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



CENTRAL BOARD OF REVENUE

Government of Pakistan

**Constitution Avenue
Islamabad - Pakistan**

Contact:

Editor: Dr. Ather Maqsood Ahmed
Member, Fiscal Research and Statistics
e-mail: memberfrs@cbr.gov.pk Phone:
(051)-920-4436 Fax:
(051)-921-9211 May: 2007

***Fiscal Research and Statistics Wing
Central Board of Revenue***

Research Team

1. Dr. Ather Maqsood Ahmed *Member,
Fiscal Research and Statistics*
2. Robina Ather Ahmed
Chief (FR&S)
3. Umar Wahid
Secretary (FR&S-I)
4. Sharfuddin Pirzada
Secretary (FR&S-II)
5. Mir Ahmad Khan *Second
Secretary (FR&S-I)*
6. Naeem Ahmed
Second Secretary (FR&S-II)

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Foreword

CBR has surpassed the revenue target of Rs. 579.7 billion, by collecting Rs. 597 billion during July-March 2006-07. The net gain has been Rs. 17.3 billion. Even though this accomplishment in itself is by no means small, nonetheless an in-depth evaluation would confirm that CBR, during this period, has absorbed an additional shock of Rs. 60 billion. This loss in revenue has been encountered on account of constantly shrinking base of import-related taxes, additional payments to the power sector, and reduction in imports of some of the revenue-yielding commodities, including vehicles and iron and steel. Fortunately, the unprecedented gains through direct taxes have more than compensated the losses incurred through customs duties and sales tax. Going forward, it is expected that CBR may have to absorb additional shock in Q4, but the overall target still remains within reach.

The present publication of the CBR Quarterly Review presents a comprehensive analysis of the four federal taxes administered by CBR. It includes two thought-proving articles on 'Iron and Steel Industry' and 'Sectoral Analysis of Taxes and GDP: Seeking Further Insight'. The in-depth analyses shed light on various aspects of tax compliance by leading sectors of the economy. An update has also been provided on how the burden of litigation has been minimized for the taxpayers to create conducive environment for furthering economic growth.

I believe that the comprehensive information, analyses, and its lucid presentation will be useful for wide spectrum of readers. Any suggestions to improve the analytical strength of the Quarterly will be highly appreciated.

*M. Abdullah Yusuf
Secretary General
Revenue Division/ Chairman, CBR*

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CBR Tax Collection: An Analysis of the Q3: 06-07 Outturn¹

The Economy

Barring bulging trade deficit and irksome inflation, the leading sectors are reasonably on track and the economy is poised for yet another high growth outturn during the current fiscal year. All major services, including telecom, banking and insurance, and wholesale and retail trade have maintained a vibrant posture all through the year. The agriculture sector is expected to perform exceptionally well, as Mother Nature has been kind to have bumper crops. Unlike last year, the dairy and poultry industries have seen no set backs. The manufacturing sector has also been quite up-beat about growth, notwithstanding the usual 'noise' from the textile sector. Similar is the status of the oil and gas sector where unprecedented businesses have been recorded. The stock market remains bullish - the investors and speculators are not shying away from risk-taking.

However, despite this 'glossy' side of the economy, there are many areas that continue to pose risks - both in the short as well as medium- to long-run. The major stumbling block has been the modest showing on the export front. In fact, the favorable export position attained during last few years has suddenly been lost. The growth of 4.2% during the first three quarters of current fiscal year (CFY) compared to around 13% average growth of preceding five years does indicate the existence of inherent weaknesses. A closer look exposes the well known structural rigidities prevalent in this area, i.e., neither there is any significant change in the export basket, nor has the composition of export-destinations altered in any

¹ The Research Team of the Fiscal Research Wing of CBR has carried out the analysis. The collaboration by the staff of the Budget Wings of Direct and Indirect Taxes and the DRS is gratefully acknowledged.

noticeable manner. Pakistani exports remain heavily dependent on few commodities going to few markets.²

The question is how long the country could survive with such a low and delicate export-base. Why the emphasis remains narrowly focused on few sectors? Even within the narrow focus, why the leading export sectors (textile in particular) is finding it difficult to compete internationally? Is it due to gross inefficiencies as questioned by certain learned quarters or there is absence of level playing field as we are led to believe by the industry. On its part, the government has bestowed enough concessions and exemptions to the exporters during the past many years. Sadly, even the textile vision has not been able to create ripples in the system. A country which is the 4th largest producer of raw cotton fails to reap the benefits of comparative advantage is simply appalling!³

Taking a holistic view of the situation, it is safe to infer that such a low level of diversification in exports is a permanent risk and a threat to the economy. To avoid unfortunate eventualities, there is a need for a comprehensive plan to revitalize the system. The recently developed 'Export Plan (2007)' has many attractive features that cut across all important segments of the economy including human resource management, research and development, industrial and labor laws, infrastructure development, taxation and environmental concerns, and most importantly, diversification in the export base.⁴ It is relevant that this thought process is given due consideration. Additional inputs are sought from wide variety of stakeholders so that an implementation strategy document is prepared and the Plan becomes a reality.

² Nearly 84% of exports belong to core category consisting of textile, rice and carpets etc, 7% to fish, fruit, meat and poultry, marble, and few engineering goods, and 9% to all other products [TDAP].

³ www.cotlook.com.

⁴ See 'Export Plan - Pakistan Inc' the document prepared by the Planning Commission (2007) for further details.

Table 1: Monthly and Quarterly Targets/Collection: 06-07 (Rs. Billion)

	Direct Taxes	Sales Tax	Excise Duties	Customs Duties	All Taxes
Quarter: 1	56.9	74.0	14.3	33.2	178.4
Quarter: 2	66.9	82.1	16.0	37.7	202.7
January	13.2	27.7	5.5	11.4	57.8
February	12.2	27.1	5.1	11.5	55.9
March	41.4	27.3	5.4	14.8	88.9
Quarter 3	59.2	82.7	17.4	39.4	198.6
July-March	183.0	238.8	47.7	110.3	579.7
FY: 2006-07	264.8	343.8	69.0	157.5	835.0
Collection: July-March 06-07	237.8	218.8	47.7	92.7	597.0

Net Gain	54.8	-20.0	0	-17.6	17.3
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It may be added that although the over-performance by direct taxes has compensated the nine months accumulated loss emanating from indirect taxes, but the whole situation requires close monitoring to avoid further slippage. CBR is taking due care to maintain the stable course of revenue collection so that there is no resource shortfall in the budget. For this purpose, besides watchful review of indirect taxes, the performance of direct taxes is also being observed carefully to ensure continuity in the remarkable performance in the 4th quarter.

Overall Collection and Refunds

The gross and net collection of CBR during July-March 2006-07 has been Rs. 663.1 billion and Rs. 597.0 billion respectively, indicating robust growth of 19.4% and 21.9% (Table 2). Compared to last year, these collections are higher by Rs. 107.8 billion and Rs. 107.1 billion, confirming that refund/ rebate payments have been close to last year level. The monthly data indicate that out of nine months, a single-digit growth was recorded during the months of August, October and February. A remarkable growth was witnessed in July, September, November, and December. Even though the double-digit growth in net collection in January and March was consistent with the growth of the economy, it fell short of the targeted growth of around 17%, thereby decelerating the overall growth momentum.

A number of factors have contributed towards this outcome. The most important being the deceleration in import growth. In fact, the growth in dutiable imports has turned negative during the CFY. It may be recalled that revenue projections assumed 15% growth in imports and dutiable imports. Instead, the month-on-month average growth in imports has been slightly over 10% and in dutiable imports -4%. Secondly, the collection has declined for one-off factors. Due to domestic supply constraints, huge amount of sugar, fertilizer, and iron and steel were imported last year. Consequently, there was a significant jump in import-related taxes. This year, the

Table 2 : Gross and Net Revenue Collection: (Rs. Billion)
Monthly/ Quarterly Comparison

	FY 06-07		FY 05-06		Growth (%)	
	Gross	Net	Gross	Net	Gross	Net
July	54.5	46.2	41.5	34.6	31.3	33.5
August	54.0	46.3	50.3	44.9	7.4	3.1
September	101.5	91.4	78.4	72.5	29.5	26.1
<i>Q1</i>	<i>210.0</i>	<i>183.9</i>	<i>170.2</i>	<i>152</i>	<i>23.4</i>	<i>21.0</i>
October	60.4	53.4	56.3	49.2	7.3	8.5
November	67.1	59.0	53.5	47.6	25.4	23.9
December	123.9	114.2	86.6	75.1	43.1	52.1
<i>Q2</i>	<i>251.4</i>	<i>226.6</i>	<i>196.4</i>	<i>171.9</i>	<i>28.0</i>	<i>31.8</i>
January	55.6	52.2	53.4	45.9	4.1	13.7
February	56.8	52.4	56	49.5	1.5	5.9
March	89.3	81.9	79.2	70.5	12.8	16.2
<i>Q3</i>	<i>201.7</i>	<i>186.5</i>	<i>188.6</i>	<i>165.9</i>	<i>6.9</i>	<i>12.4</i>

July-Ma	663.1	597.0	555.2	489.8	19.4	21.9
rch						

Table 3: Refund/Rebate Payments: July-March Comparison
(Rs. Billion)

	JM: 06:07	JM: 05:06	Growth (%)
Direct Taxes	25.7	24.3	5.8
Sales Tax	29.8	26.8	11.2
Federal Excise	0.1	0.2	-50.0
Customs	10.5	14.1	-25.5

All Taxes	66.1	65.4	1.1
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Table 4 Gross and Net Revenue Receipts of Direct Taxes: A Comparison
(Rs. Billion)

	FY 06-07		FY 05-06		Growth (%)	
	<i>Gross</i>	<i>Net</i>	<i>Gross</i>	<i>Net</i>	<i>Gross</i>	<i>Net</i>
Quarter-I	76.6	66.5	53.4	48.2	43.4	38.0
Quarter-II	115.8	106.2	66.2	56.1	74.9	89.3
Quarter III	71.1	65.1	57.3	48.4	24.1	34.5
<i>July-March</i>	263.5	237.8	176.9	152.7	49.0	55.7

Note. Figures are rounded to the decimal place.

voluntary compliance by the taxpayers. The net collection from this source increased to Rs. 37.2 billion as compared to Rs. 20.3 billion in the corresponding period of last year, indicating a growth of 83.1%. The 2nd quarter also maintained continuity in healthy tax receipts. In fact, a remarkable growth of 74.9% in gross and 89.3% in net terms was recorded. The source of this growth was once again improved voluntary tax compliance in the shape of payments with returns and advance taxes. The 3rd quarter has registered growth of 24.1%) and 34.5% respectively, which has been as per *a priori* expectations, as most of the returns are received during the first two quarters. The 3rd quarter growth mostly 'originates' from withholding taxes. Thus, the overall net direct taxes collection has increased to Rs. 237.8 billion as against Rs 152.7 billion of PFY. Another encouraging aspect has been the change in the tax mix. CBR had always invited criticism for having low tax contribution of direct taxes vis-a-vis other tax receipts. With remarkable performance, direct taxes have become the leading source of revenues for CBR. Its share in total tax receipts has jumped from 30% during PFY to 40% during CFY.

