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A Review of Resource Mobilization Efforts of Central Board of Revenue

Government of Pakistan

CENTRAL BOARD OF REVENUE

Constitution Avenue

Islamabad - Pakistan

Contact:
Dr. Ather Maqsood Ahmed
Member, Fiscal Research and Statistics
e-mail: memberfrs@cbr.gov.pk
Phone: (051)-920-4436
Fax: (051)-921-9211
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Foreword

The latest issue of the CBR Quarterly Review giving up to-date information on fiscal matters is being released. The analysis of the revenue data for the July-March 2004-05 provides in-depth analyses of federal taxes that rely on the performance of various segments of the economy, including industrial production, changing consumption habits, and commercial and trade activities. It also gives insight on the contribution of the corporate sector in revenue receipts.

The current issue also includes an article on the fertilizer industry in Pakistan. Even though the contribution of the industry in generating revenue is rather small, but it has a vital role in raising the agricultural productivity in the country. Similarly, there are concerns about soil fertility and environmental degradation that have been extensively addressed. This study underscores the need for adoption of a balanced approach to raise revenue from the agriculture sector that contributes nearly 25% of GDP and provides employment opportunities to nearly 60% of the population.

Two comprehensives articles on sales tax and income tax are also included in the Review. The study on GST draws readers' attention to implementation problems and future strategies. Similarly, the paper on Income Tax reviews the pre- and post-reform performance of the income tax structure. Finally, future reform strategy has been outlined in the paper entitled 'TARP: The Formal Launching of the Project'.

I appreciate the valuable effort put in by the Fiscal Research Wing of the CBR in bringing out the publication and hope that the contents of the Review will be useful for the readers. We look forward to receiving your valuable comments and suggestions for improving this research effort.

M. Abdullah Yusuf
Chairman, CBR

I

CBR Tax Collection: An Analysis of the 3rd Quarter Data of FY 04-05[1]

The Economy

Pakistan's economy is on the path of sustained growth. The revised assessment brightly indicates that the real GDP growth may exceed 7% mark during FY 04-05. A number of factors have contributed towards this robust escalation. The strong domestic demand has been generated by the buoyant industrial sector, unprecedented mercantile and business activities, and a long-awaited exceptional performance of the agriculture sector. Furthermore, there has been a sharp turn around in some of the leading services including the telecom and banking sectors. It is encouraging to observe that the manufacturing sector has registered a significant growth of 10.2% during the first three quarters of current fiscal year (CFY). More importantly, within the manufacturing sector, the large-scale manufacturing has recorded a substantial growth of 16.1%. Thanks to the kindness of the Mother Nature, the timely rains have not only contributed towards bumper cotton and wheat crops thereby raising the prosperity level of the agrarian population, but the shortage of water availability has also been reduced considerably.

Notwithstanding the 'shiny' side of the economy, there are few disturbing features also that must not be overlooked. One of the major concerns among policy planners has been the significant rise in prices over the last three quarters. After enjoying a rather low rate of inflation of less than 4% between FY 00-01 and FY 02-03, prices of essential food items, property rents, and transport and energy (oil) have begun to soar due to multiple factors including supply-side

[1] The analysis is carried out by the Research Team of the Fiscal Research Wing of CBR. Input from the staff of the Budget Wings of Direct & Indirect Taxes, Directorate of Research & Statistics, and Computer Wing of Sales Tax is gratefully acknowledged.

constraints and rising international fuel prices. The overall inflation rate has now reached a level that requires immediate correction.[2] Needless to say that inflation is one of the major macroeconomic instabilities, which if allowed to persist, certainly leads to further deterioration in key economic fundamentals.

Similarly, taking cue from the 'Development Economists', it is safe to argue that growth alone is only a *necessary* condition for transition from low-income to middle-income economy. The *sufficient* condition requires that the growth process be accompanied with equitable distribution of resources to avoid interpersonal and inter-regional disparities. It was pointed out in one of the earlier reviews of the economy that "to ensure equitable distribution ... it [*should*] not be left to the trickle down effect of the growth process. The problems of unemployment and poverty are far too serious to be left alone to the mercy of the market forces."[3] This assertion unfortunately remains valid even today.

CBR Revenue Position

CBR has exceeded the revenue target of first nine months of CFY by about Rs. 5 billion. A double-digit growth in *net* collection has been recorded in direct taxes (14.4%), CED (19.3%), customs duties (27.4%), and sales tax at import stage (16%). The collection of sales tax (domestic) has been adversely affected by a number of budgetary policy initiatives including the zero-rating of ginned cotton, and the introduction of uniformity in the sales tax rate by abolishing further tax @ 3% and high withholding sales tax on the selected items @ 20%. Whereas the *timing issue* in the case of ginned cotton has started to take positive effect as the processing of cotton is moving from ginning to spinning, weaving and higher stages, it is

[2] The recent reversal in trend is partly due to easing of supply constraint as the harvesting of new crop of wheat is near completion, and partly due to somewhat stability in the international price of oil. Thus, the correction through monetary policy is required only to the extent that inflation is a 'monetary phenomenon'.

[3] The *CBR Quarterly Review*, Vol. 3, No. 4, April-June 2004.

anticipated that the situation will improve in the remaining three months, as less and less refunds will be generated. A turn around in collection has already been recorded in March. Contrary to -7.7% growth during July-March period, the net domestic sales tax collection has been higher by 39.5% in March due to 15.4% less refunds than March 2004. With this pattern persisting in the 4th quarter of CFY, the chance of accomplishing the overall revenue target remains fair.

Overall Collection and Refunds

Using the stock market phrase, CBR has crossed the psychological barrier of Rs. 400 billion by collecting net revenue receipts of Rs. 401.3 billion at the close of the third quarter of the CFY. When compared with last year's collection of the corresponding period, this collection indicates a healthy growth of 13.5%. Whereas the (provisional) *gross* collection has increased by 14.9% -- raising the collection from Rs. 414.9 billion to Rs. 476.8 billion, an increase of Rs. 62 billion, the *net* collection has jumped from Rs. 353.4 billion to Rs. 401.3 billion indicating a difference of Rs. 47.9 billion. The overall refund/ rebate payments during first three quarters of CFY have been Rs. 75.6 billion, registering a growth of 23% (Table 1).

Taking note of various budgetary measures and freezing of oil prices during first half of CFY, the overall growth of federal taxes has been consistent with the performance of the economy, especially the growth of GDP, domestic industrial production and sales, and the level of total and dutiable imports. In fact, the growth in tax collection exceeds the nominal GDP growth if due adjustment is made for the changes just mentioned. Thus, the undue concern about falling tax/GDP ratio appears to be unwarranted. The entire resource mobilization effort needs to be carefully viewed within the broader framework of tax facilitation to promote investment by lowering rates of capital goods, reduction in cost of doing business, discouraging smuggling by reducing tax rates of smuggling-prone items, abolishing distortions in the sales tax regime, continuous reduction in corporate rates, and promoting hassle-free environment for the taxpayers. Furthermore, it is important to realize that tax collection cannot exceed the taxpaying capacity of the sectors that are liable to pay taxes under the existing legal framework. This is unfortunate that some of the majors sectors of the economy are outside the tax net for one reason or the other. Presently, the sectoral composition of taxes is *not* consistent with the sectoral composition of GDP. Given the present lop-sided structure of taxes whereby the manufacturing sector is over-burdened and the services sector that generates nearly 50% of GDP is lightly taxed besides agriculture sector being totally tax exempt; the requirement that tax/GDP ratio should also improve with growth in the economy, reduces to a theoretical discussion with no practical importance. A significant change in the tax/GDP ratio beyond the existing cosmetic improvement requires bold initiatives to be taken to bring all those sectors that are generating taxable income to the tax net.

Table 1: Federal Gross and Net Revenue Receipts: A Comparison

(Revenue Receipts in Rs. Billion)

	FY 03-04		FY 04-05		Growth (%)	
	Gross	Net	Gross	Net	Gross	Net
July	31.0	23.4	38.4	30.7	23.8	31.3
August	36.1	30.1	41.4	34.2	14.7	13.5
September	45.8	40.6	68.5	60.8	49.4	50.0
October	47.9	42.0	48.0	40.9	0.4	-2.5
November	39.8	33.8	46.4	38.5	16.8	14.0
December	66.9	60.6	66.5	57.4	-0.6	-5.4
January	52.0	43.7	50.4	41.3	-3.1	-5.7
February	46.7	39.3	45.5	37.2	-2.4	-5.1
March	48.7	40.0	71.6	60.3	47.1	50.9
July-March	414.9	353.4	476.8	401.3	14.9	13.5

Note: (1) Figures are rounded to one decimal place

Detailed Analysis of Direct Taxes

On the whole, the collection of direct taxes has been better than last year on cumulative basis. Even though the month-to-month comparison remains invalid due to change in the advance tax regime, the quarterly figures are reported in Table 2. It is evident that the gross collection has registered a robust growth of 20.1% -- an increase from Rs. 116 billion during first three quarters of PFY to Rs. 139.3 billion during the comparable period of CFY. However, due to higher refund payments by 71%, the growth in net collection has been 14.4%, i.e., rising from Rs. 104.4 billion to Rs. 119.5 billion during the period under review.

Table 2: Gross and Net Revenue Receipts of Direct Taxes: A Comparison

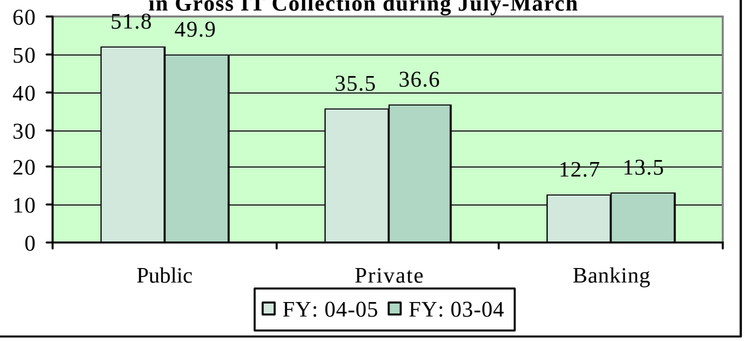
(Revenue Receipts in Rs. Billion)

	FY 03-04		FY 04-05		Growth (%)	
	Gross	Net	Gross	Net	Gross	Net
Quarter-I	27.4	25.6	45.0	41.7	64.4	63.2
Quarter-II	47.5	44.4	43.9	36.7	-7.7	-17.5
H1: 04-05	*74.9*	*70.0*	*88.9*	*78.4*	*18.6*	*12.0*
Quarter III	41.1	34.4	50.4	41.1	22.7	19.4
July-March	*116.0*	*104.4*	*139.3*	*119.5*	*20.1*	*14.4*

Note: (1) Figures are rounded

It is interesting to observe that nearly 66% of gross collection originates from the corporate sector. Of this, 41.3% is realized in the shape of advance taxes. Within the corporate sector, the share of public sector companies, as defined under the Income Tax Ordinance 2001, has been the highest (52%) followed by private and banking companies (Graph 1).

Graph 1: Share of Corporate Sector in Gross IT Collection during July-March



Detailed Analysis of the Components of Direct Taxes: Based on the currently available aggregated data for July-March 2004-05 and using the corresponding data of PFY, the following features of direct tax receipts have been observed.

