system and its administration.

Revenue Performance

During the first half of CFY the gross income tax collection at MTU has been Rs. 1007.8 million compared to Rs. 985.4 million in H1: 02-03. Even though the growth in gross receipts is only 2.3%, the voluntary compliance has increased by 10.9% during this period. The share of voluntary payments in income tax has consequently increased from 15.6% to 16.9%. However, major contribution in revenue continues to come from withholding taxes whose share has stagnated around 82% even though a marginal increase 1.7% in WHT collection has been recorded. Finally, since refund payments have been prompt, the net collection has decreased by 0.7% during H1: 03-04 over H1: 02-03.

Recent Initiatives towards Automation

Current focus of MTU is on computerization of 45,000 commercial cases. The following discussion highlights the progress on this front.

- Arrangement and proper placement of records and ascertaining pendencies was a task demanding immense patience and continuous hard work. The record was handed over to MTU, in piecemeal and was in pathetic condition. Returns and *challans* for the last many assessment years were received in bundles and not in proper files. DCR numbers were noted on the returns but no Assessment Order or IT 30 or Demand Notice was available on files. Order sheet was a rare document to be seen on any file. Lists of pending assessments of different categories (set-aside, total audit, normal or self) were not provided. Thus, an extensive initial effort was directed towards proper record keeping. Every record was examined carefully and in certain cases information was solicited from taxpayers through informal letters. This task is likely to be completed in a period of twelve weeks;

- Identifying valid National Tax Numbers (NTNs) of the taxpayers from NTN Master Index and recording them on the files was a cumbersome job requiring a lot of time and effort. In majority of cases, NTNs written on the files were not correct. Moreover, valid NTNs were also not recorded on loose Returns. Placing loose returns on their respective files meant matching of each Return with the NTN Master Index. This meant feeding 225,000 entries in computer. Since around 12,000 cases could not be matched with the NTN Master Index, it required preparation of separate lists. This job related to 45,000 cases mentioned above has been completed;
- Updating and supplementing NTN Master Index with clean and correct data was the next extensive undertaking since the information available in NTN Master Index was not only insufficient but outdated as well. In an effort to update this information all the relevant particulars of taxpayers, such as name, business name, business nature, business/ residential addresses, business/ residential telephone contact, available in the assessment records of taxpayers having valid NTNs, were traced and entered in Tax Management System. This job has also been completed;

- Data entry of arrear demand was again a big challenge. This exercise, involving 96,000 entries from 80 registers, has been completed. The computerization of these records has yielded an amount of arrears of Rs. 2100 million, which is almost four times higher than Rs. 550 million reported by Zone B when the records were kept manually. This factor alone abundantly illustrates the extent of benefits of the adoption of the modern system over the unreliable and outdated system currently in place, and which is being transformed gradually;
- Cleaning the records on arrears was an even bigger challenge. The data on arrears required substantial revision in the light of appeal effects, rectifications and credit of payments already made and through write off etc. Once again improper record keeping made this job difficult. An extensive exercise is now underway in which each and every record is being examined and corrected with an active cooperation of taxpayers. This effort is likely to continue for quite sometime;
- MTU has also brought tremendous improvement in the manner in which the information relating to the cases under litigation is kept. All necessary information relating to subjudice cases is now available on line. The concerned officers can retrieve this information from this database as per requirement;
- MTU has been extremely successful is monitoring the progress of withholding taxes. Previously, this information was received in the form of hard copies resulting in heaps of papers. Launching of the Withholding Tax Management System has made it possible for the Withholding Agents to furnish this information in electronic form. More than 20 workshops have already been held where more than 400 withholding agents have been introduced to the software. These workshops are expected to continue throughout next year to cover all withholding agents at Lahore. The system, once fully implemented, is expected to revolutionize the monitoring of withholding taxes;

- Finally, MTU has been able to make a striking difference in the area of taxpayers' facilitation. The principles that the taxpayers not be made to wait unnecessarily and they are not required to visit tax offices repeatedly have taken the top priority at the MTU. Tax officers are now deputed exclusively for the purpose of taxpayer facilitation and education to ensure promptness in service delivery.

Concluding Observations

Based on the performance of model units it is evident that automation combined with functional specialization has resulted into significant efficiency gains. Quality work is being carried out with fewer people. Taxpayers' satisfaction has been ensured and the duplication of effort largely reduced. The future prospects are bright. It is anticipated that if these model units continue to operate at the present pace and the proposed units in major cities also replicate the performance and effort of their forerunners, there should be substantial increase in revenue, expansion of the tax base, and a further improvement in the level of satisfaction and trust of the stakeholders.