The Performance of Corporate Sector

The collection from corporate sector is gradually picking up. Its share in total gross income tax collection has increased from 64% to nearly 73% during FY 2006-07. Notwithstanding the continuous reduction of corporate rates for banking and private companies, the enhanced profitability of corporate sector has been instrumental in higher revenue realization from this source. Within the corporate sector, highest collection of Rs 71.2 billion has been recorded by the private companies, followed by public and banking companies (Graph 1). Certain features of this outcome are worth mentioning. Firstly, the profitability of the banking sector has significantly improved thereby the collection has reached Rs. 36.8 billion during CFY as against Rs 13.6 billion in PFY. The achievement of 170.6% growth over PFY has pushed the share of banking companies to

Graph 1: Gross Income Tax Collection from Corporate Sector

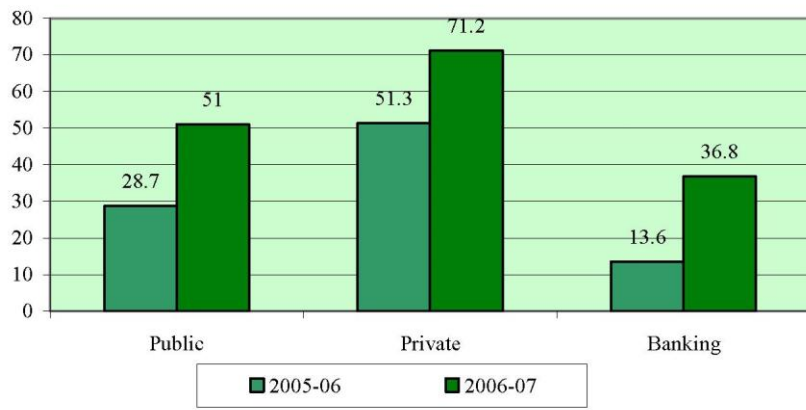


Table 5: Composition of different sources of Income Tax collection

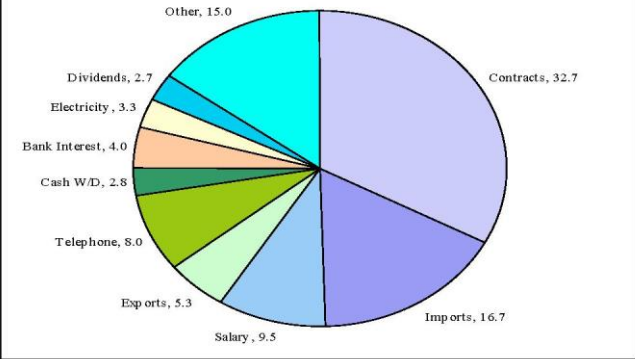
Collection Heads	Collection (Rs. Billion)		Growth (%) JM: 06-07	Share (%)	
	JM: 06-07	JM: 05-06		JM:06-07	JM05-06
Voluntary Payments	131.7	67.2	96.0	51.9	39.4
Collection on Demand	5.5	9.3	-40.9	2.2	5.4
Withholding Taxes	116.5	94.2	23.7	45.9	55.2

Gross Income	253.7	170.7	48.6	100.0	100.0
Tax					

Table 6: Advance Tax Payment by Major Sectors (Rs. Million)

Sector	Collection Up to March 2007	Collection Up to March 2006	Growth	
			Absolute	(%)
Banking	26,617.2	5,642.3	20,974.9	371.7
Oil & Gas	23,874.9	14,707.1	9,167.8	62.3
Tobacco	1,465.2	615.5	849.7	138.1
Telecommunication	5234.5	5,757.9	-523.4	-9.1
Pharmaceutical	1,374.1	812.4	561.7	69.1
Fertilizer	1496.3	1,898.4	-402.1	-21.2
Textile	55.5	149.3	-93.8	-62.8
Sub Total	60,117.7	29,582.9	30,534.8	103.2
Others	23,760.3	13,267.8	10,492.5	79.1
Grand Total	83,878.0	42,850.7	41,027.3	95.7

Graph 2: Share of Major WHT Heads in Total



A robust growth in collection in leading sources is consistent with enhanced sectoral economic activities. The two exceptions of negative growth have been on account of WHT on imports and exports where deceleration in growth of tax bases has been the primary factor. Whereas the deductions on imports have been declining for the last six months, the decline on WHT on exports is a recent phenomenon - the collection from this head has seen a shortfall of Rs. 587 million when compared to Q3:06.

On positive side, the leading source of WHT continues to be contracts/ supplies, contributing about 33% of total WHT receipts. The quarterly pattern of collection from this head reveals interesting development. The collection in Q2:07 has posted a record improvement over Q2:06. The collection in Q3:07, in absolute terms, have nearly maintained the level of Q2:07. Thus, the overall outcome remains promising provided a similar position is maintained in Q4:07. Similarly, strong growth of 103% on account of telecom sector indicates that the momentum of growth is being maintained. Over the years this has become a major source of revenue.

Apart from these major WHT contributors, the relatively minor components have also recorded sizeable growth. For instance, WHT on non-residents and prize bonds grew by 136%) and 121%), respectively during the first three quarters of CFY over the corresponding period of last year.

Of recent policy interventions, around 84.8%> growth has been attained in cash withdrawal, indicating that doubling of rate has nearly doubled the collection from this source. Similarly, revenue worth Rs. 1.6 billion has been generated through CVT on immovable property. Finally, doubling of rate of taxation on shares has resulted only 12% increase in revenue from stock market activities (Table 7).

**Table 7: July-March Data on Leading' WHT Heads:
A Comparison of FY 06-07 & FY 05-06 Collection**

(Rs. Million)

Heads	2006-07	2005-06	Difference	
			Absolute	Percent
Contracts				
Q1	9882	8872	1010	11.4
Q2	14762	9355	5407	57.8
Q3	13441	11855	1586	13.4
<i>Total</i>	<i>38085</i>	<i>30082</i>	<i>8003</i>	<i>26.6</i>
Import				
Q1	6844	6687	157	2.3
Q2	6301	6516	-215	-3.3
Q3	6277	6811	-534	-7.8
<i>Total</i>	<i>19422</i>	<i>20014</i>	<i>-592</i>	<i>-3.0</i>
Salary				
Q1	3172	2965	207	7.0
Q2	4219	3464	755	21.8
Q3	3724	3729	-5	-0.1
<i>Total</i>	<i>11115</i>	<i>10158</i>	<i>957</i>	<i>9.4</i>
Export				
Q1	2512	2306	206	8.9
Q2	2687	2373	314	13.2
Q3	964	1551	-587	-37.8
<i>Total</i>	<i>6163</i>	<i>6230</i>	<i>-67</i>	<i>-1.1</i>
Electricity				
Q1	1165	986	179	18.2
Q2	1298	1371	-73	-5.3
Q3	1316	1184	132	11.5
<i>Total</i>	<i>3779</i>	<i>3541</i>	<i>238</i>	<i>6.7</i>
Telephone				
Q1	2778	1314	1464	111.4
Q2	2985	1875	1110	59.2
Q3	3542	1395	2147	153.9
<i>Total</i>	<i>9305</i>	<i>4584</i>	<i>4721</i>	<i>103.0</i>
Cash Withdrawal				
Q1	1111	380	731	192.4
Q2	1124	693	431	62.2
Q3	1027	692	335	48.4
<i>Total</i>	<i>3262</i>	<i>1765</i>	<i>1497</i>	<i>84.8</i>
Bank Interest				
Q1	1760	1197	563	47.0
Q2	1949	1382	567	41.0
Q3	1014	1823	-809	-44.4
<i>Total</i>	<i>4723</i>	<i>4402</i>	<i>321</i>	<i>7.3</i>
Sub Total nine major items	92075	77235	14840	19.2
% share in total WHT	79.0	82.0		
Other Withholding	17553	16958	595	3.5
Total WHT	116502	94193	22309	23.7

Share in total IT

45.9

55.2

Table 8: Collection of Sales Tax (Domestic) and Sales Tax (Imports)

Description	2006-07			2005-06			Growth		
	Gross	Refund	Net	Gross	Refund	Net	Gross	Refund	Net
ST(M)	44,761	20.0	44,741	39,062	37.0	39,025	14.6	-45.9	14.6
Q1 ST(D)	42,084	11,240	30,844	31,497	7,537	23,960	33.6	49.1	28.7
ST(Total)	86,845	11,260	75,585	70,559	7,574	62,985	23.1	48.7	20.0
ST(M)	40,597	26.0	40,571	41,743	20.0	41,723	-2.7	30.0	-2.8
Q2 ST(D)	41,877	11,796	30,081	37,685	9,654	28,031	11.1	22.2	7.3
ST(Total)	82,474	11,822	70,652	79,428	9,674	69,754	3.8	22.2	1.3
ST(M)	40,428	8.0	40,420	40,386	27.0	40,359	0.1	-70.4	0.2
Q3 ST(D)	38,850	6,692	32,158	38,853	9,548	29,305	0.0	-29.9	9.7
ST(Total)	79,278	6,700	72,578	79,239	9,575	69,664	0.0	-30.0	4.2
ST(M)	125,787	55.0	125,732	121,191	84.0	121,107	3.8	-35.7	3.8
My-March ST(D)	122,811	29,728	93,083	108,035	26,739	81,296	13.7	11.2	14.5

ST(Total)	248,592	29,783	218,815	229,226	26,823	202,403	8.5	11.0	8.1
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July-March 2006-07 data indicates that 76% of gross collection (Rs. 93.2 billion out of Rs. 122.8 billion) has been generated by ten major revenue spinners that include: telecom services, POL products (including LPG), electrical energy, natural gas, sugar, cigarettes, cement, services, beverages and auto parts (Table 9). With the exception of natural gas and cement in gross terms and electrical energy, natural gas and cement in net terms, the performance of the rest of the major revenue spinners has been consistent with their respective production growth. The reduction in collection from natural gas has been mainly due to heavy input adjustment for consumption of natural gas by a large number of export oriented units for zero-rated sales as well as an increase in purchase price of gas from the gas-fields. However, in-depth examination points out abnormal input-output ratio during the months of July, August 2006 and February 2007. The low collection from cement at first sight appears to be inconsistent with over 24% increase in production, 21.4%) growth in federal excise collection and significant increase in government spending on infrastructural development. The only rationale for low GST receipts could be the decline in price. However, if this to be true, the adverse impact on value of sales would have been fairly greater than the growth in production. This aspect needs further verification.

On the brighter side, the telecom services have continued to grow at phenomenal pace. Consequently, the collection has recorded 40% growth during first nine months of CFY. In the process, its share in collection has also increased from 17.4% in July-March 2006 to 21.5%) in July-March 2007. Sustained expansion in mobile phone use and better service delivery in view of serious competition among the telecom service providers is the major contributor in improved performance of this sector. The collection from POL Products has been the second major revenue source with 18.5% share in gross sales tax (domestic) collection. Despite 11.4% growth in gross collection from electrical energy, the net collection has been

Table 9: Sales Tax Collection from Ten Major Revenue Spinners (Domestic)
during FY 06-07 and FY 05-06

(Rs. Million)

Commodity	Gross Collection		Net Collection		Growth	
	Up to March 2007	Up to March 2006	Up to March 2007	Up to March 2006	Gross	Net
Telecom Services	26,392	18,847	26,178	18,778	40.0	39.4
POL Products	22,675	20290	22,580	20246	11.8	11.5
Electrical Energy	11,511	10,337	-1,308	6,542	11.4	-120.0
Natural Gas	8,744	9,333	8,744	9,333	-6.3	-6.3
Sugar (Including Baggase etc.)	8,359	5,899	8,304	5,794	41.7	43.3
Cigarettes	4,598	3,696	4,595	3,549	24.4	29.5
Cement	3,514	3,454	3,466	3,433	1.7	1.0
Services	3,488	3,038	3,478	3,037	14.8	14.5
Beverages/ Aerated waters	2,017	1,687	2,000	1,679	19.6	19.1
Auto Parts	1,905	1,637	1,877	1,624	16.4	15.6
Sub Total	93,203	78,218	79,914	74,015	19.2	8.0
Others	29,409	29,876	13,169	7,281	-1.6	80.9

G. Total	122,811	108,035	93,083	81,296	13.7	14.5
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flourishing in the country. Despite a fall in production of higher capacity cars (1300 cc and above), the increase in production of smaller cars (1000 cc) has, to some extent, compensated for the demand for vendor industry. Finally, 19.6% growth in collection from beverages is expected to improve further due to the onset of the summer season.

Sales Tax at Import Stage:

The collection at import stage ST (M) in gross terms has been around 51% of total sales tax collection during July-March of CFY. However, in terms of net collection, ST (M) share increased to 57.5%) as the refund claims are entertained at the domestic stage of collection. Not only that the growth of 9.8%> in total value of imports has been below than budgetary expectations, the 3.8%> growth in collection of ST (M) is also on the lower side. One-off factors like substantial imports of iron and steel, sugar, and fertilizer during FY: 05-06 on the one hand and change in policy with regard to import of second hand vehicles do provide additional justification for this year's decline in collection vis-a-vis last year. Similarly, since ST (M) levy @ 15%o of import value is inclusive of customs duties, therefore any fluctuation in customs duty collection due to increased component of duty-free imports or variation in rate of duties also affects the ST (M) collection. However, despite these valid reasons, the low growth in collection remains partly inexplicable on account of relatively higher buoyancy of ST (M).