Voluntary Payments (VP)

Voluntary compliance is one of the important components of direct taxes for two reasons. Firstly, it highlights taxpayers' confidence, and secondly, an increasing share of VP is vital for maintaining the overall equity in the taxation system. It is important to observe that both the components of VP, i.e., payments with returns and advance tax, have shown an extraordinary change during July-March period. The number of returns has increased from 1.03 million during the first three quarters of PFY to 1.17 million during the same period of CFY, indicating a growth of 13.6%. Similarly, the payments with returns have increased from Rs. 9.8 billion during PFY to Rs. 13.5 billion during CFY, yielding a healthy growth of 38.7%. Similarly, the collection of advanced taxes has also registered a strong growth of 27%. In fact, the three-quarter collection of CFY under advance tax has already exceeded the reported collection of Rs. 37 billion until May last year.

Collection on Demand (CoD)

Contrary to voluntary compliance, the collection on account of demand creation has declined during the first nine months by 8.2%. The decline has occurred due to the successful implementation of the USAS wherein the declared income in returns is treated as final liability. Of the two components of CoD, the collection under arrear demand has significantly increased by 19.4% over the PFY. This growth is mainly due to disposal of the 'Brought Forward' cases lying pending with the Regions. The second component may also receive a boost during the 4th quarter of the year when initial assessment of the returns will be completed and cases will be ripe for audit/ assessment through random selection criteria.[4]

[4] The task of computerization of the Returns submitted during CFY has already been completed.

Box 1: Change in the Advance Tax Regime

Advance tax is an important component of voluntary payments within income tax. Significant changes were introduced in the advance tax regime at the time of Federal Budget FY:04-05. The first change required advance tax to be calculated on the basis of estimated income rather than the tax/turnover ratio previously used. Secondly, the due dates were changed from 15th of the following month of quarter in PFY to 15th of the last month of the quarter. Thus, instead of receiving advance tax payments on 15th of October, January, April, and June, now they are due on 15th of September, October, March, and June. The month-to-month comparison, at least for the current fiscal year has become misleading unless due correction is made.

Notwithstanding the reporting problem during the preceding years, the advance tax received until March 2004 was Rs. 30.6 billion. Compared to this a sum of Rs. 38.9 billion have been received until March 2005. However, since Rs. 7.3 billion were reported as collection for April 2004, a meaningful comparison requires that the April figure is added to March 2004 figure. With this correction, a modest growth of 2.6% has been recorded in advance tax receipts.

Thus, at least to reach the year-end figure of Rs. 56.7 billion of last year, the final installment has to be around Rs. 17.8 billion, otherwise the loss due to change in regime (including the projected growth factor) will have to be recuperated from alternative sources of income tax.

Withholding Taxes (WHT)

WHT continues to remain the leading component of direct tax receipts in view of the large informal sector of the economy. The WHT collection during July-Mar 2004-05 has been Rs. 73.3 billion against Rs. 62.7 billion during PFY, yielding a healthy growth of 16.9%. The six major withholding taxes constituting 81.3% of total WHT collection are: contracts, imports, salary, exports, electricity, and line/ mobile phones. The share of contracts (27.7%) remains at the top, followed by imports (24.5%), salary (11.7%), exports (7.7%) electricity (4.7) and telephones (4.6%).

However, notwithstanding the share, the highest growth in WHT collection has been from telecom services (54.2%), followed by contracts (25.1%). This outcome reinforces the existing evidence of related economic indicators that the commercial activities are booming and higher government spending on infrastructure development programs is generating further growth. The exceptional international trade activities duly captured by international trade taxes have also been instrumental in raising the WHT receipts. The WHT deductions on exports and imports were higher by 17.6% and 6.6%, respectively during the first three quarters of CFY over PFY (Table 3).

Table 3: July-March Data on Leading WHT Heads:
A Comparison of FY 04-05 & FY 03-04 Collection

(Rs .Billion)

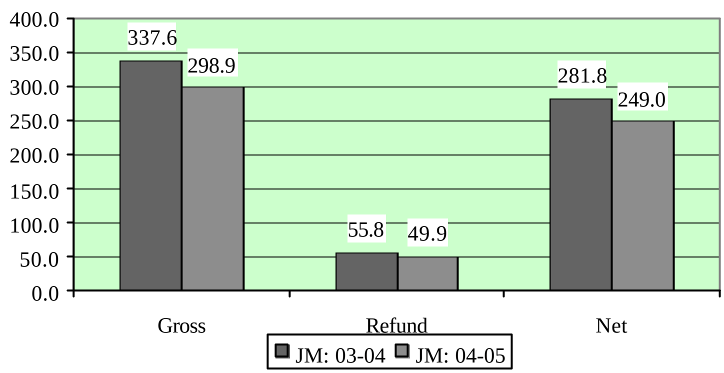
Collection Heads	FY: 04-05	FY: 03-04	Difference	
			Absolute	Percent
Contracts				
Q1	6.1	4.6	1.6	34.5
Q2	6.4	5.9	0.6	9.4
Q3	7.8	5.8	2.0	34.8
July-March	20.3	16.2	4.1	25.1
Imports				
Q1	6.3	5.8	0.5	8.4
Q2	6.0	6.0	0.0	0.1
Q3	5.8	5.2	0.6	12.3
July-March	18.2	17.0	1.1	6.6
Salary				
Q1	2.8	2.0	0.9	43.0
Q2	2.7	2.8	0.0	-1.7
Q3	3.0	2.9	0.1	3.0
July-March	8.6	7.7	0.9	11.4
Electricity				
Q1	1.0	1.0	0.1	8.8
Q2	1.2	1.2	0.0	2.2
Q3	0.9	0.9	0.0	0.0
July-March	3.1	3.1	0.1	0.0
Telephone				
Q1	1.0	0.6	0.4	61.5
Q2	1.1	0.8	0.3	33.6
Q3	1.4	0.8	0.6	68.8
July-March	3.5	2.3	1.2	54.2
Exports				
Q1	1.7	1.5	0.2	14.4
Q2	1.9	1.6	0.3	15.4
Q3	1.9	1.6	0.4	23.1
July-March	5.6	4.7	0.8	17.6
a. Sub-Total	59.3	51.0	8.3	16.2
Share (%) in Total WHT	81.0	81.5		
b. Other WHT	13.96	11.58	2.38	20.5
c. Total WHT	73.38	62.71	10.7	17.0
Share (%) in Gross I.Tax	51.4	51.1		

Apart from six major WHT contributors, the relatively minor components have recorded sizeable growth. For instance, WHT on non-residents grew by 42.2% during the first three quarters of CFY over the corresponding period of last year, dividends by 68.5% and commissions by 52.2%. On the other hand, the WHT collection from securities and bank interest has registered negative growth of 28.4% and 12.2% respectively due to declining bank rates that have started to rise recently but their impact is captured with lag.

Detailed Analysis of Indirect Taxes

The three components of indirect taxes are sales tax, central excise duties, and customs duties. The gross and net collection of indirect taxes has recorded a significant growth of 13% and 13.2%, respectively during the July-March period due to buoyancy in their respective tax bases. The gross receipts have increased from Rs. 298.9 billion during first three quarters of PFY to Rs. 337.6 billion during the comparable period of CFY. Similarly, the net collection has reached Rs. 281.8 billion during CFY from Rs. 249 billion during PFY. The difference between gross and net receipts reflects the higher amount of refund payments during the current year. The refund payments on account of indirect taxes have gone up by 11.8% during the period under consideration (Graph 2).

Graph 2: Performance of Indirect Taxes: July - March of CFY & PFY



Sales Tax*:* GST being one of the two major sources of federal tax receipts, has assumed great importance over the years. It has contributed 41.2% of the total net revenue collection during the July-March period of CFY. The gross and net sales tax collection has been Rs. 209.3 billion and Rs. 165.4 billion, respectively showing growth of 7.3% and 6.2% over the corresponding period of PFY. The refund payments have increased by 11.4% during this period, which have been paid out almost completely from domestic ST receipts. Of these two components of sales tax, the domestic sales tax collection decreased by 0.3% and 7.7% in gross and net terms respectively mainly due to zero-rating of ginned cotton and other budgetary measures. On the other hand, the growth in gross and net ST collection from imports has been around 16%, which is consistent with the growth in imports during CFY.

Box 2: Zero-rating of Ginned Cotton

The Textile Sector has been one of the leading sectors of the economy. Since around 80% of its produce is exported, it was one of the major claimants of refunds and rebates because of the zero-rating of exports. In fact, Rs 37 billion out of Rs 52 billion (71%) sales tax refund payments during FY 03-04 were made to the Textile Sector. In the face of such a colossal amount of refunds, the ginned cotton was made zero-rated in the Budget FY:04-05. Besides claims for other inputs, the sales tax on ginned cotton amounting Rs. 14.4 billion was put forward for refund claims for its use at subsequent stages of production by the Textile Sector. The objective of this policy initiative was two fold: to reduce the amount of refund claims – thereby eliminate one of the major irritants, and secondly, to improve the cash flow situation of the producers who initially had to pay and then reclaim the amount with a lag of four to six months. Not only the economic activity was slowed down in this process, the payments to ginners and growers were also delayed by the later-stage producers.

With the zero-rating of ginned cotton, a paltry sum of Rs. 642 million has been received as sales tax during the first 9 months of CFY, against Rs.12.6 billion during the corresponding period last year. Thus, the total loss in gross collection has been around Rs.12 billion. So far a saving of Rs.2.8 billion has been accrued in the shape of 'less' refund payments, and an amount of Rs 4 billion has been generated as additional gross collection from cotton yarn. The sales tax collection thus shows a loss of around Rs.5 billion, ignoring the growth factor. It is anticipated that further gains in the shape of less refunds will accrue in the 4th quarter and the policy of zero-rating of ginned cotton will be revenue neutral, as envisaged at the time of budget.

Domestic Sales Tax Collection and Major Revenue Spinners: The detailed analysis of domestic sales tax collection on the basis of data for July-March 2005 indicates that around 70% of gross collection (Rs. 73 billion out of Rs. 103.3 billion) has been generated by ten major revenue spinners that include: Services (essentially Telephone and Tele fax), POL Products, Electrical Energy, Natural Gas, Sugar, Cotton yarn, Cigarettes, Cement, Fertilizer, and Iron & Steel Products. However, with the exception of few of these commodities/ utilities, the rest of the major revenue spinners have recorded fairly low growth. Among the low-growth commodities are cigarettes and sugar and among those where the growth has been negative are cement, fertilizer, iron and steel products. The possible rationales for this apparently dismal performance has been as follows. The low collection from cigarettes has been due to the withdrawal of further tax that has provided a bonanza for the cigarette Distributors. The reduction in collection from cement despite a resounding growth in production and clearance has been due to various murky reasons. While some of the cement manufacturers have claimed huge input adjustment for import of coal, the others have sought adjustment for import of plants and machinery for enhancing their productive capacity in view of the increasing domestic demand and export potential. The paradoxical element in the whole scenario is that while their taxable sales have risen and also the retail price of cement has seen an upward trend, the tax receipts surprisingly have shrunken. A similar situation prevails for the sugar industry. Despite the availability of huge stocks, the retail price of sugar has also recorded an upward trend due to artificial supply constraints and the national exchequer is also not gaining anything out of this change. It appears that the cement and sugar cartels are getting stronger day by day! Finally, the reduction in sales tax collection from fertilizer has been due to the introduction of ‘deemed price.’