Our Vision	***Our Mission***
To be Modern, Progressive, Effective, Autonomous and Credible Organization for Optimizing Revenue by Providing Quality Service and Promoting Compliance with Tax and Related Laws.	*Enhance the Capacity 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.*

Our Values

- *Integrity*
- *Professionalism*
- *Teamwork*
- *Courtesy*
- *Fairness*
- *Transparency*
- *Responsiveness*

IV

Reform of Tax Administration and Restructuring of CBR: An Update[17]

Background

This article builds on an earlier update published in the Winter 2002 edition of the *CBR Quarterly Review* summarizing the various tax administration reforms measures initiated in CBR. The latest update is arranged as follows. Firstly, a general introduction of the need of and strategy adopted for continuing reforms in CBR is highlighted. Later on, a concise description of the various milestones achieved and those in an advanced stage is given. Lastly, a brief sketch of the outcomes of the tax administration reforms is summarized.

The Need for Continuity

Tax administration plays a vital role in the success or failure of any attempt to reform taxation. It plays a crucial role in determining the real (or effective) tax system, as opposed to the statutory tax system. Indeed, there is a growing conviction among tax policy specialists working with the developing economies that policy change without administrative change is not rewarding unless it is compatible with administrative capacity. It is therefore argued that tax administration is tax policy in developing countries.

There are many lessons that can be learnt from experiences from other countries where efforts have been made to improve tax administration. It has been observed that an essential pre-condition for the reform of the tax administration is the *simplification* of the tax system. It has to be ensured that the change could easily be applied effectively in low compliant milieu of developing countries. Second, there is a need for a *strategy* for the successful reforms of

[17] This update is prepared by Syed Hamid Ali, Secretary BPR-Customs under the supervision of Mr. M. S. Lal, Member (TP&R), CBR.

the tax administration. Strategy in this context simply means a comprehensive plan that assigns clear priorities to the tasks that must be performed, tailored to the available resources. The third ingredient for successful reform of tax administration is a strong *commitment* to reform at both policy-making and managerial levels, as well as a certain degree of technical competence. The best reform strategy applied to the most simplified system has a tendency to fail if there is a lack of political will to implement it. While some crucial initial technical support can sometimes be obtained from foreign experts, a critical core of local expertise is needed to take full advantage of such assistance. Even more important is the presence of a managerial team fully committed to taking the steps necessary to improve the quality of tax administration, with full political support of the highest authorities.

The goal of tax administration is to foster voluntary tax compliance. However, tax compliance increases only when there is an effective tax administration. Taxpayers will comply if they believe that failure to pay due taxes entails substantial risk of being penalized in a relatively severe fashion.

Fully cognizant of the fact that the success of tax reform would depend on the effectiveness/ efficiency of tax administration, the Government of Pakistan approved a medium-term program for reforming tax administration in November 2001. Since then, continuous effort has been going on to improve tax administration.

The initiatives

Some of the milestones already achieved or they are in an advanced stage of completion are summarized below:

(i) *Strengthening of CBR Headquarters on Functional Lines:* CBR Headquarters was performing in the past on cylindrical style where policy and operational functions were performed by the same member. It is now operating on functional lines. The HRM Wing under member (HRM) has been fully staffed at the Headquarters to cater to the various (HRM) issues like compensation, promotion policy, training, career planning and communication. The Wing now has sufficient support at the field level to establish linkages with the opinion makers in the field. The rest of the four new functional members from private sector i.e., member (IMS), member (TPE&F), member (FR&S), and member (Audit) have adequate staff to support them in their policy decisions and day to day working.

(ii) *Universal Self-Assessment System:* Universal Self-Assessment System (USAS) is the cornerstone of the reform strategy of CBR. While sales tax is already operating on self-assessment basis, income tax has also been brought under the USAS through the Income Tax Ordinance 2001. The government is currently examining the process to also bring customs collection under self-assessment. This will enable tax authorities to utilize the principles of risk assessment in undertaking audits of various classes of taxpayers.

(iii) *Customs Administration Reform (CARE):* The existing cumbersome manual system is highly personalized, involving 34 verifications and 62 steps. There is a face-to-face contact between taxpayer and tax collector and the taxpayer have to bear extra cost on account of inefficiency of the system. CBR has developed CARE and has decided to start a pilot project to test the new approach for imports and exports. The Karachi International Container Terminal (KICT), which clears 35% of imports through Karachi seaport, has been selected as the pilot site.