The commodity groups that recorded double-digit growth in sales tax collection at import stage have been POL products, edible oil, mechanical machinery, paper & paper board, oil seeds and aluminum products. The respective growth rates are 25.5%, 41.6%>, 43.6%, 16.3%, 41.8% and 28.7%. Consequently, there has been higher collection of sales tax. As indicated, the imports of old and used cars has been restricted through budgetary measure, therefore revenue loss has been encountered. Similarly, with the availability

Box 1: Change in Tax Regime with regard to Computers

In order to encourage the spread of information technology, computer hardware was exempted from sales tax till last year. After the emergence of IT industry as a commercially established booming industry attracting huge investment and experiencing a steady and sustainable growth, the industry was brought to the sales tax net. It was expected that 15% levy of sales tax will support the local industry as the local assembler would be entitled for input adjustment while the imported products shall be subject to the upfront incidence of 15%. The levy was introduced in lieu of 5% customs duty which was abolished. The direct outcome of this policy measure has been the strengthening of the local industry, while at the same time an additional amount of Rs. 1019 million has

been realized as taxes.

Table 10: Major Revenue Spinners of Sales Tax at Import Stage

PCT Chapter	Tariff Description	Growth in Imports (%)	ST (M) Collection [Rs Million]		
			JM: 06-07	JM: 05-06	Growth (%)
27	POL Products	25.6	51,536	41,053	25.5
87	Vehicles	-9.2	10,394	13,530	-23.2
72	Iron and Steel	-21.8	8,205	11,216	-26.9
39	Plastic Resins, etc.	8.0	7,240	6,679	8.4
15	Edible oil and Waxes	20.1	6,619	4,676	41.6
84	Mechanical Machinery	-3.5	4,968	3,460	43.6
85	Electrical Machinery	30.1	3,882	4,237	-8.4
48	Paper and Paperboard	19.5	2,698	2,320	16.3
29	Organic chemicals	5.3	2,630	2,555	2.9
12	Oil seeds & oleaginous fruits etc.	46.7	2,529	1,784	41.8
17	Sugar and Sugar Confectionary	-28.8	2,371	3,281	-27.7
38	Misc. Chemical products	-0.6	1,932	1,949	-0.9
09	Coffee, tea and spices	-1.8	1,876	1,903	-1.4
40	Rubber and articles.	3.5	1,661	1,636	1.6
76	Aluminum Products	49.2	1,486	1,155	28.7
	<i>Sub-total</i>	<i>10.4</i>	<i>770,026</i>	<i>101,434</i>	<i>8.5</i>
	Others	8.0	15,761	19,757	-20.2
	Grand Total	9.8	125,787	121,191	3.8

Note: JM stands for July-March

improved Customs Duties (CD) collection, notwithstanding the rationalization and reduction in duty rates. This phenomenon has changed comprehensively during the CFY. A slowdown has been witnessed in imports growth. Whereas the average monthly growth has reduced to 9.8%, the dutiable imports have in fact witnessed a decline of 4.4%. Secondly, as a consequence to shrinking of base, the gross and net collection of CD could reach Rs. 103.2 billion and Rs. 92.7 billion, reflecting a reduction in revenue receipts by 5.5% and 2.5%) respectively. Specifically, a loss of Rs. 2.4 billion has been recorded in the net collection compared to last year. With respect to target, the achievement has been only 84%. Compared to target, the shortfall has reached Rs. 17.6 billion. Thirdly, the reduction in realized tax base is expected to continue in the 4th quarter as well, thereby the adverse implications on revenue will remain in place. Fourthly, with regard to refund/ rebate payments, there has been a decline of around 26% during the first 3 quarters of CFY. The payment of rebates constitutes almost half of the total customs refunds/ rebates during July-March 06-07. The major beneficiary of customs rebate has been the textile sector (Rs. 1.9 billion) followed by leather (Rs. 1.1 billion). Finally, due to tariff rationalization and reduction, the effective rate with dutiable imports for 15 major commodity groups has dropped from 13.5% to 12.7% during July-March FY: 06-07 over the corresponding period of PFY. The effective rates have been higher than the maximum statutory rate of 25% for only two commodities, namely, vehicles (Chapter 87) edible oils (Chapter 15). Protection in the case of former and specific duty application for latter has been the rationale.

An Analysis of Major Revenue Spinners:

Around 77% of the gross collection has been realized from only fifteen major revenue spinners. Out of these, 13 commodity-groups have either registered low growth or there has been a decline in collection. The detailed information on imports, dutiable imports, and customs duty is presented in Table 11.

Table 11: 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 07	Up to March 06
87	Vehicles	-9.2	-16.0	-19.2	36.2	37.6
15	Edible oil and Waxes	20.1	16.5	1.0	28.1	32.4
27	POL Products	25.6	-1.5	-2.2	9.8	9.9
85	Electrical Machinery	30.1	33.4	27.5	7.4	7.7
84	Mechanical Machinery	-3.5	-11.2	-11.1	6.9	6.8
39	Plastic Resins, etc.	8.0	5.8	-1.4	8.0	8.6
72	Iron and Steel	-21.8	-30.5	-28.4	10.7	10.4
48	Paper and Paperboard	19.5	-5.3	7.6	21.1	18.6
29	Organic Chemicals	5.3	-12.5	-14.5	8.1	8.3
73	Iron & Steel Articles	28.7	23.7	-0.2	10.8	13.4
38	Misc. Chemical Prod.	-0.6	-2.5	-6.7	8.4	8.7
9	Coffee, Tea and Spices	-1.8	1.3	0.8	10.0	10.1
40	[lubber Products	3.5	8.3	1.9	11.1	11.8
32	Dyes, Paints etc.	8.4	5.4	0.8	12.4	13.0
54	Man-made Filaments	-7.8	-1.8	-2.4	8.9	9.0
<i>Sub-total</i>		<i>70.5</i>	<i>-1.2</i>	<i>-7.3</i>	<i>72.7</i>	<i>13.5</i>
Others		7.7	-18.8	1.2	21.0	16.9

Grand Total	9.8	-4.4	-5.5	14.0	14.1
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Box 2: Decline in Overall Demand for CBU Motorcars

The import of motorcars/Jeeps in CBU condition is one of the important sources of collection of CD. The policy was revised for import of old and used vehicles during FB 2006-07. A restriction has been imposed on the import of vehicles which are older than 5 years.

This policy has resulted into reduction in imported motor cars. During July-March, only 16,782 motorcars/jeeps were imported against 22,583 in the corresponding period of PFY, entailing a decline of 25.7%.

Another interesting transformation has been that around 48% of the total imported motor cars were 1000cc during July-March, FY: 06-07 against 31.2% in PFY. Its contribution in CD has increased from 8.2% to 14.9%. However, the overall collection from CBU motor cars has declined by 42.7% mainly due to 55% drop in high CC vehicles, as higher capacity imported cars used to fetch higher customs duties

and other taxes.

Box 3: Decline in Overall Demand for Mechanical Machinery

The import of machinery is vital for expansion of industrial sector and overall development of the country. The duty rates of the machinery and raw materials have been slashed significantly during the last few years. The reduction of rates means bringing down cost of business and increasing the pace of business activities. Major imports of mechanical machinery (Chapter 84) are in the areas of industrial goods (25.3%), textile (19.3%), construction (12.8%), pumps (10.8%) and engines (10.2%).

The recent data confirms that the import of textile, construction machinery and agriculture implements have dropped by 35.5%, 22.8% and 47.4% respectively. Resultantly, the collection has

decreased by 38.2% and 31% respectively

that five major revenue spinners of FED have contributed around 85% in total collection during July-March 2006-07 against 90.5% in the corresponding period of last year. All the major items have shown positive growth (Table 12).

The performance of cement, POL products and natural gas has been notable and all the three items recorded a double digit growth. The growth in collection from cement is attributed to increase in domestic demand due to enhanced construction activities in the country. To meet the local demand, the production of cement during first eight months has increased by 24.5% over the corresponding period. The increase in the collection of natural gas in the third quarter by 17.9% after a slower growth during first two quarters is a welcome sign. On the other hand, the collection from beverages during third quarter remained low, however, it is expected that with the arrival of summer season, the collection will pick up further. The lower growth in collection from cigarettes is attributed to the continuing 'lag-effect'. The collection, even though recorded a double-digit growth in Q₂ and Q₃, the decline in Q₁ continues to haunt the overall growth. Further more, 6.8% growth in FED appears to be inconsistent with 24.4% growth in sales tax. Finally, the collection on account of services remains below expectations. During the budget 2006-07, FED was imposed on additional services like Cable TV operators, money changers, non-fund services by banks, international air travel etc. The annual estimated revenue impact of these policy changes was Rs. 7.6 billion including major contribution from international air travel and non-fund services. The projected revenue estimate was 11% of the total FED target. Compared to these projections, the collection from these measures has so far been Rs.2.1 billion, which is 4.4% of the FED revenue. Major contribution has been made by international air travel and non-fund services. If not captured in Q₄, services may create difficulties for achieving the overall FED target.

Table 12: A Comparative Analysis of FED Collection

(Rs. Million)

Major Revenue Spinners	JM:2006-07	JM: 2005-06	Difference	
			Absolute	Percent
<i>Cigarettes</i>				
Q1	4238.0	4555.8	-317.8	-7.0
Q2	6399.2	5592.1	806.8	14.4
Q3	6909.6	6282.8	626.8	10.0
Total	17547.1	16430.7	1116.4	6.8
<i>Cement</i>				
Q1	3461.1	2952.9	508.2	17.2
Q2	3692.2	2938.5	753.7	25.6
Q3	3844.4	3164.4	680.0	21.5
Total	10997.7	9055.8	1941.9	21.4
<i>Natural Gas</i>				
Q1	1419.3	1341.5	77.8	5.8
Q2	1438.7	1377.3	61.4	4.5
Q3	1557.4	1321.1	236.3	17.9
Total	4415.4	4039.9	375.5	9.3
<i>POL Products</i>				
Q1	977.6	1051.6	-74.0	-7.0
Q2	1233.1	1046.5	186.6	17.8
Q3	1163.2	915.9	247.3	27.0
Total	3373.9	3014.0	359.9	11.9
<i>Beverages & Concentrate</i>				
Q1	1766.5	1398.0	368.5	26.4
Q2	1294.2	1029.1	265.1	25.8
Q3	1239.4	1163.8	75.6	6.5
Total	4300.1	3590.9	709.2	19.7
<i>Sub-Total</i>				
Q1	11862.8	11299.8	563.0	5.0
Q2	14057.4	11983.5	2073.9	17.3
Q3	14714.0	12848.0	1866.0	14.5
Total	40634.2	36131.3	4202.9	12.5
<i>All Commodities</i>				
Q1	14040.0	12493.0	1547.0	12.4
Q2	16892.0	13061.0	3831.0	29.3
Q3	16895.0	14379.0	2516.0	17.5

Total	47827.0	39933.0	7894.0	19.8
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Concluding Observations

CBR has maintained a steady path in resource mobilization. There are no slippages as far as the start-of-the-year revenue target assignment is concerned. The realized growth in tax collection is two and half percentage points higher than the required growth. Even though some slow down in growth has been encountered during the third quarter, it has been compensated by exceptional performance during first two quarters of current fiscal year. It is anticipated that the fourth quarter will maintain the required growth momentum and the overall target will be achieved.

Those who wish that CBR should 'do more' must realize that the revenue organization has already suffered a revenue loss of about Rs. 60 billion on account of various factors that were not taken into consideration at the time of projections for FY: 06-07. This loss is expected to swell further during the fourth quarter. However, despite this set back, CBR is expected to manage its affairs. In fact, the overall tax/GDP is expected to improve further, which is creditworthy and no less an achievement.