On the brighter side, the highest positive growth of over 200 % has been recorded for Cotton Yarn mainly due to zero-rating of ginned cotton and higher prices of cotton during the harvest season. Similarly, nearly 55% increase in ST (D) collection from services confirms the significant improvement in economic activity and the widespread usage of mobile and telecom facilities (Table 4).

Table 4: Sales Tax Collection from Ten Major Revenue Spinners (Domestic) for during FY 04-05 and FY 03-04

(Rs. In Million)

S. No.	Commodity	Collection Up to March 2004	Collection Up to March 2005	Growth (%)
1	Services (Including Telephone/Fax etc)	10636.4	16470.7	54.9
2	POL Products (Including Petroleum, Lubricating Oils)	15188.1	16267.2	7.1
3	Electrical Energy	9429.6	10038.1	6.5
4	Natural Gas	7155.8	7888.7	10.2
5	Sugar (Including Baggase and Molasses)	6009.1	6079.8	1.2
6	Cotton Yarn	1852.0	5813.3	213.9
7	Cigarettes	3646.0	3727.4	2.2
8	Cement	3096.7	2494.2	-19.5
9	Fertilizers/Urea	2855.7	2411.1	-15.6
10	Iron & steel Products	2088.5	1822.1	-12.8
	Sub Total	61957.9	73012.6	16.5
	Others	41691.1	30281.4	-27.4
	G. Total	103649.0	103294.0	-0.3
	Refunds	39343.0	43908.0	11.6
	Net GST Collection	64306.0	59386.0	-7.7

Sales Tax at Import Stage:

In terms of gross collection of sales tax, the contribution of Sales Imports [ST (M)] has been around 51% during the July-March of CFY. However, since all refund claims are entertained from the domestic collection of sales tax, the contribution of ST (M) in net sales tax collection has been 64%. Interestingly, the ST (M) is levied on import value inclusive of customs duties for commodities that are subjected to customs duties and on actual import value if they are duty free. Accordingly, slight variations in the effective rate of sales tax on imports vis-à-vis the standard rate are observed.

Of all the commodity groups subjected to sales tax, the major five that have registered double-digit growth are: Iron & Steel, Vehicles, POL Products, Paper & Paper Board, and Rubber Products. The respective growth in these cases has been 66.5%, 51.8%, 39.7%, 23.8% and 23.1%. It is interesting to observe that the zero-rating of specific machinery belonging to Chapters 84 & 85 has boosted the overall imports of electrical and mechanical machinery tremendously. The collection of electrical machinery has grown by 9.8%, which reflects that substantial improvement in volume has taken place that has more than compensated the adverse impact of zero-rating. The policy change of reducing the up-front cost of plant, machinery, and equipment and thereby providing a competitive environment for investment has paid of. Similarly, the reduction of duty on smuggling-prone items, especially tea, has encouraged importers and as a consequence, the sales tax receipts have also increased. On the whole, the recent boost in imports has improved the sales tax collection at import stage by 16% (Table 5).

Table 5: Major Revenue Spinners of Sales Tax at Import Stage

(Growth and Effective Rates in percent)

PCT Chapter	Tariff Description	Growth in Imports (%)	ST (M) Collection [Rs. Billion]		
			JM: 04-05	JM: 03-04	Growth (%)
27	POL Products	41.6	10.3	7.4	39.7
87	Vehicles	65.0	8.7	5.7	51.8
29	Organic Chemicals	28.2	7.3	6.9	5.4
72	Iron and Steel	113.6	7.1	4.3	66.5
39	Plastic Resins, etc.	47.6	5.6	5.2	7.2
85	Electrical Machinery	104.8	4.8	4.4	9.8
84	Mechanical Machinery	74.6	4.4	4.6	-5.2
38	Misc. Chemical Prod.	37.8	2.3	1.9	19.8
40	Rubber Products	39.0	1.8	1.5	23.1
48	Paper and Paperboard	27.2	1.8	1.4	23.8
9	Coffee and Tea etc.	19.2	1.8	1.7	6.0
32	Dyes, Paints etc.	22.4	1.4	1.5	-8.8
54	Man-made Filaments	16.7	1.1	1.2	-4.6
73	Articles of Iron & Steel	31.8	0.9	0.6	37.3
15	Edible oil and Waxes	7.6	0.6	7.5	-91.7
Sub-total		*54.6*	*60.0*	*56.0*	7.2
Others		38.4	46.0	35.5	29.6
Grand Total		**47.8**	**106.0**	**91.5**	15.9

Customs Duties: The gross and net collection from customs duties has exhibited remarkable growth during July-March 2004-05, by collecting Rs. 91.9 billion gross and Rs. 80.1 billion net collection, showing a sizeable growth of 25.5% and 27.4%, respectively over the comparable period of PFY. At the same time, Rs. 11.8 billion have been paid back as refunds/ rebates during the CFY that are 13.5% higher as compared to the same period of PFY. The extraordinary growth in collection is attributable to a number of factors including the record level of international trade transactions, incentives to investors and traders, and the continuous improvement in customs business processes and efficiency gains.

The information presented below indicates the performance of major revenue contributors of customs duties. The highest growth of 72% in customs duty has been recorded by vehicles listed in Chapter 87 of Pakistan Tariff, followed by 61% growth in electrical machinery (Chapter 85), machinery 55.5% (Chapter 84), and iron and steel with growth of 41.5% (Chapter 72). The growth of 15 major commodities reported in Table 6, has been 32% and the overall growth of all commodities is around 25%.

With extensive revision in the duty structure within the existing slabs whereby duty has been reduced for capital goods and smuggling-prone items, the effective rate on dutiable imports for 15 major commodity groups has declined from 16.7% to 14.2% during July-March 2004-05 over the corresponding period of PFY. Similarly, the effective rate for all commodity groups has also declined from 17.5% to 15.1%. This reduction has been due to the changing composition of dutiable imports. Finally, it is also relevant to mention that the effective rate remains higher than the maximum statutory rate for only two commodities implying that the tariff structure is well within the specified limit. Thus, the tariff peaks have been reduced greatly. The exceptions for two commodity groups within the 15 major revenue spinners are for commodities listed in Chapter 87 (essentially Vehicles) and Chapter 15 (essentially edible oils).

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

(Growth and Effective Rates in percent)

PCT Chapter	Tariff Description	July-March Growth			Effective Rates on Dutiable Imports	
		Import Value	Dutiable Imports	Customs Duties	Up to March 04	Up to March 05
87	Vehicles	65.0	64.1	72.1	35.6	37.3
15	Edible oil and Waxes	7.6	9.7	6.5	31.7	30.7
84	Machinery	74.6	86.3	55.5	9.9	8.3
85	Electrical Machinery	104.8	118.4	61.1	13.7	10.1
27	POL Products	41.4	36.3	34.5	10.2	10.1
72	Iron and Steel	113.6	121.5	41.5	15.5	9.9
39	Plastic Resins, etc.	47.6	51.9	0.6	18.5	12.2
29	Chemicals	28.2	15.7	7.0	9.8	9.1
48	Paper and Paperboard	27.2	26.7	24.2	19.2	18.8
38	Misc. Chemical Prod.	37.8	44.6	24.4	12.3	10.6
9	Coffee and Tea etc.	19.2	21.8	-30.9	19.0	10.8
40	Rubber Products	39.0	30.5	9.0	13.9	11.6
54	Man-made Filaments	16.7	12.6	31.8	16.2	18.9
32	Dyes, Paints etc.	22.4	21.5	-5.3	18.0	14.1
73	Iron & Steel Articles	31.8	80.7	42.6	18.5	14.6
	Sub-total	*54.6*	*55.2*	*32.0*	*16.7*	*14.2*
	Others	38.4	17.4	7.8	19.9	18.2
	Grand Total	**47.8**	**45.4**	**24.9**	**17.6**	**15.1**

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

Central Excise: Unlike past many years when CED collection was constantly declining mainly due to continuous withdrawal of additional commodities from CED net and gradual shifting them to the GST net. The gross and net collection during CFY has been extraordinary. The net collection of CED during July-March 2005 has been Rs. 36.3 billion against Rs. 30.4 billion during the corresponding period of PFY, depicting a double-digit growth of 19.3 %. The vibrant performance of CED is mainly due to the healthy growth in the CED-base, particularly the exceptional growth of 16.1% in the large-scale manufacturing sector.

The five major revenue spinners of CED have contributed 86.7% in total gross collection during the period under review. The highest growth of 21% has been registered in cigarettes mainly due to upward revision of CED duty and prices after the budget 2004-05.

Incidentally, the production of cigarettes has also gone up by 10.5% during the first three quarters of CFY that has also been a contributing factor. Similarly, CED from cement has increased by 17.4% and this improvement is attributable to 15.3% growth in cement production in response to the booming construction activity in the country and export potential. The higher demand of cement has been accomplished partly by expansion in productive capacity and partly by improved capacity utilization of the existing units. Finally, the 12.2% growth in CED from Natural Gas, 11.2% from POL Products, and a nominal growth of 4.3% in beverages have all contributed towards overall CED growth (Table 7).

Table 7: A Comparative Analysis of CED Collection

(Rs. Million)

Five Major Revenue Spinners	FY:03-04	FY:04-05	Difference	
	July-March		Absolute	Percent
Cigarettes	12129.7	14674.5	2544.8	21.0
Cement	6735.8	7906.2	1170.4	17.4
Natural Gas	3639.0	4081.6	442.6	12.2
POL Products	2823.1	3138.7	315.6	11.2
Beverages	1644.5	1714.8	70.3	4.3
Sub Total	26972.1	31515.8	4543.7	16.8
All Commodities	30512.0	36371.0	5859.0	19.2
% Share in Gross	88.4	86.7		

Concluding Observations

The CBR is well on its way to accomplishing the assigned target of collection for FY 04-05. It is heartening that all the four federal taxes are faring well. Various tax policy and administrative interventions are proving successful as far as revenue collection is concerned. The reduction of tariff and tax rates has provided the much-needed impetus to growth by reducing the cost of doing business. The zero-rating of ginned cotton has eased-up the liquidity situation, that in turn has been instrumental in boosting economic activity in the country. It is anticipated that with further improvement in taxpaying capacity of the taxpayers, the tax revenue will also increase with the passage of time.

II
Industry Profile:
Fertilizer Industry in Pakistan[5]

Introduction

Fertilizer is an important component of agriculture activity. Fertilizer compliments the deficiency of nutrients required for the growth and maturity of plant that is translated into development of agriculture. Sixteen essential elements are required for proper plant growth. The air and water provide Carbon, Hydrogen and Oxygen whereas the remaining 13 elements are supplied by soil. These are usually grouped into three classes namely: Primary or Major Nutrients that include [Nitrogen (N), Phosphorus (P) and Potassium (K)]; Secondary Elements (Calcium (Ca), Magnesium (Mg) and Sulphur (S)]; and Micro-Nutrients [Boron (B), Manganese (Mn), Copper (Cu), Zinc (Zn), Iron (Fe), Molybdenum (Mo) and Chlorine (CI)]. The requirement of these elements varies from crop to crop.