(iv) *Establishment of Large Taxpayer Unit (LTU) at Lahore:* The experience of the establishment of Large Taxpayer Unit (LTU) at Karachi, which encompasses all the three domestic taxes i.e., Sales Tax, Central Excise Duty and Income Tax has been a resounding success both in terms of revenue

collection parameters as well as individual and collective benchmarks. This impressive experience has encouraged the government to setup another LTU at Lahore by August 2004.

(v) *Establishment of 5 Medium Taxpayers Units (MTU):* The model Medium Taxpayers Units (MTU) at Lahore, which started functioning in October 2002 has successfully demonstrated the transformation of income tax from a circle-based system to a functionally organized setup. The benchmarks outlined for the unit have also been achieved. This has been a great morale booster for the tax reform team and has goaded the CBR to plan the establishment of further five MTU's at Karachi, Peshawar, Quetta, Faisalabad and Rawalpindi. These Units would start functioning from August 2004.

(vi) *Sales Tax Automated Refund Repository (STARR) Project:* The reengineering and automation of sales tax refund system has been identified as an essential component of the reform of sales tax. The software has been developed and central data base office has been established. The implementation of the first phase has been completed and the system is being evaluated and reviewed for the development and implementation of the second phase (STREAMS) of the project The second phase will be implemented by June, 2004 and on its completion the sales tax refund system will be transformed into a simpler, fully automated, risk based system, enabling quick refund and identifying high risk cases for scrutiny and audit.

(vii) *Taxpayers Facilitation Centers:* With a view to promote voluntary compliance in a self-assessment system of tax administration, taxpayer education and facilitation has been given top priority. All the laws, rules, circulars have been placed on website. Taxpayer facilitation centers are being established. By July 2004, seven new taxpayer facilitation centers (TFC) will be established at the various stations in the country.

(viii) *Income Tax Organization Structure:* The existing structure of income tax, which is circle based where all administrative, judicial, legal and enforcement powers are exercised by one person is being replaced by a functional system. A new income tax organizational structure containing functions of taxpayer service, information processing, audit, enforcement, collection, legal, information technology, HRM and internal control has been developed and is being presently tested at MTU in Lahore. A homegrown automated reengineered Tax Management System (TMS) has also been developed which will drastically reduce the locations as well the personnel in the income tax organization. The strategy revolves around information technology based processes. The implementation of IT software and hardware, and efficient use of technology is aimed at achieving the objective of minimum taxpayer interface and to allow the tax administration to be taxpayer friendly while reducing compliance costs. The reform of tax administration is not only focusing on a change in skills but major efforts are underway to transform the organizational culture. Significant improvements in human resource management function are in hand. These include (a) HR audit, (b) Implementing new and effective decision-making processes, (c) Competency / Skill enhancing training programs, (d) Improved compensation package, and (e) Redundancy planning and sequencing.

(ix) *Clearance of the Strategy Document:* A detailed document providing high level strategies for redesign of business processes, information technology architecture, human resource management, combating corruption and extensive infrastructure development was developed with the assistance of M/s. Maxwell Stamp, Plc., UK. The Strategy Document with timelines was presented before the government and the World Bank in March 2003. The Strategy Document has been approved by both these forums and now acts as the bible for the future tax reform program.

(x) To give practical shape to the various strategies outlines in the Strategy Document, a detailed project implementation plan (PIP) was prepared and submitted to the World Bank in August 2003. The (PIP) enshrines the different projects with cost and resource timelines which encompass the whole of reform program.

Cabinet Committee for Federal Revenues (CCFR)

The cabinet committee on federal revenues was conceived to institutionalize the reform program of CBR. The CCFR chaired by the Finance Minister acts as the apex monitoring body for CBR. Major decisions pertaining to reform program are approved by the Committee.

Concluding Remarks

The wide-ranging tax and tariff reforms as well as reform in tax administration have started paying dividends. The collection of CBR has picked up significantly. Additional revenue of Rs. 152 billion has been collected, showing an increase of 49.3%. On a broader front, the underlying structure of the tax system has improved vastly to place the public finances on a permanently sound basis. The continuous reduction in the relative share of international trade taxes and increase in the relative shares of taxes on income and consumption is one of the yardsticks of an improvement in the tax system. However, despite these achievements, consistent and tireless effort is continuing to develop the tax system that is taxpayer friendly and fully appreciated by all the stakeholders. The strategy document and the action plans have been developed to serve as forward vision to maintain the arduous yet fateful course of change and modernization.