Going forward, CBR has already launched a comprehensive audit plan for effective enforcement. This, however, does not mean that the era of facilitation is over. While achieving its primary responsibility of collecting due taxes, CBR is committed to create and maintain a business-friendly environment in the country for further acceleration in economic growth. But to avoid delinquency, the policy of outright facilitation needs to have appropriate controls. The audit plan has been designed to carry out this job in a manner that the confidence of various stakeholders is not compromised. It is sincerely hoped that the economy maintains its vibrant posture. In the process, CBR will also continue to mobilize adequate resources to avoid difficulties of economic management.

II

Industry Profile: Iron and Steel Industry in Pakistan⁵

Introduction

Steel is one of the most commonly used metals in the world and for maximization of its utility most of the iron is converted in to steel. The steel has a good domestic as well as industrial use, mainly because it does not corrode easily. It has high tensile strength and is far less brittle than iron. Currently there are more than 3,500 different grades of steel with various properties - physical, chemical, environmental etc. About 75% of these grades have been developed during last 20 years. Steel has the distinction of being the most recycled material in the world today. In the contemporary world, per capita consumption of steel is regarded as an indicator of economic development of a country. Given its role, steel has established itself as the backbone of any economy.

Pakistan had inherited dilapidated industrial structure at the time of independence. Steel industry was no exception in this regard. Pakistan started its journey with only two steel units situated in eastern and western parts of the country. Since the output of those units was not sufficient for domestic needs, reliance was naturally on imported iron and steel products. As the time progressed, Pakistan in collaboration with former Soviet Union initiated the construction of integrated Steel Mills at Karachi in 1973. The first blast furnace of this important endeavor in national history started its operations in 1981 and the project was completed in 1985.

The historical decision taken at that time has paved the way for future development in this field. Today over 500 steel units are

⁵ *Authors:* Mr. Umar Wahid, Secretary and Mr. Naeem Ahmed, Second Secretary (Fiscal Research & Statistics) CBR, Islamabad.

operating in the country but none of them compares to the size and contribution of other than Pakistan Steel Mills (PSM).

The objective of present study is to gain insight on the magnitude of Iron and Steel Industry in Pakistan and its contribution to the economy. Special emphasis of the study is on fiscal matters, namely the tax base, tax structure and the level of compliance, and the integrated approach to address the issues related to tax matters of the industry. The study seeks to highlight certain issues which need attention for the future course of action. Since PSM plays a pivotal role within this sector, a separate section is dedicated to evaluate its performance.

Pakistan Steel Mills (PSM)⁶

PSM is located 40 km south east of the coastal city of Karachi, in close proximity to Port Bin Qasim, with access to a dedicated jetty, which facilitates import of raw materials. It is the country's largest and only integrated steel manufacturing plant. It was incorporated as a private limited company in 1968 and commenced full-scale commercial operations in 1985. When started functioning, its installed capacity of production was 1.1 million tons of raw steel per annum, with built in potential to expand to over 3 million tons. About 14,000 labor force is working in the Mill. The PSM complex includes coke oven batteries, a simmering plant, blast furnaces, steel converters, bloom and slab casters, billet mill, hot and cold rolling mills, galvanizing unit and 165 MW of own power generation units, supported by various other ancillary units. The PSM manufactures a wide mix of products including flat and long products. It effectively enjoys a captive domestic market due to the prevalent demand-supply imbalance in the country where demand has historically exceeded local supply.

⁶ The data used in this section has been obtained from the web-site of Pakistan Steel Mill, and publication of the Lahore Chamber of Commerce & industry entitled 'Steel Industry in Pakistan-2006'.

PSM has gone through many ups and downs since its inception. Continuous political interference all through the decades of 1980s and 1990s had created a situation where the industry reached a state of virtual close-down. The capacity utilization was extremely low, sales were constantly declining, establishment costs were sky rocketing, and the worst of all there was no respite from huge losses on continuous basis.

Realizing that the closure of the industry will have serious socio-economic implications and repercussions, the Government undertook a number of bold steps to make the PSM economically viable. On the recommendations of the Restructuring Committee, the PSM was facilitated to reduce its debt liability. As a result of these corrective measures, sales and profitability have increased and the liquidity of PSM has also enhanced. By 2003-04 PSM started operating at more than 90% of its capacity and its declared after-tax profits were Rs. 4.85 billion.

Steel Processing Techniques⁷

Steel is made from iron ore and coke by blast furnace and basic oxygen furnace route or from scrap via the electric arc furnace (EAF) method. Currently 64% of global steel is produced in Basic Oxygen Furnaces (BOF). Coking coal is converted to coke, which is then used in the blast furnace to melt iron ore. The resulting molten iron is then taken to the BOF, where steel scrap and limestone are added. A stream of high purity oxygen is blown through the molten bath to remove impurities, leaving almost pure liquid steel. About 0.6 tons of coke are required to produce 1 ton of steel (around 1 ton of coking coal = 1 ton of steel).

A further 34% of steel is produced in Electric Arc Furnaces (EAF);

⁷ Source World Coal Institute www.worldcoal.org

much of the electricity used in this process is generated from coal-fired power stations.

Classification of Steel: Steel is grouped into following five main classifications.

Carbon Steel: More than 90% of all steels are carbon steels. They contain varying amounts of carbon. Machines, automobile bodies most structural steel for buildings, ship hulls, bedsprings and bobby pins are among the products made of carbon steels.

Alloy Steels: These steels have a specific composition, containing certain percentages of chromium, molybdenum, or other elements as well as larger amounts of manganese silicone and copper. Automobiles gears and axles, roller skates and carving knives are some of the many things that are made of alloy steels.

High -Strength low- Alloy (HSLA) Steels: HSLA steels are the newest of the five groups of steels. They have been specially processed, to have much more strength than carbon steels of the same weight. For example, freight cars made of HSLA steels can carry larger loads because their walls are thinner than carbon of HSLA steels of equal strength. Numerous buildings are now being constructed with frameworks of HSLA steels, as these structures could be made thinner without sacrificing their strength.

Stainless Steels: Stainless steel contains chromium, nickel and other alloying elements that keep them bright and rust resistant in spite of moisture or the action of corrosive acids and gases. Stainless steels are used for pipes and tanks of petroleum refineries and chemical plants, for jet planes and for space capsules. Surgical instruments and equipments are made from these steels and they are also used to patch or replace for broken bones because the steels can withstand the action of body fluids. In kitchens and in plants where food is

prepared, handling equipments is often made of stainless steel because it does not taint the food and can be easily cleaned.

Tool Steels: These steels are fabricated into many types of tools or into the cutting and shaping parts of power-driven machinery for various manufacturing operations. They contain tungsten, molybdenum and other alloying elements that give extra strength, hardness, and resistance to wear.

Categorization of Steel industry in Pakistan⁸

Steel industry can be classified into the following categories.

Ship breaking: Provides ship plates for re-rolling industry after breaking old ships. The ship breaking activities are carried out at Gadani in the Balochistan province located some 40 Km away from Karachi. The annual production ranges between 50,000 - 100,000 metric tons. The number of employees in the ship breaking industry is up to 4000.

Steel Melters: These units produce and sell ingots and cast billets. Cast billets are produced by melting steel scrap in electric furnaces and casting it through continuous casting machines (CCM). Currently about 120 steel furnaces functioning with approximately 15000 labor force is employed in this sector. The production of steel melters stood at 3 million metric tones in FY: 05-06

Steel Rollers: These units roll billets/ingots and sell various roll sections including re-enforcing bars. Steel billets, ingots, continuous cast billets and ship plates are the raw material of re-rolling. The production includes steel bars, flat, tee iron, channels, girders, and other sections including wires rods and bailing hoops. The estimated annual installed capacity is around 4 million tons in 2005-06. Around 20,000 labor force is employed in this sector.

⁸For details see official websites of PSM and Chambers of Commerce and Industries of Pakistan

Steel Pipe Industry: This industry was non-existent at the time of independence, however, it flourished with the passage of time and currently its installed capacity is 525,000 tons per year. It is able to produce all sizes in categories of seamless, seam welded, spiral welded and arc-welded pipes. Approximately 3500 people are employed in the industry.

Steel Production

Steel is produced in more than 50 countries and on every continent except Antarctica. The global steel production is dependent on coal - over 66% of total global steel production relies on inputs of coal. 592 Mt of coking coal and pulverized coal injection (PCI) coals are used in global steel production, which is 13% of total hard coal consumption worldwide. Rapid industrialization throughout the world has created a huge demand for steel.

According to the World Coal Report 2005, China is the leading steel producer with a share of around 31% in the world total production. Other leading producers in the world are Japan (10%), USA (8%), Russia (6%) and South Korea (4%)⁹. The annual production of iron and steel in Pakistan is comparatively low. The statistics of last nine years indicate that the production of iron and steel has ranged between 2 to 3 million tons (Pakistan Economic Survey 2005-06), whereas the demand has been increasing at a rapid pace due to widespread industrialization and construction of mega projects. Consequently, a huge sum of foreign exchange is being spent on the import of steel to meet the local demand. In 1997-98, the import bill was of Rs. 19 billion, that increased to Rs. 96 billion in FY: 05-06, indicating a growth of 53.8% as compared to previous year. The share of import of iron and steel products in total import value has increased from 4.4% in 1997-98 to 5.6% in 2005-06 (Pakistan Economic Survey 2005-06). The future demand for steel is expected

⁹ For further details please visit the official website of World Coal Institute www.worldcoal.org

to increase further which could have adverse implication for BoP position and CAD.

Contribution to the Economy

The industry plays a pivotal role by significantly contributing to the manufacturing and construction sectors of the economy. The industry generates direct and indirect tax revenues and also provides jobs to the skilled and unskilled workers in the country.

Manufacturing Sector: Manufacturing is the second largest sector of the economy, sharing 18.2% in the GDP. The share of Iron and Steel industry in manufacturing is 3.3%.¹⁰ The iron and steel is being demanded quite extensively throughout this sector. The FY: 2004-05 was successful year when the PSM was in full operation and the manufacturing sector registered a growth of 12.6% over the growth of 10.2 % in the FY; 2003-04. On the contrary, the manufacturing sector registered 8.6% growth during FY: 2005-06, mainly due to closer of two coke oven batteries of the Pakistan Steel Mill in July 2005-06 and the Mill was operating at around one-third of its capacity, resultantly, the entire chain of production based on iron and steel and related component was badly affected.

Construction Sector: Iron and steel products are the main raw material for construction sector. The construction sector recorded a healthy growth of 9.2% during FY: 2005-06. There have been enhanced activities in private housing, spending on physical infrastructure and construction in the earthquake affected areas. It is anticipated that this up-surge in construction activities will continue in coming years, thereby boosting the demand for iron & steel.

¹⁰ See Robina. Ahmed and Ather M. Ahmed (2006) 'Sectoral Contribution in GDP and Taxes: In Search of the Missing Link' *CBR Quarterly Review*, Vol. 6, No. 2, October-December, pp. 31-45.

Table 1: GST Base of Iron and Steel Sector

Categories	Jun-04	Jun-05	Jun-06
Manufacturers	487	545	599
Importers	318	413	451
Exporters	12	18	24
Distributors	267	310	315
Wholesalers	675	786	820
Retailers	47	46	51

Total	1806	2118	2260
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Table 2: Compliance Level of Iron and Steel Sector in ST(D)

Categories	Return Filers			<i>Compliance Level (%)</i>		
	2003-04	2004-05	2005-06	2003-04	2004-05	2005-06
Manufacturers	384	424	443	79	79.1	74.0
Importers	280	346	357	88.1	85	79.2
Exporters	12	11	15	100	78.6	62.5
Distributors	236	277	272	88.4	83.9	82.3
Wholesalers	480	552	508	71.1	70.7	62.7
Retailers	29	30	27	61.7	58.8	52.9

Total	1421	1640	1622	78.7	77.4	71.8
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areas vis-a-vis others. For example, only 44 out of 73 units registered with the Gujranwala collectorate have filed returns indicating a compliance level of 60.3%. Similarly the Rawalpindi Collectorate also faces a serious non-compliance problem (Table 3).