Since the soil takes time to replenish these nutrients, appropriate gaps or alternative crop combination is necessary to makeup for the deficiency of these elements. Simultaneously, essential nutrients are provided to the land in the form of fertilizer. Thus the use of fertilizer with proper constituents and adequate quantity leads to improvement in soil fertility and as a result the average per hectare crop production increases by 30% to 70%. Additionally, the balanced and efficient use of fertilizer also improves the quality of crops in the form of high nutrient value and increases plant resistance to diseases and climatic conditions.

This article is aimed at focusing the key input of agriculture i.e., fertilizer, its role in improving the soil's fertility to increase the agricultural production, and thus establishing the food security of

[5] Authors: Dr. Ather Maqsood Ahmed, Member (Fiscal Research & Statistics), and Mr. Sharfuddin Pirzada Secretary (FR&S) CBR.

the nation. Additionally, the contribution of fertilizer industry has been analyzed within the broader industrial set-up to understand its contribution to the economy.

Historical Background

The atmospheric nitrogen available to the tune of 89,000 tons over every hectare of the earth's surface remained untapped until 1905 when its conversion was achieved by Birkeland and Eyde of Norway and the first synthetic nitrogen fertilizer 'Calcium Nitrate' was produced in 1907. This achievement opened the gate of prosperity to the farmers in the form of increased yield. The gradual development of different fertilizer products reduced its cost significantly and the use of fertilizer became popular and the crop yield increased. In 1930, the use of nitrogen fertilizer, super phosphate and potassium fertilizers was widespread in Europe. The continued research in the sector resulted in outstanding development of granulation of fertilizer, introduction of compound fertilizer and slow-release fertilizer. The high-producing stable agricultural system by means of fertilizer has been developed in many parts of the world and paved the way for other developing nations to increase their production accordingly.

Fertilizer is generally categorized into following groups each having specific utility that cannot be substituted for other.

i) Nitrogen 46% (Urea)
ii) Calcium Ammonium Nitrate (26% Nitrogen) (CAN)
ii) Nitrophas (23% Nitrogen and 23% Phosphorus) (NP)
iii) Single Super Phosphate, (18% Phosphorus) (SSP)
iv) Di-Ammonium Phosphate (18% Nitrogen and 46% Phosphorus) (DAP)
v) Sulphate of Potash (SOP) - (Potash fertilizer)
vi) NPK in different ratios - (Mixed fertilizer)

Introduction of Fertilizer in Pakistan

Fertilizer was introduced in Pakistan in early 1950s. With the introduction of High Yielding Varieties (HYVs) of wheat, rice and maize in 1960s, there was increasing need of fertilizer, and therefore its use increased manifold. In particular, the consumption of fertilizer grew by 22% to 27% during 1970s. The ever-increasing demand for fertilizer has attracted huge investment and the fertilizer industry is now established in the country after the installation of its first unit in 1958. It is evident from Table 1 that major investment in fertilizer sector was made during nineties when seven plants were installed with a total capacity of 5266 thousand tons. Presently, there are ten manufacturing units in Pakistan. Out of these, four units are located in the public sector and six are operating in the private sector. The province-wise distribution of units confirms that 5 units are located in Punjab, 3 in Sindh and 2 in the NWFP.

Table 1: Existing Fertilizer Manufacturing Units with Capacity and Year of Installation

Manufacturer		Product	Year Installed	Capacity ('000' MT)
Dawood Hercules Chemicals Ltd		Urea	1990	445
Engro Chemical Pakistan Ltd.	Plant-1	Urea	1998	850
	Plant-2	N:P:K	2002	100
Pak Arab Fertilizers Ltd.(NFC)	Plant-1	Urea	1986	92
	Plant-2	CAN	1978	450
	Plant-3	NP	1979	305
Pak American Fertilizer Ltd.(NFC)		Urea	1998	346
Fauji Fertilizer Company Ltd.-II (GM)		Urea	1992	695
Fauji Fertilizer Company Ltd.-II (GM)		Urea	1993	635
Pak Saudi Fertilizer Ltd.		Urea	1980	557
Fauji Fertilizer Company Ltd.-BQ	Plant-1	Urea	1998	550
	Plant-2	DAP	1998	450
Lyallpur Chemicals & Fertilizers Ltd.		SSP	1958	72
Hazara Phosphate Fertilizers Ltd.		SSP	1989	90
Pak China Fertilizer Ltd. (SCHON) **		Urea	1982	102
GRAND TOTAL (OOO MT)				5739

Source: Fertilizer Sector Profile (2002), Experts Advisory Cell, Islamabad.
** Now closed

Supply and Demand of Fertilizer

Notwithstanding the steady increase in installed capacity and production, the demand for fertilizer has often exceeded its supply from domestic sources. Consequently, the gap between local production and requirement of fertilizer has been met through imports (Table 2). It is evident that despite nearly doubling of domestic production between 1989 and 1999, the import requirement also increased by an average annual rate of 1.1%. Since then the growth in import has decelerated on annualize basis. Within various categories of fertilizer, the import demand for Phosphate has continued its upward trend since 1989-90, while the same for Nitrogen and Potash has been declining continuously.

Table 2: Local Production and Import of Fertilizer (Major Nutrients) in Selected Years

('000' tons)

	Domestic Production				Imports of Fertilizer			
	Nitrogen	Phosphate	Potash	Total	Nitrogen	Phosphate	Potash	Total
1952-53	0.0	0.0	0.0	0.0	2.1	0.0	0.0	2.1
1959-60	8.9	0.2	0.0	9.1	10.8	0.2	75.0	86.0
1969-70	129.3	4.2	0.0	133.5	292.2	11.5	0.0	303.7
1979-80	388.9	49.8	0.0	438.7	440.8	142.4	13.8	597.0
1989-90	1156.4	105.1	0.0	1261.5	285.5	262.9	41.5	589.9
1999-00	2039.6	223.5	0.0	2263.1	233.0	416.0	13.8	662.8
2003-04	2273.0	254.0	13.0	2540.0	204.0	553.0	6.0	763.0

Source: *Fertilizer Review*, Various Issues, National Fertilizer Development Center (NFDC), Islamabad.

The fertilizer's off-take is generally taken as proxy for consumption of fertilizer. As anticipated, the off-take of fertilizer grew at a faster pace during the decades of 1960s and 1970s response to the cultivation of HYVs. Nonetheless, despite continuous increase in total quantum of use of fertilizer, the tempo of growth has slowed down gradually, in the more recent years. The total off-take during FY 03-04 was 3222 thousand tons compared to 2833 thousand tons in FY 99-00.

Prices of Fertilizer

The following Table 3 shows the prices of different varieties of fertilizer over an extensive period of past thirty years. The time series data indicates that price variability at the retail stage has been one of the important sources of fluctuations in fertilizer demand in Pakistan. Even though every variety of fertilizer has experienced a rising trend since 1975, but the rate of increase has been faster in recent years as compared to the decade of 1980s. For instance, the retail prices of Urea and DAP, on average, have increased by 6.7% and 9.6%, respectively between 1999 and 2004 as compared to 3.7% and 7.2% respectively between 1983 and 1990.

Table 3: Time Series Data on Retail Sale Prices of Fertilizer Products in Pakistan

(Rs. per bag of 50kg)

Effective Date	Urea	CAN	AS	NP 23:23	DAP 18:46	SSP (Gran)	SSP Powder
09/05/1975	75	43	34	55	75	22	-
25/02/1980	93	50	42	78	100	25	-
08/12/1983	128	60	59	110	133	40	-
12/02/1990	165	90	85	150	217	68	63
1994-95	253	177	176	279	439	157	134
1999-00	324	228	288	466	632	287	243
2003-04	420	298	373	622	913	329	268

Source: *Fertilizer Review*, Various Issues, NFDC, Islamabad.

One of the serious repercussions of sharp changes in prices of certain categories versus others is that it has led to ‘switching’ by the farmers between varieties. For instance, the big jump in the prices of phosphate fertilizer has induced the farmer to use nitrogen as the sole source of fertilizing the land. The second complication of buying expensive fertilizer is that farmers are now using less than the required quantity of fertilizer, thereby reducing the yield of the cultivated crops. According to the agronomics soil test surveys conducted in the recent past, the fertilizer requirement of soil in Pakistan is 270 kg per hectare whereas the actual current use is 147 kg/hectare. Even though the rate of per hectare use of fertilizer during past years has improved slightly nonetheless, there is still a wide gap in actual and desired application level of fertilizer.

The third adverse implication of sudden price changes is the failure of the farmers to maintain the desired NPK ratio. The average recommended ratio for Pakistan soil is approximately 2:1 (N:P) whereas the prevailing ratio is 3.75:1 (N:P). This shows that the current practice of fertilizer application is highly skewed in favor of nitrogen. It is argued that the higher price of phosphate fertilizers is one of the reasons that force the farmers towards excessive use of nitrogen fertilizer. Thus, there is no wonder why the productivity is so low in Pakistan.

To prove the point further, the information provided in Table 4 presents the agro-economic analysis of impact of fertilizer on wheat yield in irrigated area of Punjab during 1996-2000.[6]

Table 4: Impact of Fertilizer Application on Wheat Yield

Treatments (NPK)	Yield Kg/ha	Incr. In Yield	Fertilizer Cost Rs/ha	Gross Return Rs./ha	Net Return Rs/ha	Grain Nutrient Ratio
0-0-0	1529	-	-	-	-	-
120-0-0	2748	1219	1800	7311	5511	10
120-90-0	3943	2414	3870	14479	10609	11
120-90-60	4199	2670	5190	16015	10825	9

N @ Rs.15, P @ Rs.23 and K @ Rs.22/kg and wheat Rs.6/kg
Source: *Balanced Fertilization Through Phosphate Promotion* (2001), Islamabad: NFDC.

The first row shows the average production of wheat was 1529 kg/ha when no fertilizer was used. The production increased by 1219 kg/ ha with an application of 120 kg of Nitrogen fertilizer. The

[6] This study was conducted by the Rapid Soil Fertility Survey and Soil Testing Institute, Lahore and it relied on 93 trials/experiments. See *Balanced Fertilization Through Phosphate Promotion* (2001), Islamabad: NFDC.

application of 120 kg/ha of Nitrogen and 90 kg/ha of Phosphate has resulted an increase of 2414 kg/ha in wheat production. Finally, a combination of 120 kg/ha of Nitrogen, 90 kg/ha of Phosphate and 60 kg/ha of Potash application resulted in increase of 2670 kg of wheat/ ha. It was found that the best value cost ratio was possible by applying 120 kg nitrogen/ha, nonetheless, the grain nutrient ratio was highest when a ratio of 120:90:0 (NPK) per hectare was adopted.

Taxation Structure and Revenue

Keeping in view the importance of the agriculture for sustenance of the economy, the taxation on agriculture sector has always been negligible. This is the reason that the share of federal tax collection from agriculture sector has been only 0.12% of GDP in FY 03-04. This low share indicates that effectively the entire value-added chain in the agriculture sector is nearly tax-exempt.

Specifically stating, fertilizer has remained exempt from taxation until 2001. However, with a view to broaden tax base and improve its coverage, sales tax was levied on urea at the rate of 15%. But in an effort to minimize the incidence of taxation on the prices of urea (which was mainly a domestic product), the base price for assessing the sales tax liability called deemed price was fixed with effect from April 2001.[7] Customs duty was also imposed @5% on fertilizer in FY 01-02. Sales tax was extended to other varieties of fertilizer other than urea in September 2001 and the concept of deemed price fixation was extended to varieties other than urea in November 2003. The details of deemed prices fixed for important fertilizers are given in the following Table 5.

[7] The concept of deemed price: In November 2003, price of DAP increased rapidly. In order to keep the local price of DAP at manageable level for the farmers, it was fixed at $ 160 (or Rs. 9,280) per metric ton (PMT) for levy of sales tax as against actual international price of $ 210 PMT. Presently, the international price is $ 273 PMT but the sales tax is being charges on a fixed (deemed) price of $ 160 PMT at import and local supply.

Table 5: Deemed Prices Fixed for Fertilizer

Effective Date	Deemed Price (Rs. per M/T)
Urea	
02-04-2001	4000
01-02-2002	6660
30-06-2004	7900
13-07-2004	6660
Di-Ammonium Phosphate (DAP)	
25-11-2003	4610
Potash Fertilizer	
03-02-2005	4610

Source: Sales tax Wing, CBR, Islamabad

Notwithstanding the imposition of sales tax and customs duty on fertilizer, the revenue contribution from this source has been fairly nominal. Since FY 01-02 onwards, the contribution of fertilizer in total indirect tax collection has been between 0.51% and 0.91%, which is quite insignificant (Table 6).

Table 6: Contribution of Fertilizer in Tax Receipts

(Rs. in Million)

	Customs Duty	ST at Imports	Sales Tax Domestic	Indirect Taxes from Fertilizer	Share of Revenue from Fertilizer in Total Indirect Tax Receipts (%)
2001-02	3.0	12.5	1309.8	1325.3	0.51
2002-03	5.1	15.8	2791.4	2812.3	0.91
2003-04	5.9	17.7	2994.0	3017.6	0.85

Source: PRAL & ST Computer Wing, CBR , Islamabad

Issues and Concern

In view of the growing population, food security has assumed great importance. While for an agrarian economy like Pakistan food security should not be a difficult proposition if food self-sufficiency is ensured. However, one of the major difficulties in gaining self-sufficiency in food has been the low productivity of important food crops.[8] As indicated, low and imbalanced use of fertilizer is one of the leading factors for this outcome. Besides price variability, there

[8] Even though Pakistan became self-sufficient in food grain production, but this advantage was lost due to multiple factors.

are host of other factors including lack of interest and coordination among various departments for this failure. The soil testing facility, which provides information and education to the farmers is far below the required need; Irrigation and extension services and other infrastructure needs are sub-optimal; the supply of necessary inputs is erratic and often sub-standard; and finally lack of storage facilities has adverse implications as far as prosperity of the farmers is concerned. There is no doubt that all these factors require immediate and continuous attention, but the focus of present study has been restricted to fertilizer only.

In one of the studies it has been confirmed that farmers use higher fertilizer input when credit facility is available to them.[9] According to the latest information, the disbursement of credit increased by 12.4% between FY 01-02 and FY 02-03. One of the major changes in credit disbursement has been the increasing contribution of commercial banks. Their disbursement increased by around 30% between FY 01-02 and FY 02-03. Similarly, the share of commercial banks in total disbursement has also increased from 33% in FY 01-02 to 38.5% in FY 02-03.[10] While this has been a welcome development in view of the low interest rate structure prevalent during the period under consideration, what will be impact on farmers' indebtedness when the rates will start rising should be a concern, as the period of low interest rates has already been surpassed? Secondly, strict measures are also required to ensure availability of credit facility to the deserving farmers, as there are significant loopholes in the existing system that have prompted misuse of the facility.

That the use of fertilizer and availability of water are positively related is now a well-established fact. The higher cost of electricity

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[9] *Fertilizer Use at Farm Level in Pakistan* March 2000, Islamabad: NFDC.

[10] Pakistan Economic Survey: 2003-04.

and diesel to pump the under-surface-land water has emerged as a serious concern, especially when there is water scarcity. The indirect way of creating enabling environment for the farmers is to reduce the financial pressure on them by providing subsidized inputs for tube wells, as has been the case in the neighboring countries. The problem is relatively more acute for the tail-end farmers. Providing crop specific subsidy is another way to facilitate the poor-sourced farmer as for example, the sugarcane farmer of European Union avail subsidy of Euro 471 per ton, Australia A$ 182 per ton, and India US$ 25 per ton (WWF – Pakistan Sustainable Sugar Initiative, 2004). However, any decision with regard to provision of subsidies has to be carefully evaluated in the changing global environment after WTO.

Similarly, as indicated earlier, higher prices of phosphate fertilizer and lack of knowledge about the importance of different fertilizer-use has induced farmer towards less costly nitrogenous fertilizer. However, this action has further deteriorated the 'Nitrogen Phosphate use ratio.' In fact, the ratio has gone up from 3.61:1 in FY 02-03 to 3.75:1 in FY 03-04 whereas agronomics recommendation is close to 2:1.[11] It needs to be mentioned that the imbalances in fertilizer-use has also increased the cost of production besides affecting the soil fertility.

Now portraying the gloomy side of the picture, i.e., the disadvantages of using excessive amount of fertilizer. The higher doses of nitrogenous fertilizer often leads to nitrate leaching which pollutes the drinking underground water. The abuse of nitrogen, phosphorus and potassium fertilizers affects soil, water, flora and fauna. On-farm impacts of fertilizer application include raising the pH of the soil, which can cause soil alkalinity and decrease the uptake of the micronutrient in the soil. This can also affect the

[11] See *Fertilizer Review* 2003-04, Islamabad: NDFC.

internal constituents of the produce causing various additional problems. Soil alkalinity combined with depletion of soil organic matter reduces the nutrient holding capacity of the soil. This can result in reduction of soil productivity thus requiring a higher level of fertilizer application, which, in turn, can increase the likelihood of nutrients being leached from the soil profile. The continuous application of nitrogenous fertilizer may cause soil acidity. (WWF – Pakistan Sustainable Sugar Initiative, 2004) In addition, rain and floodwater wash away the fertilizer constituents from one part of the land to the other, thus damaging the fertility and nutrition level of the soil in the downstream areas. Thus, there are gains as well as damages of fertilizer use, especially in areas where flood irrigation is a norm.

Concluding Remarks

Creating congenial atmosphere for the farmers to realize full potential of the land is essential to acquire self-sufficiency in food grains. It has been established that low productivity of food crops is partly due to the improper use of fertilizer and other bottlenecks. The tax revenue from fertilizer sales has been nominal in relation to total tax collection in a given year. Thus, it is valid to inquire how far taxation of agriculture inputs, including fertilizer, is justified. Even though this concern is highly debatable if not controversial, but it is also true that various incentives given in the past in the shape of reduction in tax rates or complete abolition of taxes were not fruitful, as the gains were not reaped by the final consumers (the farmers in the present case), rather the rent-seekers were the main beneficiaries. To avoid similar outcome, there is a need for a well thought out policy so that the benefits actually accrued by the farmers. At the same time it is also desirable that the agriculture sector pays its due share of taxes for the provision of infrastructure and similar facilities. After all, nearly one quarter of the national income is generated by this sector alone and nearly 60% of the population is engaged in agriculture and agro-based activities.

III

Implementation of VAT: Pakistan's Experience[12]

Introduction

The emergence of the consumption based Value-Added Tax (VAT) and its unprecedented success in the developed world, motivated largely by its greater efficiency and buoyancy, encouraged the developing countries to adopt VAT during the decades of the eighties and nineties. However, with the exception of a few, many countries faced multiple difficulties in the adoption and implementation of VAT. Pakistan, undeterred by the concern generally expressed in the developing countries, decided to take the bold initiative and move forward with the introduction of VAT in the country, the goal being to develop it into a major national tax. The move launched more than a decade ago was initially confronted with resistance from some of the stakeholders but owing to the efforts on public awareness about the progressive and futuristic dimensions of the tax and political recognition of its significance, the desired support eventually came in. The confidence-building measures introduced over the period helped to further improve the operational environment with the result that VAT is now an accepted part of the country's fiscal landscape. The efforts to address the issues spurred by its introduction, whether concerning the legislative side or the operational element, remain a part of the continuous reform process.

This paper will briefly trace the development of VAT in Pakistan and provide an exposition on its introduction as well as implementation. Starting from its historical context, the paper will

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[12] Author: Shahid Ahmad, Member (Sales Tax and Central Excise), CBR Islamabad.

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briefly dilate upon the issues of taxpayers' registration, adoption of basic threshold, structure of tax rate, audit, and refund payments etc. It will also encompass the contentious areas where the tax administration and the taxpayers are trying to develop uniform solutions consistent with the overall philosophy of VAT. These areas include selection of audit including investigative audit and improvement in tax compliance.

Historical Context

In 1947, when Pakistan attained independence, the sales tax was a provincial levy covering a limited area of commercial activity. With its conversion to a federal tax in 1951, its scope was extended to imports and domestic sale of goods by manufacturers and licensed wholesalers.[13] The enactment of the Sales Tax Act, 1990 introduced its value added version renamed as General Sales Tax (GST).[14] This was levied on goods only (with many exemptions) and that too at the manufacturing and import stages. A major leap forward was taken in 1995-96 when GST was converted into a full-fledged VAT mode tax with all its basic features; self-assessment, functional distribution, input tax credit facility and audit based procedures. To further increase its base, its coverage was extended to importers in 1997 and to wholesalers and retailers in 1998. Following the trend observed in many less developed economies where documentation was limited, Pakistan also embarked on the levy of GST on goods rather than services. With the expansion of service sector in 1990s, the anomaly that goods are being taxed but not the services was removed and the scope of GST was extended in 2000.

The effort mounted by tax administration in Pakistan during the last fifteen years supported by the extension of tax base to wholesalers

[13] The debut collection of in FY 50-51 was Rs. 116.1 million or 12.2% of total Federal tax receipts [CBR Year Book 1988/89 – 1990/91].

[14] The terms VAT, GST or Sales Tax have been used interchangeably in this paper implying same meaning.

and retailers and utilities has led to a significant improvement in the VAT collection in the country. VAT revenues, both at domestic and import stage, have increased sharply from Rs. 17.01 billion in FY 90-90 to Rs. 219.05 billion in FY 03-04. The remarkable performance of VAT can be judged from the growth in revenue during the last fourteen years presented in Table 1.