Table 3: Collectorate-wise Compliance Level: 2005-06

		<i>(Rs. Million)</i>					
		Manuf acturer	Importer	Exporter	Whole/ Dist	Retailer	Total
Faisalabad	Registrants	4	2	1	21	4	32
	Filers	2	2	1	17	2	24
	<i>Compliance (%)</i>	<i>50.0</i>	<i>100.0</i>	<i>100.0</i>	<i>77.3</i>	<i>50.0</i>	<i>75.0</i>
Gujranwala	Registrants	73	95	8	70	1	247
	Filers	44	79	4	49	1	177
	<i>Compliance (%)</i>	<i>60.3</i>	<i>83.2</i>	<i>50.0</i>	<i>70.0</i>	<i>100.0</i>	<i>72.1</i>
Hyderabad	Registrants	4			2		6
	Filers	4			2		6
	<i>Compliance (%)</i>	<i>100.0</i>					<i>100.0</i>
LTU (K)	Registrants	6					6
	Filers	5					5
	<i>Compliance (%)</i>	<i>83.3</i>					<i>83.3</i>
Lahore	Registrants	353	33	4	438	10	838
	Filers	280	24	4	336	9	653
	<i>Compliance (%)</i>	<i>79.3</i>	<i>72.7</i>	<i>100.0</i>	<i>76.7</i>	<i>90.0</i>	<i>77.9</i>
Multan	Registrants	1			15	1	17
	Filers	1			14	1	16
	<i>Compliance (%)</i>	<i>100.0</i>			<i>93.3</i>	<i>100.0</i>	<i>94.1</i>
Peshawar	Registrants	17	5	3	11	10	46
	Filers	14	5	2	6	1	28
	<i>Compliance (%)</i>	<i>82.4</i>	<i>100.0</i>	<i>66.7</i>	<i>54.5</i>	<i>10.0</i>	<i>60.9</i>
Quetta	Registrants	6	1		4		11
	Filers	6	1		4		11
	<i>Compliance (%)</i>	<i>100.0</i>	<i>100.0</i>		<i>100.0</i>		<i>100.0</i>
Rawalpindi	Registrants	35	5	1	39	2	82
	Filers	24	4	1	27	2	58
	<i>Compliance (%)</i>	<i>68.6</i>	<i>80.0</i>	<i>100.0</i>	<i>69.2</i>	<i>100.0</i>	<i>70.7</i>
STH Karachi	Registrants	111	314	8 6	536	23	992
	Filers	68	248		346	14	682
	<i>Compliance (%)</i>	<i>61.3</i>	<i>79.0</i>	<i>75.0</i>	<i>64.6</i>	<i>60.9</i>	<i>68.8</i>
Total	Registrants	599	451	24	1135	51	2260
	Filers	443	357	15	780	27	1622
	<i>Compliance (%)</i>	<i>74.0</i>	<i>79.2</i>	<i>62.5</i>	<i>68.7</i>	<i>52.9</i>	<i>71.8</i>

Table 4: Comparison of Sales Tax and Income Tax Returns by Iron and Steel Sector 2005-06

(Numbers)

Categories	Sales Tax Filers	Showing NTNon ST Returns	Achievement (%)	Income Tax Filers	Compliance (%)
Manufacturers	443	339	76.5	175	51.6
Importers	357	321	89.9	184	57.3
Exporters	15	11	73.3	7	63.6
Distributors	272	245	90.4	140	57.1
Wholesalers	508	420	82.8	240	57.1
Retailers	27	24	88.9	13	54.2
Total	1622	1360	83.8	759	55.8

Source : Sales Tax liter Wing and PRAL Data Base

products i.e. steel bars are subjected to fixed tax rate @ Rs.1000/ per metric ton and ship breaking on the supply of scrap on fix value addition of Rs. 2470/ per metric ton. In respect of wastages; subject to a maximum aggregated wastage of 7%, the following is normally the percentage or proportion of scrap and other products obtained from the breaking of oil tankers, bulkers, cargo ships, drilling ships, warships, passenger ships and cattle carriers:¹²

- i. Ship plate and profiles of V2 inch thickness and above 40%;
- ii. Ship plate and profiles of 3/8 inch thickness and above but below V2 inch 20%;
- iii. Second quality re-rollable scrap of short lengths 15%;
- iv. Small irregular pieces and re-meltable scrap 15%

Finally, Iron & Steel products are also subjected to customs duty at import stage as per specification of the products. The rate of customs duty varies from 5% to 25% with the exception of few items which are taxed at rate of 35%.

Sales Tax Procedures:

- a. For the purpose of determination of sales tax liability, the production of a steel-melter is being calculated at the rate of eight hundred units of electricity consumed for production of one metric ton of ingots or billets,
- b. For steel melter who melts and casts ingots or billets from locally generated scrap for which a sales tax invoice is not available, sales tax is payable on a fixed value addition of three thousand and six hundred rupees per metric ton,
- c. For steel melter who melts and casts ingots or billets from imported scrap against which a valid GD is possessed by melter's own name; from scrap purchased from Pakistan Steel Mills against a valid sales tax invoice in his name, sales

¹² For details please see S.R.O.678 (I)/2006 dated 30th June 2006

tax is chargeable on fixed value addition of two thousand four hundred and seventy rupees per metric ton,

- d. For steel melter who melts and casts ingots or billets from imported scrap as well as from the scrap purchased from Pakistan Steel Mills or uses local scrap, sales tax liability is determined on proportionately as under clause (b) and (c).

For the purpose of determination of tax liability, the production of all steel re-rollers is being calculated at one hundred and thirty units of electricity consumed for the manufacture of one metric ton of long mild steel products (bars, reinforced bars, rods, wire rods and structural sections made of mild steel) and the re-rollers is liable to pay sales tax on long MS products on fixed value addition of one thousand and eight hundred rupees per metric ton:

To have a tight cap on this, steel melters and re-rollers paying sales tax on fixed value addition are not entitled to any input tax adjustment.

Revenue Receipts

The direct and indirect tax contribution of the industry to the exchequer has been quite amazing. Whereas the collection from indirect taxes increased from Rs.13.6 billion in FY: 03-04 to Rs. 18.1 billion in FY: 04-05 and further going up to Rs. 23.7 billion in FY: 05-06, the direct tax receipts saw wild fluctuations during this period. The collection increased from a paltry sum of Rs. 326 million in FY: 03-04 to Rs. 3.9 billion in the next year, but declined to Rs. 748 million in FY: 05-06. In fact, industry's contribution was only 0.32% in total direct taxes.

To add insult to injury, out of total direct tax receipts, the PSM alone has contributed Rs. 607 million or 81.1% of the total income tax paid by the sector. On the other hand, the remaining 598 manufacturing units other than PSM, all distributors, wholesalers, and retailers collectively could barely contribute Rs. 141 million on account of income tax (Table 5).

Table 5: Collection and Share of Taxes from Iron & Steel Products
(Rs. Million)

Collection	03-04	04-05	05-06
Customs Duties	4,149	5,440	7,224
ST(Imports)	5,918	9,174	14,516
Sales Tax (Dom)	3,540	3,450	1,976
Total Indirect Taxes	13,607	18,065	23,716
Income Tax	326	3,881	748
Total	13,933	21,945	24,465
<i>Share (%) in Total</i>	03-04	04-05	05-06
Customs Duties	3.95	4.14	4.61
ST(Imports)	4.70	6.33	8.46
Sales Tax (Dom)	2.44	2.32	1.27
Total Indirect Taxes	3.22	3.78	4.40
Income Tax	0.18	1.83	0.29
Federal Taxes	2.29	3.18	3.06
Tax/ GDP ratio	0.25	0.33	0.32

Source: DRS, ST (Comp) wing and PRAL

FY: 05-06 when the amount of GST increased to Rs. 14.5 billion. The reason behind this increase has been the heavy import of raw material in the country to fill the yawning gap between domestic demand and production.

Sales Tax at Import Stage: The maximum revenue at import stage under the head of iron and steel is generated through sales tax (Imports), contributing around 67% during 2005-06. In absolute terms Rs. 14.5 billion were collected during 2005-06 as compared to Rs.5.9 billion in 2003-04 and recorded a growth of 145.3%.

Domestic Taxes: Three domestic taxes i.e., sales tax on domestic consumption, federal excise on production and income tax on the personal income and property with different rates are generally applicable. FED applicable on iron and steel production in the past has been withdrawn to encourage local production and reduce construction cost. Thus, the industry is subjected to two taxes.

The GST (domestic) collection from iron and steel products has declined over the period of last three years to Rs. 1976 million in 2005-06 against Rs. 3540 million in 2003-04. The disaggregated position by GST registered persons shows that the major chunk (more than 95%) of sales tax domestic is being realized from the manufacturers. Within manufacturers, the contribution of the PSM was 90% in FY: 03-04, 69% in FY: 04-05, and 30% in FY: 05-06. It is rather difficult to understand why the contribution of other categories, especially the wholesalers, distributors and retailers is so low. Is it due to the taxation structure currently in vogue? If so, then there is a need to review it to make the system tax compliant. Similarly, the PSM appears to be more tax compliant than others as its contribution remained much higher than others, especially during FY: 03-04 and FY: 04-05. Moreover, its contribution appears to be quite consistent with its production. The same has not been the case for other steel producers.

Table 6: Category-wise Sales Tax Domestic Collection of Iron and Steel Sector

Categories	Collection (Rs. Million)			Share (%)		
	Jun-04	Jun-05	Jun-06	Jun-04	Jun-05	Jun-06
Manufacturers	3456.8	3364	1885.2	97.7	97.5	95.4
Importers	45.6	29.5	34.5	1.2	0.9	1.7
Exporters	0.4	2.2	0.9	0.0	0.1	0.1
Wholesalers/Distributors	31.5	48.7	49.5	0.9	1.4	2.5
Retailers	5.5	5.1	6.2	0.2	0.1	0.3
Total	3539.8	3449.5	1976.3	100.0	100.0	100.0

Table 7: Taxable Sales and Input Output Ratio in Iron & Steel Sector 2005-06

Categories	Taxable Sales	Input	Output	I-O Ratio (Rs. Million)
Manufacturers	103870.6	11832.4	11598.2	102.0
Importers	13712.4	1822.4	2084	87.4
Exporters	488.7	70.9	73.5	96.5
Wholesalers/Dist	16634.8	2370.2	2635.7	89.9
Retailers	2221.9	311.5	333.3	93.5

Total	136928.4	16407.4	16724.7	98.1
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**Table 8: Collection from PSM as Compared to Other Units of
Iron and Steel Sector**

	2003-04	2004-05	2005-06
	<i>(Rs. Million)</i>		
PSM			
Customs	432	120.6	251.1
Sales Tax (Imp)	1360.4	2177.5	1473.3
Sales Tax (Dom)	3,104.9	2,333.7	565.5
Income Tax	118.1	3,646.9	607.4
Total	5,015.4	8,278.7	2,897.3
Others			
Customs	3,717	5,319	6,973
Sales Tax (Imp)	4,558	6,997	13,043
Sales Tax (Dom)	435	1,117	1,411
Income Tax	208	234	141
Total	8,917.6	13,667.9	21,567.3
PSM + Others			
Customs	4,149	5,440	7,224
Sales Tax (Imp)	5,918	9,174	14,516
Sales Tax (Dom)	3,540	3,450	1,976
Income Tax	326	3,881	748

Total	13,933.0	21,945.6	24,464.6
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Table 9: Collectorate-wise and Category-wise share % of ST (D) Registrants and Collection (2005-06)

		Manufac-					Total
		Turers	Importers	Exporters	Whole/Dist	Retailers	
Faisalabad	Registrants	0.7	0.2	0.0	2.0	7.8	1.4
	Collection	0.2	0.0	0.0	1.4	0.5	0.2
Gujranwala	Registrants	12.2	21.1	33.3	6.2	2.0	10.9
	Collection	12.0	70.4	11.1	1.0	0.0	12.7
Hyderabad	Registrants	0.7	0.0	0.0	0.2	0.0	0.3
	Collection	0.2	0.0	0.0	0.0	0.0	0.1
LTU(K)	Registrants	1.0	0.0	0.0	0.0	0.0	0.3
	Collection	42.8	0.0	0.0	0.0	0.0	40.9
Lahore	Registrants	58.9	7.3	16.7	38.6	19.6	37.1
	Collection	35.1	9.0	0.0	72.0	3.2	35.4
Multan	Registrants	0.2	0.0	0.0	1.3	2.0	0.8
	Collection	0.0	0.0	0.0	0.4	0.0	0.0
Peshawar	Registrants	2.8	1.1	12.5	1.0	19.6	2.0
	Collection	1.7	0.0	0.0	0.0	0.0	1.7
Quetta	Registrants	1.0	0.2	0.0	0.4	0.0	0.5
	Collection	0.1	0.0	0.0	0.4	0.0	0.1
Rawalpindi	Registrants	5.8	1.1	4.2	3.3	3.9	3.6
	Collection	4.2	0.0	0.0	0.8	81.9	4.2
STH	Registrants	18.5	69.6	33.3	47.0	45.1	43.8
	Collection	3.8	20.6	88.9	23.8	14.4	4.7
Karachi	Collection	3.8	20.6	88.9	23.8	14.4	4.7
Total (Collection & Registrants)							

Registrants)	100.0	100.0	100.0	100.0	100.0	100.0
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Income Tax: The share of Income tax collection from Iron and Steel sector has been 0.2%, 1.8% and 0.3% in year 2003-04, 2004-05 and 2005-06 respectively. The contribution of income tax is very low as compared to 3.2%, 3.8% and 4.4% share of the industry in indirect taxes during the same period. It is a paradox that the sector, which is backbone of the economy and plays a key role in the provision of raw material for the capital formation and economic development, itself not paying the income tax as per capacity.