Table 1: Collection and Growth of VAT: 1990/91 – 2003-/4

	Annual Collection[1]	Annual Growth[2]
1990-91	17008	
1991-92	20799	22.29
1992-93	23521	13.09
1993-94	30379	29.16
1994-95	43574	43.43
1995-96	49841	14.38
1996-97	55668	11.69
1997-98	53942	-3.1
1998-99	72105	33.67
1999-00	116711	61.87
2000-01	153565	31.58
2001-02	166561	8.46
2002-03	195139	17.16
2003-04	219059	12.26

[1] *Collection in millions rupees;*
[2] *Growth in percent*

It is interesting to observe that the significant of GST in overall resource mobilization effort has increased stridently over time. The share of VAT in the Federal Tax receipts has grown from about 15% in 1990-91 to over 40% in FY 03-04 (Table 2). Within the indirect structure, the GST share has increased by over 40 percentage points between FY 90-91 and FY 03-04. Similarly, the VAT to GDP ratio has also risen from 1.7% to 4.2% during the same period. It is, therefore, heartening to observe that among the developing countries of Asia, Pacific and South America that have adopted VAT, Pakistan’s performance has been among the better performers.

Table 2: Contribution of VAT in Pakistan

	Share of Sales Tax in		
	Indirect Taxes	Federal Taxes	GDP (MP)
1990-91	18.8	15.4	1.7
1991-92	18.8	14.9	1.7
1992-93	20.2	15.3	1.8
1993-94	23.5	17.6	1.9
1994-95	26.4	19.2	2.3
1995-96	26.2	18.6	2.3
1996-97	28.3	19.7	2.3
1997-98	28.3	18.4	2.0
1998-99	36.4	23.4	2.5
1999-00	49.8	33.6	3.1
2000-01	57.4	39.1	3.7
2001-02	63.7	41.2	3.8
2002-03	63.2	42.4	4.0
2003-04	62.0	42.2	4.0

Note: (1) Share in percent.

Implementation: Handling the Issues

Pakistan has reached a stage where VAT has developed into a major national tax and been accepted by taxpayers. The journey up to this has not been very easy. Thanks to the gradual introduction of various measures and reengineering of the business processes, the implementation of VAT has been possible in its present manner. Some of the issues and the way they were dealt with would be discussed below.

Threshold

At the outset, a system of multiple thresholds was designed to cater to the needs of all categories and levels of taxpayers. In this system, four different kinds of threshold levels for manufacturers and retailers were offered. A lower threshold level of Rs. 0.5 million (US$ 8 thousand) was fixed for manufacturers and Rs.1 million (US$ 16 thousand) for retailers. The enrolled persons under this category were required to pay turnover tax at the rate of 2 % of their annual turnover. Similarly, higher threshold levels of Rs. 2.5 million

(US$ 40 thousand) and Rs. 5 million (US$ 80 thousand) were fixed for manufacturers and retailers, respectively, making it mandatory for them to pay sales tax at the rate of 15% of their total turnover.

This layered system brought into focus difficulties of various dimensions. On the one hand, it prompted taxpayers to register under the wrong category to avoid tax payment at the standard rate of 15% and on the other hand it encouraged ‘short-life’ taxpayers given the restriction of sales tax registration for suppliers to the government departments. In this case, suppliers would register with the tax department when they were required to show sales tax registration number only to disappear soon, thereby increasing the infractuous tax base. To overcome this problem, the government has recently done away with the system of multiple thresholds and instead set a single threshold for manufacturers and retailers at Rs. 5 million (US$ 8000). Although this move alone has shrunk the VAT base by about 26%, the revenue sacrifice implicit by this action has been nominal as the contribution of the ‘de-listed’ taxpayers was already fairly insignificant. There has been, nonetheless, a substantial gain in terms of reduced cost of tax administration, as the department has to deal with a smaller yet more compliant tax base. It is further hoped that this provision would serve as a reasonable safeguard against taxation of small businesses.

Registration

Since its inception, registration for VAT was done by the local sales tax offices after a thorough investigation. The intending tax registrant was required to submit a large number of documents such as national tax number, income tax returns for the last two years, rent or ownership details of the business premises and utility bills pertaining to the business premises. Physical verification of the business premises and manufacturing machinery was then necessary for VAT Registration. There were repeated complaints from taxpayers of unnecessary delays and harassment by the staff of the

VAT department deputed for physical verification. In July 2004, a new system of Centralized Registration was put in place at the Central Board of Revenue, Islamabad, using automated Risk Based Registration Module to overcome the registration problems and broaden the much required tax base. The registration form has also been simplified and requirement of documentation has been minimized. Most of the necessary verifications are done through data from other sources. Thus, registration that used to take more than a month is now completed in three to four days and registration certificate is delivered directly to the taxpayer. The new mechanism has also significantly improved the maintenance of comprehensive database of all the VAT registered persons. It is anticipated that the redesigned system will minimize contact between the tax department and the prospective registrants, helping to reduce the complaints emanating from the interaction between the two.

Multiple Tax Rates

VAT in its present form was introduced in Pakistan at the standard rate of 12.5 % in 1992. With an ever increasing need for additional revenue to reduce budget deficit (one of the conditionalties of the Structural Adjustment Program of the IMF), the VAT rate was raised to 18 % in 1995 with a reduced rate of 2 % introduced to bring the small businessmen into the tax net. In response to the taxpayers' pressure, the rate was cut to 15 % in 1998, though a higher rate of 20 % was introduced on a range of industrial raw materials. Further, a penalty system was introduced in 1999 whereby an additional tax at the rate of 3 % was levied on the supplies made by the registered persons to the unregistered persons. Introduced with a noble intention of encouraging documentation in the economy, the move nonetheless complicated the situation by introducing a system of multiple tax rates. Thus, by 2004 VAT was administrated at five different rates i.e., 2%, 15%, 18%, 20% and 23%. Besides creating administrative difficulties, it also increased the cost of compliance for the registered persons. The complications triggered by the multiplicity of these inconsistent measures finally led to the levy of VAT at the uniform rate of 15% introduced from July 2004.

Refund Payments

Another problematic area in the implementation of VAT has been refund payments. Since VAT is primarily a tax based on value addition at source and exports are zero-rated on the principle of destination, there is an in-built need for the documentation of transactions involved in the entire supply chain in the export business. However, the system is marred by the element of fake invoices creating difficulties for its smooth functioning. While textiles cater for the major exportable commodities of Pakistan, various intermediary manufacturing and processing activities are largely carried out in the unorganized and undocumented sector. This gap is filled by invoicing malpractices to inflate refund and suppress local supplies. Thus the refund issue in the textile sector has assumed staggering dimensions posing serious challenges for the VAT administration in Pakistan.

However, with greater automation of the VAT department through be-spoke software, the problem of refund is being dealt with in a systematic manner. On the basis of data covering supplies and purchases (including imports) of the exporters, all the refund claims are scrutinized centrally by verifying the acquisitions of input including imports and exports. The results of such verifications are transmitted to the local sales tax offices for finalization of refund claims. Through automated verification of refund claims, a number of fraudulent claims have been detected during the last few years. As a result, VAT refund bill of the government has curtailed. In the meantime, payments of the genuine refunds have been accelerated (from 45 days to 10 days).

To further improve the VAT refund system, introduction of a mechanism for "cross matching" of every input tax invoice used in refund claims, on the model in place in Korea, is already underway. Hopefully from July 2005 onwards, every registered person shall be required to give an aggregate summary of invoices along with the monthly VAT return and this information shall be used to verify the accuracy of assessments and genuineness of the refund claims across the board. The verification process will undergo a prioritized set of risks identified on the basis of information pooled from diversified sources.

The government earlier introduced the scheme of Duty & Tax Remission on Export, whereby a taxpayer is entitled to VAT free purchases of export-inputs from the local market or abroad. Adopted from Korean VAT model but configured to accommodate the local business practices, another comprehensive scheme for duty free delivery of input goods and service for the production of exportable goods has recently been designed. Initially, this scheme will apply to the large-size industrial exporters of textile sector who are exporting at least 50% of their production, meanwhile covering the vending industry and second stage suppliers from registered sectors. The scheme will be stretched to other export sectors in the near future besides other segments of textile sector. The scheme will be monitored through a tailor- made IT-based infrastructure.

Adjudication

With the introduction of many appellate fora such as the Collector Appeals, Appellate Tribunal and Federal Tax Ombudsman, the number of appeals has increased considerably in the last couple of years. The time involved in settlement of cases before these institutions not only blocks government revenue, but also increases the cost of doing business for the taxpayers, especially the small businesses. In an effort to address this exploding problem, the tax administration has come up with an innovated idea of adopting an

Alternate Dispute Resolution (*ADR*) mechanism. An independent judicial committee is constructed comprising members from private sector and tax department that deals with cases of disagreement on the outcome of audit or assessment.

Difficulties due to VAT Design

Pakistan has a peculiar background of VAT implementation. New sales tax legislation was introduced in the year 1990 without any major structural shift in previous legal framework. Till 1996 sales tax was administered through physical controls and documentation partially analogous to excise. Liberal exemptions were available and regulated out of statutory precincts. However, in the budget 1996-67, sales tax legislation was drastically altered by incorporating the heterogeneous exemption regimes within the statutory framework. This allowed automatic adjustment of invoice-based credit replacing traditional sales tax rebate regime with zero rating system and managing absolute exemptions through the concept of deemed exports. Besides, small size enterprises were accommodated by separately fixing lower level thresholds for manufacturing and retail sectors. Commercial importers and wholesaler were subjected to compulsory registration. Concessions on capital goods were bound with such procedural compliance in order to encourage voluntary adherence to VAT laws.

Though hitherto several improvements have been made in the VAT design as adopted by Pakistan, there are some problems which need to be addressed in future to make the applied design closer to the one ideally desired. Service sector as such is still out of VAT coverage. However, given the constitutional constraints, several services have been brought under VAT net through provincial and central excise legislations. Meanwhile, attempts have been made and are still being made to minimize VAT exemptions and broaden the tax base by curtailing breaks in VAT application on different stages of the supply chain. Fixation of lower threshold has always remained a problem in Pakistan's model. It is believed that VAT design problems of Pakistan will be resolved by sharing experience of VAT implementation in other countries.

The government earlier introduced the scheme of Duty and Tax Remission of Exports, whereby a taxpayer is entitled to VAT free purchases of input goods from the local market or abroad for export utilization. Adopted form Korean VAT model but configured to accommodate the local business practices, another comprehensive scheme for duty free delivery of input goods and services for the production of exportable commodities has recently been designed. Initially, this scheme will apply to the large size industrial exporters of textile sector who are exporting at least 50% of their production, meanwhile covering the vending industry and second stage suppliers from registered sectors. The scheme will be stretched to other export sectors in near future besides other segments of textile sector. The scheme will be monitored through a tailor-made IT based infrastructure.

Lingering Concerns

However, despite this improvement in implementing VAT, there are various aspects of policy and administration where more effort is required. Some of these areas are discussed as follows:

Audit and Penalties

For VAT to be successful, high and fair probability of detection (audit) and strict application of penalties is important. In Pakistan we are actively engaged to base audit on the principle of risk management and selection of criterion on input/output analysis. It is likely to take more time before it is effectively put into place. Currently, our audit programs have lower yield. In the OECD countries average audit yield is 2.23 % to 5.04 %, in Pakistan it is less than 1 %. Similarly, the strict application of penalties is not forthcoming. A legal system that allowed long delays in the application of penalties tends to contribute toward the blockage of government revenues besides creating a wide gap between the statuary and effective penalties giving thereby a signal to the taxpayer to evade taxes.

Efforts are being made to have cost effective audit by relying more on desk audit and conducting investigative audit wherever necessary. The audit strategy would ensure equality of treatment for all taxpayers regardless of their size, activity or location. It would also develop and enforce sectoral approach in audit and introduce computer auditing.

Tax Compliance

Another area of greater concern to the VAT administration is tax compliance. Tax compliance is fairly low in Pakistan. Only 50 % of the registered persons and businesses file monthly tax returns. Realizing that adversarial relationship between taxpayer and tax administration is the major cause of this low compliance, a new taxpayer education and facilitation strategy is designed. Many initiatives have been introduced to make the system more fair and easy. For example voluntary disclosure (before commencing of audit) does not attract penalties. To facilitate taxpayers, separate returns for different taxpayers have been designed. It is also being considered to introduce electronic filing of return.

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

Future Directions

VAT in Pakistan is a recent phenomenon. Nonetheless, its growth has been faster than that of the any other tax, which reflects its buoyancy. In order to tap the potential that it holds for the future financial landscape of the country, it is important that the systems are developed in a manner, which responds to the future needs and assures easily workable methodologies, while embodying appropriate safeguards. Integration and automation will replace the present footloose and, in certain areas, segmented approach. That being the goal, Pakistan will soon invites expression of interest from the international firms on Supply, Customization and Implementation of Off-the-Shelf (COTS) Sales Tax Application Software Solution. The project seeks the designing, development and implementation of an end-to-end web-based sales tax system with simplified procedures aimed at providing speedy and reliable services to the taxpayers while minimizing their contacts with the tax officials. The new system will be based on functional and technical requirements and will also involve the training of the selected end users. In less than two years, Pakistan expects to have in place a fully modernized and automated VAT system that will be geared towards the future needs.

Conclusion

The implementation of VAT in Pakistan in terms of tax collection and basic principles has been encouraging. While adverse elements in its introduction have been effectively dealt with, some concerns do remain. Issues of compliance, effective audit and strict application of penalties are being studied to further strengthen the system and root out areas of concern. While effective solutions to such problems will form part of the upcoming reforms project, interim measures are underway to address them in ways that are taxpayer friendly and in line with the overall VAT scheme. In this constant pursuit of seeking improvement, Pakistan has learnt from the trail of developments and the elements of progression experienced by some of the countries that have achieved phenomenal success in terms of the growth of VAT. The UK and Korean models contain components concerning the key areas of VAT activity that are akin to our requirements and operational environment. Their further relevance to the indigenous environment will be studied and it is likely that they will be adopted in the upcoming reforms. It will only be fair if the cooperation of these countries in sharing their experiences with us is acknowledged. The support extended by the World Bank and other international institutions has also been highly instrumental in the progress that Pakistan has made in adopting VAT so far and in undertaking its further reformation.

Given the present pace of progress, two years hence, Pakistan will become the first major country in South Asia having implemented VAT in its true sense and modern form. The magnitude of VAT's impact on the national economic life and its acceptance by all and sundry, evolved over the years, will come to represent a major paradigm-shift in the mindset of the people.

IV

Structure of Direct Taxes in Pakistan: A Preliminary Assessment[15]

Introduction

In an effort to promote tax compliance, CBR has embarked upon a liberal income tax regime based on the concept of universal self-assessment. The new regime has been designed to promote investment, encourage foreign direct investment and exports. The rationale behind the new approach is that expansion of economic activity is prerequisite to higher tax collection.

The purpose of this article is to evaluate the performance of the income and corporate tax structure in a broader framework. The analysis focuses on recently introduced reform measures that promise to remove the distortions in the existing system. In particular, it is essential to know how far the voluntary compliance has improved and what are the additional sources of strength. We start with a brief review of the income tax system in Pakistan.

Direct Taxes: Historical Background

The income tax was imposed for the first time on agriculture in the Indian sub-continent in 1860. The original Income Tax Act was amended in 1866 that continued until 1922 when a progressive income tax scale was introduced. Pakistan on its creation adopted the Income Tax Act of 1922 and continued with it until the promulgation of Income Tax Ordinance, 1979. Currently the Income Tax Ordinance, 2001 is in vogue.

The important components of direct taxes are: income and corporate taxes, capital value tax, workers' welfare fund and the wealth tax.

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[15] *Authors*: Dr. Ather Maqsood Ahmed, Member and Mr. Umar Wahid, Secretary, Fiscal Research and Statistics, CBR

The wealth tax is currently held in abeyance but the revenue is still trickling in, albeit insignificantly. Since the share of income and corporate taxes is around 96% in direct tax receipts, the present study concentrates on its components and base.

Definitionally, the Income Tax is levied on income-tax-chargeable incomes of individuals, association of persons, registered firms, and corporate entities. The three main components of income tax are voluntary payments (VP), collection of demand (CoD), and withholding taxes (WHT). The collection is dominated by WHT with 55% share in direct taxes. The collection is made through the withholding agents who are responsible for deducting the due amount of tax out of such disbursements that are taxable receipts in the hands of recipients of those disbursements. WHT as a mechanism of tax collection was first introduced in the late 1960s but later on its scope was enhanced to a number of additional activities. Presently, there are 19 activities subjected to WHT.[16]

The second largest component of income tax is VP, which consists of payment with returns and advance tax. The taxpayers are required by law to submit annual returns to the income tax department as per time schedule fixed by the CBR. Similarly, the advance tax is also mandatory by law and it has to be deposited in four installments according to the timeframe prescribed by the CBR.

The third component of the income tax is collection on demand (CoD). This component has assumed critical importance in an era of universal self-assessment (USAS). It allows the authorities to investigate the level of under or misreporting by the taxpayers. Under the USAS only a small percentage of returns are randomly selected on the basis of the pre-announced criteria. Recently, the primary objective of this component has been reduced to act as

[16] However, of these nineteen heads the contribution of six is around 80%.

deterrent against possible tax evasion rather than a source of revenue receipts. Thus, the tax collection notified as CoD includes the amount detected through audit, penalties imposed for failing to comply with the provisions of tax laws, and taxes recovered for failure to deposit tax within the prescribed limit of time.

The direct taxation system, prima facie, continues to have a narrow base with 2.21 million taxpayers including around 0.6 million infructuous cases. The share of taxpayers to total population is 1.5%, which compares with 2.2% in India, 13.6% in Argentina, 53% in France and 82.5% in Canada.[17] Often it is argued that on the basis of alternative estimates the income taxable population filing annual returns should range between 25 to 30 million. However, due care is required while interpreting the number of the existing base, as there is ample confusion between taxpayers filing returns and statements. The problem is compounded when one statement does not exactly match with one taxpayer.

The Revenue Performance

The overall performance of direct taxes has been inconsistent when viewed in a historical perspective. A review of collection during past five years indicates that there has been significant variability in growth of tax receipts. This inconsistency not only makes mockery of tax effort, it also creates difficulties for management of the economy, as shortfall in revenue collection directly disturbs the execution of the national budget allocations. The excessive fluctuations in growth can be confirmed from the fact the net collection grew by 10.3% during FY 00-01, increased to 14.4% in the next year, but scaled down to only 6.6% in FY 02-03. A slight improvement has been seen in FY 03-04 when the growth was 8.8% (Table 1). Given this situation, it is relevant to know factors that cause these disturbances.

[17] See Report of the Task Force on Reform of Tax Administration by Syed Shahid Hussain (2001) 'Reforms of Tax Administration in Pakistan' Islamabad.

Notwithstanding, these rather wild fluctuations in growth, the average share of direct taxes in the total collection has remained stagnant around 32 % during the last five years. Similarly, it is also disquieting that direct taxation in Pakistan accounts for only 3% of GDP whereas in other competing developing countries this ratio is as high as up to 7%.[18]

Table 1: Direct Taxes Collection and Share

(Rs. in billion)

Years	Net Collection	Increase (%)	Share in Total Federal Taxes (%)	Tax/GDP Ratio (%)
1999-00	113.0	-	32.6	3.0
2000-01	124.6	10.3	31.8	3.0
2001-02	142.5	14.4	35.3	3.2
2002-03	151.9	6.6	33.0	3.2
2003-04	165.1	8.7	31.7	3.0

To gain further insight, the analysis of income tax by components during FY 99-00 and FY 00-01 is presented in Table 2. We treat this to be the ‘pre-reform’ era, i.e., when the system was operating under the 1979 Act and the Universal Self-assessment Scheme (USAS) was also not offered. The historical data confirms that due to heavy reliance on WHT, having a significant proportion of presumptive taxes, the progressivity of the income tax structure to neutralize regressivity of indirect taxes has been compromised. The 27% share of voluntary compliance in FY 00-01 was low given the level of economic activity and the corporate structure in the country. At the same time, within VP, even though the share of advance taxes has increased overtime, but it was not a source of comfort, as it led to higher refund requirements in the future. Finally, despite the prevalent system of complete assessment of returns causing serious difficulties for the taxpayers, the resources generated through CoD were rather meager.

[18] For instance, the income and corporate tax to GDP ratio in Indonesia is 6.8%, Philippines 5.7%, Malaysia 7%, Thailand 6.3%, and India 3.7%. In the case of Bangladesh it is only 1.7% [Source: Information down loaded from Official Websites of respective countries].

Table 2: Performance of the Income Tax by Components

(Rs. in million)

Revenue Heads	Revenue Collection		Growth (%)	Share in Collection (%)	
	1999-2000	2000-01		1999-2000	2000-01
Voluntary Payment	34,878	34,993	0.3	28.0	26.8
With Returns	*13,267*	*11,758*	*-11.4*	*38.0*	*33.6*
Advance Tax	*21,611*	*23,235*	*7.5*	*62.0*	*66.4*
Collection on Demand	14,507	16,486	13.6	11.6	12.6
Arrear Demand	*4,875*	*4,153*	*-14.8*	*33.6*	*25.2*
Current Demand	*9,632*	*12,333*	*28*	*66.4*	*74.8*
Withholding Tax	75,189	79,155	5.3	60.4	60.6
Gross Income Tax	**124,574**	**130,634**	**4.9**	**100.0**	**100.0**

Reforms in the Income Tax Structure

The reform process in the income tax system was started with the promulgation of Income Tax Ordinance, 2001 effective from 13th September 2001. The objective was to simplify the language of the Ordinance by removing ambiguities for ensuring uniformity in treatment for various categories of taxpayers, reduce dependence on withholding taxes, and encourage voluntary compliance backed by strong audit and minimum tax exemption.

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

Similarly, model large and medium taxpayers units, i.e., the LTUs and the MTUs have been established in major cities of the country with the objective to facilitate taxpayers. It has been observed such endeavors in other countries had been a success for the simple reason that only a limited fraction of taxpayers contribute a major chunk of revenues. Pakistan is not an exception to this rule. The second objective of these model units has been to reduce compliance cost for the taxpayers through integration of work processes, improvement in audit capacity and monitoring of arrears. Further gains are also envisioned through co-location of all domestic taxes, i.e., the direct taxes, sales tax, and central excise.