Concluding Remarks

Keeping in view the size and volume of business transactions of the industry, its contribution in federal taxes has been insignificant. The industry as a whole has paid Rs. 24.5 billion tax during FY: 2005-06, out of which income tax has been only Rs. 0.8 billion. The lower contribution in income tax by the sector is a disturbing aspect. Secondly, major contribution, particularly with regard to domestic taxes, comes from the PSM. The share of the remaining industry, other than PSM, has been quite low. It appears that the state owned entities are more reliable and dependable source of tax revenue as compared to private enterprises. Thirdly, on the basis of geographical location of industrial units, the compliance ratio both in terms of sales tax and income tax is not satisfactory. It has been found that the regions like Lahore and Gujranwala, where maximum industry is located, are not paying their due share of taxes.

While effort has been made to carryout analysis on the basis of consistent data base, yet it remains defective. The required information, especially on production, capacity, and capacity utilization, is not readily available. The Federal Bureau of Statistics (FBS) has to have a comprehensive database with regard to industrial base. Similarly, the information available with PRAL needs to be updated to improve its reliability. May be more time is needed to be spent on data coding, cleaning, checking and verification. There is an urgency to assign dedicated teams to work

on database in view of the on-going reorganization of internal taxes in the shape of Regional Tax Offices (RTOs). In the process, the Master Index would also become a reliable source of information for comparison purposes. The efforts to clean the data will eventually lead to minimize tax evasion.

The study has demonstrated that there is a dearth of training and research institutions in the country to train the local workers and technicians. Poor HRD is a major concern for the manufacturing sector and the Steel Industry is no exception to this. To fill the skill-gap in the country it is vital that quality institutions are established to train workers on the modern lines. NAVTA alone cannot handle this job. Unfortunately, no effort has been made by the Industry itself to promote technical education in the country. The inefficiencies prevalent in the system highlights the need for effective public-private partnership to improve to meet the current and future manpower demands.

Finally, the fixed tax system needs a comprehensive review, as the present setup has created distortions in the system. The low level of compliance vividly demonstrates that despite special concessions and exemptions, including the special (fixed) tax regimes, the system is being abused. Such distortions not only reduce tax collection (realized collection remains below potential), they also discourage documentation of the economy and create further difficulties for undertaking effective audit. Thus, the study strongly recommends regular (and similar) tax treatment for every industrial unit, including iron and steel, to have an equitable and efficient taxation system.

III

Sectoral Contribution in GDP and Taxes: Seeking Further Insight¹³

Introduction

This study presents further insight on the contribution of various sectors of the economy to Gross Domestic Product (GDP) and taxes. To start with, a one-to-one correspondence was established between goods and services classified within the National Income Accounts (NIA) framework and direct and indirect taxes collected by CBR.¹⁴ To substantiate these results, Average Effective Tax Rates (AETR) were calculated. The quantitative analysis confirmed, beyond any doubt, that there has been a great mismatch between the way various sectors contribute towards GDP and taxes. While there is no denying to usefulness of these arithmetical calculations in quantifying the lopsidedness in the system, the real concern is why this asymmetry or unevenness arises? Which features are responsible for creating such distortions in the taxation system and how quickly these could be sorted out so that the issue of revenue inadequacy for the government is effectively addressed?

The present study aims at answering these concerns. It starts with the estimation of Revenue Productivity (RP) to serve as an additional measure of efficiency of the tax system. This is followed by an exhaustive discussion on the contribution of various sub-sectors of the economy to separate the reasons for lopsidedness. The analysis focuses on two major issues, namely, the extent of exemptions and concessions that provide 'legal' basis for non-

¹³ *Authors:* Ms. Robina Ather Ahmed, Chief (Fiscal Research & Statistics), and Dr. Ather Maqsood Ahmed, Member (FR&S), CBR Islamabad.

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¹⁴ See Robina Ahmed and Ather M. Ahmed (2006) 'Sectoral Contribution in GDP and Taxes: In Search of the Missing Link' *CBR Quarterly Review*, Vol. 6 No. 2, October - December, pp. 31-45.

payment of taxes, and the nature of tax regimes within various taxes that create peculiar set of distortions on their own. The discussion in this section revolves around the withholding tax regime, the extent of depreciation allowance, and minimum and presumptive tax regimes. Major findings of the study are summarized towards the end.

The Concept of Revenue Productivity

This indicator measures the extent to which revenues that should be received given the rate and potential base compared to what are actually being realized. It is measured as the ratio of the effective to statutory tax rate.¹⁵ Algebraically Revenue Productivity (RP) is defined as:

$$RP = \frac{\text{EffectiveRate (ER)}}{\text{StatutoryRate (SR)}} < 1$$

RP takes a value of unity when ER equals SR. However, this seldom is the case as ER generally falls short of SR due to exemptions and concessions. When expressed in percentage terms, the ratio would be less than or equal to 100, and nearer it is to 100, the closer would be the collection to potential within the announced rate structure.

International Evidence on RP

We start with international evidence on RP. Unless specified otherwise, the comparison relates to Corporate Income Tax for 2003 (Table 1). Whereas the statutory corporate has been around 35% for majority of the economies, low rates of less than 20% were opted by Hungary, Chile, and Poland in early 2000. This confirms that there are economies that had taken bold initiative of reducing corporate rates when others were still contemplating on this issue. While it may be difficult to conclude whether or not low rates have been responsible for higher RP, it seems reasonable to assume that the tax

¹⁵ See Kramer, Moritz and Eileen Zhang (2004) 'Flexibility in Taxing Time - A New Index of Governments' Revenue Raising Potential' London: Standard and Poor.

Table 1: Revenue Productivity of CIT (2003): An International Comparison

Countries	Statutory CIT Rate	Corporate Taxes/GDP	Revenue Productivity
India	35.9	2.3	6.4
Argentina	35.0	2.7	7.7
Bolivia	25.0	1.8	7.2
Chile (2001)	17.0	4.6	27.2
China	33.0	2.5	7.5
Colombia	35.0	4.7	13.4
Hungary	16.0	8.0	49.8
Indonesia	30.0	1.7	5.5
Mexico (2000)	33.0	5.0	15.3
Pakistan	35.0	3.6	10.2
Peru	30.0	3.4	11.4
Philippines	32.0	2.6	8.2
Poland	19.0	4.9	25.6
Russia	24.0	4.0	16.6
Singapore (2001)	22.0	8.0	36.5
South Africa	37.8	5.5	14.4
Thailand	30.0	3.0	10.0
Turkey	33.0	2.5	7.6
Ukraine	25.0	5.0	20.0
Uruguay	35.0	2.6	7.4
Venezuela	34.0	14.7	43.1
All: Mean	29.0	4.5	17.2

Source: IMF Working Paper (2006)¹⁶

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¹⁶ Alesina, G. and Wacziarg, R. (2006) "The Tax System in India: Could Growth Be Higher?" IMF Working Paper No. 06/93, IMF, Washington D.C.

' IMF Working Paper No.

Detailed Sectoral Analysis

In an effort to understand why RP is low in Pakistan, we have computed RP of the four leading sectors of the economy, i.e., agriculture, mining and quarrying, manufacturing and services. Since the rate structure varies significantly across direct and indirect taxes and at the same time burden of one type of tax vis-a-vis other also differ, therefore RP is decomposed by type of tax and sectors. In the second step, the same exercise has been repeated for leading industries in the manufacturing sector and also for sub categories of services within the services sector.

The detailed sectoral calculation of RP re-confirms the earlier results that the sectoral contribution is quite low and worrisome not only across taxes but also sectors. On the whole, 64% of potential revenue is being collected from the manufacturing sector and 57% from mining and quarrying sector. Whereas the services sector contributes only 13% of its potential, the contribution of agriculture sector is far too low to be regarded as significant. Hence, the overall RP reduces to only 20% (Table 2).

Splitting of RP into direct and indirect taxes sheds intriguing insight to the problem. For instance, for FY 04-05 the RP estimate of direct taxes has been only 8% if SR of 35% is chosen. However, for a low SR of 20%), RP increased to 14%. Since part of agriculture income is tax exempt, with due allowance for this exemption, the RP increased to 17.6%). On the other hand, RP of indirect taxes has been 25% for SR of 25% (GST 15%, Customs Duties 8%, and FED 2%). This means that only 17.6% of the *potential* revenue is being generated through direct taxes and 25% through indirect taxes.

As expected, the direct tax RP of agriculture sector is nearly zero and it is only 2% for indirect taxes. Similarly, 13% contribution of services sector is way below its potential. In fact, it is estimated to be only 6% for direct taxes. Similarly, RP of 11% for indirect taxes

Table 2: Sectoral Average Effective Tax Rate (AETR) and Revenue Productivity (RP) of Federal Taxes (2004-05)

Economic Activities	Indirect			Direct			Total		
	Taxes	AETR	RP	Taxes	AETR	RP	Taxes	AETR	RP
Agriculture	6.1	0.00	0.02	0.2	0.00	0.00	6.3	0.00	0.01
Mining & Quarrying	44.1	0.25	0.99	1.2	0.01	0.03	45.3	0.25	0.57
Manufacturing	251.7	0.23	0.91	6.5	0.06	0.30	31.7	0.29	0.64
Services	105.2	0.03	0.11	116.6	0.03	0.15	221.8	0.06	0.13
Grand Total	407.0	0.06	0.25	183.4	0.03	0.14	590.4	0.09	0.20

Assumed Statutory Rates: Direct Taxes 20%, Indirect Taxes 25%

Table 3: Manufacturing Sector Average Effective Tax Rate (AETR) and Revenue Productivity (RP) of Federal Taxes (2004-05)

Economic Activities	Indirect Taxes	AETR RP		Direct Taxes RP	AETR	Total Taxes	AETR	RP
Petroleum	27.1	0.42	1.04	28	0.43	55.1	0.85	1.41
Automobiles	23	0.76	0.95	4.3	0.14	27.3	0.9	0.9
Machinery	20.3	0.4	1.58	3.7	0.07	24	0.47	1.04
Cigarettes	27841	0.66	1.66	1.2	0.03	29	0.69	1.16
Iron & Steel	18.1	0.26	1.03	0.5	0.01	18.6	0.26	0.59
Chemicals	21.4	0.23	0.93	8.3	0.09	29.7	0.32	0.72
Textiles	-22.7	-0.07	-0.28	8.2	0.03	-14.5	-0.05	-0.1
Edible Oils	15.7	0.55	1.11	1.7	0.06	17.4	0.62	0.88
Cement	14.8	0.42	1.05	1	0.03	15.7	0.45	0.75
Sugar	8	0.21	0.83	0.7	0.02	8.7	0.23	0.5
Food & beverages	7	0.07	0.18	0.8	0.01	7.8	0.08	0.17
Fertilizer	4.1	0.14	0.56	2.3	0.08	6.4	0.22	0.49
Other Manufacturing	87.1	0.43	1.73	4.5	0.02	91.6	0.46	1.01
Manufacturing	251.7	0.23	0.91	65.4	0.06	317	0.29	0.64

Statutory rate (indirect taxes): petroleum 40, automobile 80, cigarettes 40, edible oils 40, cement 40 and F&B 37.

Table 4 : Services Sector Average Effective Tax Rate (AETR) and Revenue Productivity (RP) of Federal Taxes (2004-05)

Economic Activities	Indirect			Direct			Total		
	Taxes	AETR	RP	Taxes	AETR	RP	Taxes	AETR	RP
Construction	0.3	0	0.01	0.3	0	0.01	0.7	0	0.01
Electricity & Gas Distribution	26.7	0.13	0.52	2.7	0.01	0.07	29.3	0.14	0.32
Transport Storage & Communications		0	0	0.4	0	0.01	0.4	0	0
Telecom	20.4	0.04	0.16	18.4	0.04	0.18	38.8	0.07	0.16
Wholesale & Retail Trade	39.8	0.04	0.14	16.1	0.01	0.07	56	0.05	0.11
Sale, Maintenance/ Repair of motor Vehicles	16.8	0.21	0.85	0.5	0.01	0.03	17.2	0.22	0.48
Wholesale Trade and Commission Agents		0	0	4.1	0.02	0.11	4.1	0.02	0.05
Retail Trade except motor vehicle	21.6	0.03	0.13	10.5	0.02	0.08	32.1	0.05	0.1
Hotels & Restaurants	1.5	0.01	0.04	1	0.01	0.03	2.5	0.02	0.04
Finance & Insurance		0	0	24.9	0.11	0.53	24.9	0.11	0.24
Ownership of Dwelling		0	0	0	0	0	0	0	0
Public Administration & Defense	6.5	0.02	0.08	8.5	0.02	0.12	15	0.04	0.1
Other Services	11.5	0.02	0.08	45.2	0.08	0.41	56.6	0.1	0.23

Services	105.2	0.03	0.11	116.6	0.03	0.15	221.8	0.06	0.13
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Analysis of Services Sector

The services sector presents a gloomy picture. Not only that AETR is low, the RP is also unsatisfactory. In fact, except for few sub-sectors like telecom, finance and insurance, electricity and gas distribution, and sale maintenance and repair of motor vehicles, most of the other services have negligible tax contribution. As a consequence, RP is extremely low (Table 4).

When decomposed into direct and indirect taxes, it becomes immediately clear that barring finance and insurance and other services, no other sub-sector makes any significant direct tax contribution. As a matter of fact, the revenue realized from construction, transport, storage and communication, sale, maintenance of motor vehicles and hotels and restaurants remains frightening below their respective potential. While this situation improves slightly when indirect taxes are considered, it also remains worrisome.

Admittedly services sector has always been a difficult-to-tax area, but a mechanism has to be developed to tax economic activities taking place in this sector. The tax administration cannot ignore this sector whose overall contribution to GDP is over 50% and this share is growing with the passage of time.

Reasons for Lopsidedness

The wide gaps in AETRs and RP indicate that there are different tax treatments for different economic activities. As indicated, RP is generally low because widespread exemptions, concessions and incentives are enjoyed by various sectors and sub-sectors of the economy. Similarly, diversified tax regimes provide opportunities for reduced tax liability or encourage operations in the informal economy thereby creating difficulties of effective resource mobilization. We start with the implications of exemptions and concessions on tax collection.

Exemptions & Concessions

Within four federal taxes, exemptions and concessions are available through law to various sectors, regions and activities. Sometimes these are granted to act as a safeguard against the regressive impact of taxation system; at other places these are available to promote industrialization. Under the existing regime of taxation, exemptions are granted through the 2nd Schedule of the Income Tax Ordinance, 2001 and the 6th Schedule of the Sales Tax Act, 1991. In case of Customs, general concessions are granted under Section 19 and special concessions are available under Section 20 of the Customs Act, 1969.

The various types of exemptions and concessions under the Income Tax Ordinance, 2001 include exemptions of income - for instance, income earned by research organizations, power companies, mutual funds, capital gains, industries set up in the industrial zones -reduction in tax rates to such entities as M/s Fauji Foundation and Army Welfare Trust, reduction in tax liability to professions like pilots, flight engineers, full time researchers and teachers, and exemption from specific provisions, for example, industries operating in Export Processing Zones.

Under the Sales Tax Act, 1990 exemptions are provided to food items, Defense Stores (whether manufactured locally or imported by the Federal Government including trucks, trailers and vehicles), ships, aircrafts, tractors, bulldozers and combined harvesters and import and supply of CNG Euro-2 buses (whether in CBU or CKD condition) etc.

Some of the sectors enjoying wide-ranging exemptions and concessions are analyzed in the following.

Agriculture: The agriculture sector as specified in NIA includes major and minor crops, livestock, fishery and forestry. Its

contribution to GDP is more than 20%, but its share in total federal taxes is less than 2%. The reason being, that while vesting the power to tax incomes on the Federal Government, presumably as a legacy of history, the Constitution excluded income from agriculture from the purview of the federal income tax. Thus, violating the canon of horizontal equity and opening up scope for evasion. Moreover, under the income tax law, a person having agriculture and non-agriculture income is liable to pay income tax only on the non-agriculture income if the agriculture income exceeds Rs. 80,000. Experience shows that income from other sources is also reported under agriculture income to avoid taxation.

In case of provincial income tax, a paltry amount of less than Rs. 2 billion is collected by the provincial governments as presumptive tax and this is mostly from Punjab. Sindh and the NWFP make an insignificant contribution, while Balochistan has no contribution at all. The only federal tax paid by the agriculture sector is in the form of indirect tax on agricultural inputs like fertilizer and pesticides.

Food and Beverages: Food & beverages having a 2% share in GDP and about 10% share within manufacturing has the lowest revenue productivity of 2% in direct taxes and 27% in indirect taxes. Food is generally exempt from indirect taxes. Under 6th Schedule of the Sales Tax Act, 1990, all types of foods, agriculture or marine, including fruit juices and cereals are exempt from sales tax and customs duty at domestic or import stages. Only the processed food and beverages are liable to tax.

Selective or general, taxation of food is a controversial issue. Whereas exemption of food is considered a pro-poor policy to alleviate poverty, it is also argued that on efficiency grounds exemption of food from sales tax or VAT is a socially costly policy. Food is not only consumed by poor, but also by middle and high income groups. It is generally argued that this issue can be handled

rather effectively through expenditure policies in the form of targeted subsidies, social safety nets, food stamps etc. rather than distorting the VAT system.

Textiles: With 5% share in GDP and about 29% in manufacturing, it is the main industrial activity in the country. The economy is heavily dependent on the textile sector for creation of employment opportunities and export earnings. However, partly as a result of zero-rating of sales tax and partly due to the wide-ranging tax exemptions and concessions granted by the taxation system due to pressure by the strong textile lobby, the industry has failed to contribute effectively to federal tax receipts. As a result of zero-rating of exports for sales tax purposes, a huge amount of refund was created in the past. In 2004-05 CBR paid Rs. 40.7 billion as refund and rebate to the textile industry whereas the industry paid only Rs. 13.8 billion as indirect taxes (sales tax, customs and excise). Resultantly, the net revenue paid by the industry was (*negative*) Rs. 26.79 billion. In case of income tax, the only payment made by the industry is through withholding taxes at the export stage, where tax rate currently in vogue ranges between 0.75% and 1.5%. The amount of tax collected through this tax regime has been an un-impressive sum of only Rs. 4.5 billion.

To deal with this issue, the entire textile chain from ginning to ready made garments was zero-rated for VAT purposes in 2005-06. The inputs used in the industry including electricity and natural gas are also zero-rated. Furthermore, to improve competitiveness, textile machinery was also exempted from customs duty.

Since, 80% of textile produce is exported and the rest is sold in the domestic market, to recover tax on domestic sale a 3% retail tax was introduced that included 2% sales tax and 1% income tax on retailers of textile. However, an insignificant sum of Rs. 12.1

million was collected under this scheme which included Rs. 4.4 million in income tax and Rs. 7.7 million in sales tax.

At this stage it is pertinent to determine whether the textile sector is paying any amount under the heads of sales tax or income tax on its domestic supplies that are not zero-rated. A very simple calculation shows that for the textile sector GDP of Rs. 319,541 million, if 80% is exported and only 20% of value addition is sold locally, then at the rate of 15% sales tax, there is a tax potential of Rs. 9,586 million for sales tax alone. Even if the reduced rate 3% is applied, it should result in a tax yield of at least Rs. 1,917 million. As indicated, the collection is no where near this amount.

Sugar: Sugar industry is regarded as the second largest industry after textile. However, for one reason or another, the industry has not played its role in tax contribution. Within the manufacturing sector, the sugar industry provides about 4% of the value addition whereas its share in direct and indirect taxes is around 2% and 0.4% respectively only. This translates into RP of 83% for indirect taxes and only 9% for direct taxes. A historical profile of the industry confirms that its functioning has always been encouraged through peculiar economic policies. Handicapped either by obsolete sugar processing technologies or insufficient R&D support, it has always tried to take refuge behind concessionary provisions of taxation policies to keep its profitability intact. A careful analysis shows that it used to enjoy wide-ranging exemptions and concessions. Subject to excises and sales tax earlier, since 1999, the industry is enjoying total exemption from federal excise.

Besides these legal exemptions, the industry has a long history of controversies and scams too. It has remained an 'object of confrontation' between tax collectors and taxpayers. An analysis of individual sugar units in the country reveals an interesting fact that there is a large discrepancy in value addition across operational units

- e.g., two sugar mills located in Faisalabad have indicated such diverse value addition as 3% and 96% during the same year.¹⁷ Such discrepancy creates enough apprehensions about low tax compliance by the industry that needs to be sorted out.

Transport and Storage: T&S sector in GDP includes passenger and freight transport by rail, road water or air. It also includes auxiliary activities like terminal and parking facilities, cargo handling, storage and postal and telecommunication activities. With the exception of telecommunication the rest of the sector enjoys a very light tax treatment. With a 4% share in GDP its contribution to taxes is virtually nil. The transport sector is subject to a very nominal withholding tax @ Rs. 250 to Rs. 2000 in case of passenger transport vehicles plying for hire according to their seating capacity and Rs. 1,200 to Rs. 36,000 in case of goods transport vehicles according to their registered laden weight. For indirect taxes airplanes, buses, wagons, railway carriages are exempt from customs duty. The services provided by the transport sector do not carry any tax either with the exception of courier service and air travel. There is no service tax on transport by bus or train. With a value addition of Rs. 267 billion to GDP, this sector carries a big revenue potential as the activities are expected to increase further with the growth in economy and the development of related infrastructure.

Hotels & Restaurants: H&R is quite a significant activity in the economy - contributing 2.4% to the GDP and about 5% to the services. However, AETRs to the extent of only 1% in direct and indirect taxes and RP of 4% for indirect taxes and 3% for direct taxes is alarmingly low. It is feared that the scale of tax evasion in this sector is very high.

¹⁷ Value addition measured as 1-input output ratio.

The study by the FBS indicates that restaurants cafes and other eating places account for 60% of the total hotel & restaurants activity. The average value added per establishment in hotel industry is Rs. 1,247,000 and Rs. 231,000 in restaurants and cafes. Of the hotel enterprises, 83% remain operational throughout the year and the remaining 17% are seasonal.¹⁸

There are two other booming sectors of the economy which require a careful interpretation in this context. These include telecom and automobile sectors whose contribution in indirect taxes is substantial but not quite as much as one would have expected for income tax.