There are signs that these changes have started to contribute positively. The voluntary compliance has improved significantly. From a negligible growth of 0.3% in FY 00-01, it has shoot up to 21% in FY 02-03. It increased further by 12.7% in FY 03-04. More importantly, the share of VP has jumped to 37.3% in FY 03-04. Similarly, another important development in the post-reform era has been the gradual reduction in dependence on the WHT. The share of WHT in the total income tax collection has declined from 61% to 54% during the CFY (Table 3).

Table 3: Post- Reforms Performance of the Income Tax

(Rs. in million)

Revenue Heads	01-02	02-03	Growth (%)	03-04	Growth (%)	%Age Share	
						02-03	03-04
Voluntary Payment (a+b)	48,896	59,070	20.8	66,544	12.7	34.8	37.3
a) With returns	13,267	11,758	-11.4	9,854	-16.2	27.1	19.9
b) Advance tax	35,629	47,312	32.8	56,690	19.8	72.9	80.1
Collection on Demand (c+d)	23,247	25,539	9.9	19,884	-22.1	15.1	11.1
c) Arrear Demand	4,355	4,530	4.0	4,130	-8.8	18.7	17.7
d) Current Demand	18,892	21,009	11.2	15,754	-25.0	81.3	82.3
Withholding Tax.	78,884	84,973	7.7	92,018	8.3	50.1	51.6
Total Gross Income Tax	**151,027**	**169,582**	**12.3**	**178,446**	**5.2**	**100.0**	**100.0**

The Significance of the Corporate Sector

The corporate sector is the backbone of the economy. It is the largest contributor of direct tax receipts in the developed world. In an effort to understand its contribution in Pakistan, the income tax structure has been further evaluated separately for the corporate and non-corporate sectors. To refresh us the corporate sector consists of listed public and private companies, including banking companies. Currently 21,008 companies are registered with the tax department against over 40 thousands listed with the SECP. Even more unfortunate fact is that only 11,526 companies have filed corporate returns during FY 04-05. Of which 468 are public companies, only seven are registered as foreign companies and the remaining 11,051 belong to the private sector.

The tax profile of the sector reveals that gross collection of Rs. 92.2 billion has been generated by the corporate sector. Its share in the total income tax gross collection has gone up to 66.2% during current fiscal year from 63.9 % during last year (Table 4). Probably, the differential in the corporate tax rate structure, i.e., 35% for the public limited companies and 39% for the private limited companies on the one hand and comparatively higher overall corporate rate on the other are the apparent reasons for low level of corporatization in the country. It may be added that the Income Tax Ordinance, 2001 provides for progressive reduction in these tax rates by 2% for the privately incorporated companies per annum for the next 5 years and 3% for the banking companies to achieve parity in rates at 35% by tax year 2007.

Table 4: Income tax collection by sectors.

(Rs. in million)

Heads	Collection up to March		Growth (%)	Share (%)	
	04-05	03-04		04-05	03-04
Corporate Sector (i+ii)	92,195.4	74,118.2	24.4	66.2	63.9
i) Advance Tax.	38,102.3	29,693.9	28.3	41.3	40.1
ii) Others collection.	54,093.1	44,424.3	21.8	58.7	59.9
Non-Corp Sector (iii+iv)	47,072.6	41,872.8	12.4	33.8	36.1
iii) Advance Tax.	777.6	918.0	-15.3	1.7	2.2
iv) Others collection.	46,295.0	40,954.8	13.0	98.3	97.8
Income Tax Collection	**139,268.0**	**115,991.0**	**20.1**	**100.0**	**100.0**

A further break down into public, private and banking companies presents an interesting picture. Currently the public companies despite their small number (468) are the major contributors in total gross collection. Their share has been around 52%. The private and banking companies on the other hand have contributed around 36% and 13%, respectively in gross receipts of Rs. 92.2 billion (Table 5). This outcome is against the conventional wisdom that the private sector is the mainstay of the economy. Thus, the future policy planning to encourage private investment in the country needs to be carefully assessed within the available information.

Table 5: Share of Corporate Sector in Total Gross Collection

(Rs. in million)

Type of Corporations	Collection up to March		Growth %	Share (%)	
	04-05	03-04		04-05	03-04
Public	47,757.2	36,985.0	29.1	51.8	49.9
Private	32,729.4	27,127.3	20.7	35.5	36.6
Banking	11708.8	10,005.9	17.0	12.7	13.5
Total	**92,195.4**	**74,118.2**	**24.4**	**100.0**	**100.0**

Concluding Remarks

The promulgation of Income Tax Ordinance, 2001 has brought positive changes in the income tax system. However, there are a number of areas where more effort is desired. With increasing pressures of globalization of the world economy, continuous revisions are required in the corporate tax structure to attract FDI. Secondly, the WHT structure needs streamlining to minimize tax burden on final consumers. Thirdly, with the introduction of USAS the audit function has to be strengthened in the light of experience of those countries where audit has a high degree of success. Fourthly, serious effort is needed for broadening of tax base, as the existing tax base is too low by any standard. The corporate base is not only narrow but also largely dormant that needs to be activated. Finally, a much stronger linkage is required for information flows between headquarter and field offices for improving tax compliance and efficiency gains.

V

TARP:
The Formal Launching of the Project[19]

Background

In the past the taxation system in Pakistan was suffering from two major weaknesses, namely the difficulties arising out of complicated laws and procedures, and inefficiencies emerging due to administrative bottlenecks. In an effort to correct this situation, a reform agenda focusing on wide ranging revisions in tax laws and tariff structure as well as improvement in tax administration was envisioned towards the second half of the 1990s and beginning of the new millennium. It required major shakeup in the whole system of taxation system through sequential and parallel actions. Using the experience of other countries, the reform program included establishment of additional support units for large and medium taxpayers. Even though many reform related activities were initiated over the past three years, the formal launching of the Tax Administration Reform Program (TARP) took place of 4th of April 2005. Some of the details of the TARP are as follows.

Organization and Policy

In order to improve the tax machinery and its working, main focus has been placed on revenue operations, management services and policy and reforms. The overall strategy is to increase voluntary tax compliance through better management and facilitation of the taxpayers. The salient features of the TARP strategy are:

- Streamlining the top management structure in the CBR by reducing the responsibilities of the top management to four key areas, viz., revenue operations, revenue services, management services, and policy and reform;

[19] This up-date is based on Mr. M. S. Lal's presentation during the launching ceremony.

- Creating the functional structure of tax administration in CBR;
- Introducing a formal annual planning and performance monitoring process;
- Decentralizing logistical support;
- Strengthening tax policy capacity in the CBR; and
- Developing a comprehensive integrity strategy for the CBR.

Major Areas of Reforms

The major areas of reform under TARP are: human resource development, audit, enforcement, appeals and dispute resolution, and taxpayers' education and facilitation. The enabling environment is to be provided through extensive IT support.

Human Resources Development: The present level of training and skill of the personnel was not considered up to the required standards for working on professional lines. To introduce professionalism and acquaint CBR staff with the modern management techniques, a comprehensive program of training and capacity building has been envisioned. The focus of the HRM strategy is on capacity building of employees, up-gradation of the working environment through provision of better facilities, and improved induction, promotion and remuneration packages.

Audit: Audit has taken a key position in the working of CBR after the introduction of self-assessment scheme. The effective audit can result in the reduction of tax evasion and is helpful in increasing compliance. Due to audit, non-filing of return can also be checked. Some of the initiatives where further effort will be concentrated are:

- Establishment of specialized internal audit functions in CBR;
- Setting up of an internal audit office for planning, program direction, procedures, training and evaluation of the internal audit program throughout the CBR for which staff would rely on

intelligence built into the system to identify possible errors and irregularities;

- Annual Audit Plans for Direct and Sales Taxes which cover available resources and projected case audits at the various jurisdictions;
- Programs and procedures for detection of potential fraud/evasion for referral to the Customs & Tax Fraud function; and
- Post Clearance Audit in Customs.

Revenue Operations

The old and primitive field structure in tax collection has equally contributed in the inefficiency of taxation system. The experiment of establishing LTUs and MTUs has been a success on the basis of a number of indicators, including revenue collection, joint audits by income and sales tax teams, enforcement, provision of modern facilities, and facilitation of the taxpayers. It is anticipated that complete integration of domestic taxes will further improve the efficiency of the system. Some of the steps envisioned for future are given below:

- Redesigning the organization structures and business processes in ways that will lead to co-location as soon as possible and to eventual integration of the Direct and Sales Tax administrations;
- Merging of as many support services as possible in the long run for all Revenue Administrations, including Customs, even though the Customs operations will always be maintained as a separate wing;
- Creating an integrated tax information system, including a taxpayer account for each taxpayer and a taxpayer accounting system, governed by the unique taxpayer-identification-number system;
- Designing and implementing modern risk-management systems based on mathematical ratios, taxpayer profiles, and industry standards, etc., to support compliance-enforcement programs.

- Designing vigorous enforcement programs to target taxpayers who choose not to comply voluntarily; and
- Introducing amendments/ additions to the Tax and Customs Laws that will support and enable the envisioned reforms and transformation.

Enforcement

Enforcement is an important area of reform in view of the weak tax compliance. It is envisaged that the tax policy and administrative reforms should lead to better enforcement, as complete tax profiles of target population will be available to the tax administrators.

Appeals and Dispute Resolution

Often ignored in the past is the area of Appeals and Adjudication. The reform program projects that the burden of litigation at various appellate fora would be reduced greatly to reduce elaborate human resource involvement in the entire process, which incidentally has generated only meager revenues for the government but at the expense of great hassle for the taxpayers. A complete overhauling of this important area requires the following:

- Continuation with Alternate Dispute Resolution (ADR) mechanism and test Pilot the idea of 'Dispute Resolution Complex';
- Alignment of tax laws;
- Training and tenure posting of adjudicating officers with suitable infrastructure and facilities;
- Protection of staff from extraneous influences and investigating agencies;
- Countrywide computerization of Adjudication Collectorates; and
- On-line access of the adjudicating officers to data on valuation, imports-exports, local production of goods, information/profiles of taxpayers, case laws, latest ruling/judgments of superior courts; and computer-generated adjudication orders.

National Intelligence and Risk Management

This sub-component provides for creation of an intelligence-gathering function at the national level, which will cover and support all operational areas of the three the revenue streams at the field level. A national risk-management function will be co-located with the intelligence function to provide similar support field operations. The risk-management function will design automated systems and databases based on ratios/taxpayer profiles/industry and goods 'profiles' etc. to gather, analyze and identify cases for audit and enforcement which have the greatest risk for revenue loss to the Government. The intelligence function will focus heavily on creation and use of automated databases for the identification and preparation of cases for field investigation for potential tax/ customs fraud or evasion.

Taxpayer Education and Facilitation

Proper education of taxpayer is essential for efficient enforcement of tax policies and compliance. The CBR has already taken a number of steps for education and facilitation like the introduction of help-line, web facility, printed material and establishment of facilitation center etc. Furthermore, the taxpayers are being facilitated through media campaigns to improve compliance. Taxpayers are also being educated on such basic things as: how to fill the returns, revisions in the existing rate structure, time-to-time changes in rules and procedures etc. CBR is also working on broadening of tax base and proper registration and maintaining national tax number (NTN).

It is anticipated that these changes will help in transforming the taxation system on modern lines where the three principles of equity, efficiency, and transparency will be universally adhered.