Telecommunication: Liberalization and deregulation of telecomm sector in 2003 and the associated inflow of FDI has made Pakistan one of the fastest growing markets in telecommunication. As a result, the magnitude of indirect taxes has increased from Rs. 12.3 billion in 2002-03 to Rs. 23 billion in 2004-05. However, the contribution in direct taxes is significantly low. With 98% of the direct taxes contributed by PTCL and NTC, the contribution of the private sector is negligible. As discussed earlier, notwithstanding the rather high contribution in shape of indirect taxes, the AETR is only 4% and revenue productivity is 16%. In direct taxes, the AETR for telecomm is 4% and revenue productivity is 8%. Primarily because of wide-ranging exemptions and concessions allowed by the tax code, such as declining corporate tax rates, allowance of remittance capital, profits and dividends, allowance of royalty and technical fee, and R&D fund 1% of adjusted gross revenue. However, with the completion of gestation period on investment by the private sector in telecomm, one should expect a fair contribution in years to come.

¹⁸See the study on Wholesale & Retail trade, Hotels & Restaurants in Pakistan by the Federal Bureau of Statistics, Islamabad, March 2002.

Automobile: Automobile is the only highly protected industry in Pakistan. Even though the protection provided earlier against import through high tariffs has been reduced only recently, this sector continues to present 'tariff peaks'. As a result, the contribution of the sector during 2004-05 in the shape of customs duty on import of CBU, CKD and SKD has been quite significant. On the other hand, despite increased production and profitability, the income tax revenue from this source has decreased from Rs. 4,521 million in 2003-04 to Rs. 3,846 million in 2004-05. The three big car manufacturers, i.e., the Pak Suzuki Motors, Honda Atlas Cars, and Indus Motor Company have paid Rs. 826 million, Rs. 615 million and 608 million, respectively as sales tax. In income tax these companies have paid only Rs. 845.6 million, Rs. 207 million and Rs. 725.2 million, respectively. Resultantly, the average effective tax rate (i.e., collection as percentage of tax base) in case of indirect taxes has been 76% but only 14% in the case of direct taxes.

We now turn to the next important issue related to tax regimes.

Tax Regimes

Besides exemptions and concessions there are various tax regimes like treatment of depreciation of the assets, withholding taxes, minimum taxes and presumptive taxes that promote tax evasion and tax avoidance, narrow down the tax base, discourage compliance and reduce sectoral contribution towards taxes.

Depreciation: The adequacy of the depreciation rates depends on the period of the useful life of the asset. The depreciation is granted either by the diminishing balance method or the straight line method. Past and expected rates of growth of prices of capital goods are also taken into consideration. The tax treatment under the income tax law for capital assets takes into account returns from capital and enables companies to recover tax free the original investment leaving tax applicable only to the return on the

investment. The Income Tax Ordinance provides for depreciation rate of 10% to building, 15% to furniture, machinery and plant, 30% to computer hardware and 100% to mineral oil concerns below ground installations and 20% for offshore platforms.

Over the last couple of years drastic changes have been made in tax structure to give boost to investment including zero-rating of plant and machinery. In the presence of such exemptions and concessions the present rate of depreciation allowance is quite generous and needs to be reduced to move realistic levels.

It is also important to look at the useful life of the asset, which depends upon the extent of its use and physical determination of the asset. The legal rates do not convey the utility or useful life of the asset in question. For companies, since the Third schedule is sacrosanct, the relevance of useful life of the asset is virtually non-existent. This creates distortions in the system by claiming depreciation by the owners on idle assets. The claim for depreciation in income tax has to be substantiated with reference to ownership and usage of asset for the purpose of business.

Withholding: A large share of income of individuals, AOPs and companies is subjected to withholding tax, either presumptive or adjustable. Whereas the withholding agents are sometimes difficult to be identified, more disturbing is the fact that the withholding rates are not consistent with incomes derived in these activities. It is generally, but rightly feared, that withholding rates are substantially lower than the trade margins applicable in the open market. For instance, in case of imports the trade margins range between 20% and 25%) of the import value whereas the effective withholding rates are not more than 2%. A similar situation prevails for exporters also.

Minimum Tax Regimes: Under Income Tax Ordinance, 2001, section 113 allows a resident company which has no tax payable, to

pay tax at 0.5% of the turnover for the year. This tax is adjustable for next five years. Similarly in Sales Tax Act, 1990, under section 11 (5), a registered person who has not paid tax in the regular scheme is liable to pay minimum tax based on tax paid during the last five tax periods. Experience has shown that these provisions are often misused by the companies.

Presumptive Tax Regimes: In sales tax, there are various presumptive taxes based on fixed value addition in various sectors especially on retail and wholesale. These fixed value additions are far less than the trade margins fixed in the national income accounts. For instance, in imports the trade margins are between 20% to 25% whereas the value addition is fixed at 10%. It is important to understand that though these tax regimes are convenient in implementation, that limit the capacity of the taxation system to raise revenue to its full potential. It is important that with the introduction of far reaching reform in tax system, the usefulness and structure of these regimes is revisited periodically and updated according to the economic environment and internationally best practices.

Many other provisions in law such as allowing adjustment of a subsidiary company against income of its holding company provide room for tax avoidance. In the absence of any solid system of audit, the likelihood of tax evasion and avoidance increases further.

Concluding Observations

The analysis on the relative strength of different components of GDP and their contribution to revenue is quite revealing. Distortions in the taxation system are quite obvious. It is patently clear that growth in a number of sub-sectors does not correspond on one-to-one basis with growth in CBR tax revenue. Thus, the objective to raise tax/GDP ratio to the desired level of 14-15% is not possible without changing the existing taxation regime in a drastic manner.

It has been highlighted that higher contribution by the industrial sector does not necessarily imply that the private sector is paying higher taxes. In fact, a huge chunk of resources continue to flow from public sector or captive manufacturing units such as Pakistan Steel Mills, OGDC, and PTCL and NTC etc. Industrial sector though paying higher taxes as compared to services or agriculture sectors, yet it remains an under-performer in terms of revenue productivity. Sugar and textile industries are the leading examples of disparity between revenue growth and production growth. There is no doubt that the textile industry is passing through a difficult phase. Despite heavy investment in plant and machinery, the industry has failed to retain its competitive edge against its competitors in the post quota free era. However, a careful examination reveals that the reasons for this malaise are domestic rather than international. It is high time that the industrial setup learns to handle its affairs judiciously rather than using taxation as a scapegoat for its inefficiencies. Wide gaps in AETRs suggest that there is ample room for raising revenue productivity as the economy registers sustainable growth.

It is worth emphasizing that Pakistan has managed to escape the era of high tax rates, excessive litigation and cumbersome procedures. The tax policy currently in vogue is targeting at low tax rates and simplified procedures. Taxpayer facilitation has gained importance over a policy of coercion. With the implementation of self-assessment, the onus now falls on the taxpayers to comply with their tax obligations without any fear or favor. The downward revision in rates and a continuous effort to reduce and rationalize tariff structure means that the revenue loss to the national exchequer will have to be compensated through better tax compliance by the existing taxpayers and bringing those into tax net who are currently out of it. The present study has shown in a comprehensive manner that one of the reasons for revenue inadequacy is the existence of distortions in the system. Even though the distortions have taken many shapes but

the most serious of them is the policy of granting exemptions and concessions. Moreover, there are certain attributes of the existing tax regime that are inconsistent with international best practices. All these will have to change in a systematic manner if the aim is to raise tax/GDP ratio adequately.

IV

CBR Reform Program: Addressing the Litigation Backlog¹⁹

Background

Procedural simplicity and easy accessibility to legal system plays important role in the confidence building of stakeholders concerned with an organization. The viable and productive legal system ultimately leads the nation to acceptability of their responsibilities and useful participation in the nation building process. Many evidences are there in the world, where a good and practicable legal structure has imprinted positive reflections on the society in the shape of general behavior, active participation and trust on the state functionaries. On the contrary dilapidated system creates mistrust, non-cooperative behavior and dejection amongst the stakeholders.

It is encouraging that CBR has been the forerunner in bringing out effective changes in its legal system through simplification of rules and procedures and speedy disposal of complaints, at times in an innovative manner. This change has brought pleasant surprises for many. The purpose of this paper is to provide an update on the extent of litigation burden prior to the reform initiatives and its position as of now. The paper also elaborates on the success of the novel alternative for settling disputes offered by CBR.

History

Under the income Tax Ordinance, 1979, the returns filed by the taxpayers were subjected to 100% scrutiny. This process often resulted into disagreement between the taxpayers and the

¹⁹ Author: Mr. Umar Wahid, Secretary (Fiscal Research and Statistics) CBR.

Author's Note: The information used in the update has been provided by the Legal Wing of CBR. Their cooperation is highly appreciated.

department. Eleven Appeals Commission rates were entrusted to handle the job of litigation at first level of appeal. However, since the inflow often exceeded the disposal, the litigation burden kept on increasing over the years. A similar situation prevailed as far as indirect taxes were concerned because sales tax and federal excise collection was functioning on supervision based system. The accumulated record confirmed that there were more than 80,000 pending cases awaiting decisions at first-level of appeal. On the other hand, even though the magnitude of pending appeals at the Tribunal, High Court and Supreme Court levels was far less in number, but the entire process was very time and energy consuming. On the administration side, specialized legal wing to monitor the performance of the field offices was generally absent. No wonder that the taxpayers were facing difficulties and the system started to degenerate at a rapid pace; thereby creating a wedge of mistrust between the taxpayers and tax administrators.

The Initiatives:

The tax policy and administration reforms program has been designed to change the entire complexion of the organization. The promulgation of Income Tax Ordinance 2001 was the first step toward addressing the issues. The introduction of the concept of universal self-assessment (USAS) for all categories of taxpayers, without any conditionality was a major break through in this pursuit. 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 receipts. However, a limited percentage of cases are selected for audit on risk assessment basis for various classes of taxpayers in income tax. A change in the advance tax regime has also helped in reducing the institution of fresh appeals. Similarly, the introduction of self clearance system in the sales tax and federal excise structures has also helped in elimination/ reduction of fresh appeals to a great extent. On the

Table 1 Restructuring of the Appeals Commissionerates

Years	Existing Offices	Merged Offices	After merger position
March 2005		Nil	Nil
August 2006	16	5 CIT (A) III Lahore CIT (A) VI Lahore CIT (A) II Islamabad CIT (A) Sialkot CIT (A) III Karachi	11
January ,2007	11	4 CIT (A) Faisalabad CIT (A) II Lahore CIT (A) Peshawar CIT (A) II Karachi	7
March, 2007		1 CIT(A) Rawalpindi	6 5
7 April, 2007		1 CIT(A) Hyderabad	

Table 2: Restructuring of the Appeals Collectorates

Years	Existing Offices	Merged Offices	After merger position
March 2005		Nil	11
August 2005	11	2 Karachi III	9
August, 06	9	Quetta 1	8
January, 07	8	Gujranwala 2 Karachi II Peshawar	6

April, 2007

Nil

6

Table 3: Disposal and Pendency of of Direct and Indirect Taxes during FY: 2006-07

(Numbers)

Months	Opening	Fresh	Total	Disposal	Balance
	Balance	Institutions			Pendency
July, 2006	3,131	2,251	5,382	1,818	3,564
August, 2006	3,564	2,364	5,928	2,200	3,728
September, 2006	3,728	2,483	6,195	2,329	3,866
October, 2006	3,866	1,911	5,777	1,997	3,780
November, 2006	3,780	1,612	5,392	1,978	3,414
December, 2006	3,414	2,374	5,788	3,251	2,537
January, 2007	2,537	3,028	5,564	2,133	3,431
February, 2007	3,431	3,133	6,564	2,554	4,010

March, 2007	4,010	3,025	7,035	2,714	4,321
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Table 4: Latest Progress on Alternate Dispute Resolution (ADR)
(As on 31-03-2007)

Tax Head	Applications received	Rejected/ Withdrawn	Committee Formed	Recommendation Received	Recommendation Rejected	Recommendation Implemented
Income Tax	251	85	149	91	19	68
Customs	208	28	151	90	28	61
ST&FE	749	46	698	211	14	162

Total	1208	159	998	392	61	291
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