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A Review of Resource Mobilization Efforts of Federal Board of Revenue

FEDERAL BOARD OF REVENUE

Government of Pakistan

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Foreword

The current issue of the FBR Quarterly Review provides an update on FBR revenue generating efforts. The in-depth analysis of data for July-March 2007-08 provides an insight into various components of federal taxes. The Review analyzes the factors that were responsible for less than the targeted collection. It also highlights how extra efforts through demand creation have been instrumental in reducing the gap emanating from reduced voluntary payments. The overall shortfall at the end of third quarter has been restricted to Rs. 35 billion.

Besides revenue analysis, the current issue includes an article on the Petroleum Sector in Pakistan. The paper evaluates the contribution and significance of the sector in transforming the national economy. Using historical evidence, the study explores how the sector has grown, its contribution to the economy and taxes. An update on The Tax Policy Program (TAP) has also been included which highlights the importance of seven studies initiated at FBR in collaboration with the World Bank and the Andrew Young School of GSU to strengthen the taxation policy framework for short to medium and long term. The focus of these studies is on incidence of taxation on various segments of the society, tax-gap analysis, and enterprise taxation in Pakistan.

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

M. Abdullah Yusuf
Secretary General Revenue Division/Chairman, FBR

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FBR Tax Collection: An Analysis of the Q3: 07-08 Outturn[1]

Our greatest glory is not in never-falling, but in getting up every time we do.
Confucius (551 BC – 479 BC) Chinese Philosopher & Reformer

The Economy

There is no doubt that the entire world, including Pakistan, is trying to grapple with the impact of steep rise in prices of petroleum and primary products. However, the severity of macroeconomic pressure at home has reached alarming proportions. Besides external shocks, our economy is also confronted with additional internal disturbances in the shape of power and food crises, political instability, and incessant law and order situation. Resultantly, the pinch of economic hardship is being felt to the extent that the projections for real growth of the economy have been revised downward. It is indeed unfortunate to see macroeconomic stability slipping away that was ensured so painstakingly over the past many years. Surely, the resurfacing of fiscal and current account deficits, deterioration in debt burden, soaring inflation, and the continuous depreciation of currency have serious adverse implications and require immediate attention. However, the foremost requirement is to implement a plan of action that helps in arresting the slide of the economy. Once this objective is achieved, it should lead the way to reactivate the growth process through second round of policy interventions.

Let's examine each of the core macro imbalances separately. Regarding price instability it is important to determine the root cause of the malaise to offer any remedial advice. We believe that it has originated from three main sources. Firstly, the near doubling of

[1] Dr. Ather Maqsood Ahmed, Member (FR&S) has written the review of the economy. The rest of the document has been prepared in collaboration with the research team of the Fiscal Research Wing of FBR. The support of the staff of the Budget Wings of Direct and Indirect Taxes, and Computer wings of DRS and sales tax is gratefully acknowledged.

international price of oil has created inflationary pressure in most of the oil importing countries, including Pakistan. However, the situation in the country has been further complicated by initial hesitation and indecision on whether or not to shift the burden forward. Unfortunately, despite this reluctance, the egotistical have failed to avoid its spiraling effect on domestic prices. Secondly, the sharp increase in international prices of primary products (wheat, rice, edible oil, and basic metals) has put tremendous pressure on the domestic economy. As a result, not only has the cost of production risen sharply, eroding corporate profitability, the phenomenon has also introduced uncertainty in the system with its own adverse ramifications. Finally, the supply constraints related to basic food stuff, primarily wheat flour (*atta*) have played havoc with the overall situation. Regrettably, this has more to do with 'human error' than anything else. Failure to have effective control through timely intervention has fueled the inflationary pressure at an amazing speed.

The real concern is how to deal with this situation. One of the positive aspects is that the harvesting season of wheat is in progress. It means that most of the subsistence farmers, who have cultivated wheat for their own consumption, would have sufficient stocks at least for next few months. Therefore, this segment of the population will not be at immediate risk of food scarcity. Similarly, the medium to high income groups should have no affordability problem. Thus, the only segment whose vulnerability has increased is the poor urban and rural dwellers, particularly the wage earners. It is high time that we get rid of general subsidy program and instead initiate targeted subsidies to those whose risks have increased. This will not only reduce the government expenditure on general subsidies but will also benefit those who deserve this support the most. Secondly, let the farmers accrue the benefits of the 'tilting terms of trade in their favor'. The agriculture pricing has not benefited the farmers in the past, which has added to rural poverty. Now that the domestic prices of agricultural produce have started to mirror image international prices, it is essential that we refrain from reintroducing artificial distortions. Finally, it is absolutely essential to ensure food security within the country by preserving the surplus stock of food grains, while keeping a watchful eye on hoarders and speculators.

The second issue concerns with fiscal imbalance that has also entered into the ‘unsustainable’ range. Here again effective controls have been lost due to expenditure overruns and rising debt servicing requirements. Unfortunately, not only the hard earned fiscal space has been lost, the fiscal profligacy has also rendered monetary policy ineffective in controlling inflation. While there is a usual demand for raising tax revenues to address this problem, it needs to be realized that tax collection suffers badly when there is an economic downturn, as economic growth and revenues generally rise and fall together. Furthermore, it is no secret that there are serious structural problems associated with the existing tax regime. It continues to be inefficient and lacks buoyancy; that there is a massive drain on resources due to large underground and informal economy; the provincial contribution to tax collection is low within the existing revenue sharing formula. In fact, there is hardly any incentive for generating ‘own funds’; the tax culture is almost non-existent, and above all, the stakeholders’ perceive government as a revenue-hungry leviathan having little respect for their rights.

There are two sides of this coin. While these constraints are inherent in the system and cannot be rectified quickly, especially when the chips are down, on the flip side it is also true that the tax effort is low as there is huge gap between resources generated and the potential of the economy. The mismatch between sectoral contribution to GDP and taxes highlighted about three years ago remains as stubborn as ever.[2] Using modeling approach, it has been

[2] The sectoral decomposition of GDP and taxes for 2006-07 has been found no different than our earlier estimates for 2004-05.

shown quite comprehensively that the tax contribution of many sectors of the economy is well below their potential, suggesting that there is ample scope to exploit the situation. To begin with why can't the informal sector be brought into the tax net? Within agriculture sector, dairy, poultry, and meat industries, as well as incomes from orchards and nurseries have managed to escape the system. Similarly, taxation of services, especially wholesale and retail, transport, and construction continue to avoid full payment of due taxes. Within the existing system where services remain in the provincial domain, there is little that one could do as services is a hard-to-tax area and there are capacity constraints at the sub-national level. Nonetheless, the tax-gap has to be narrowed quickly as future strength of the taxation policy lies in broadening of base. While this would require legislative changes in the tax design and its administration between federating units and the centre, it is about time that these sensitive issues are resolved once for all.

Besides revenue mobilization, the need for judicious spending of hard earned resources is also essential. The pattern of expenditure in recent years needs re-visiting in a holistic manner. The country can ill afford to maintain the status quo, especially with regard to the expenditure pattern of 'protected' heads of account and the way development spending is designed and executed.

The third area of macroeconomic instability relates to international trade transactions, where the trade gap is widening at a fast speed. Not only that there is an unprecedented increase in imports, the slowdown in exports has also increased the complexity of the situation. Some of the items that have contributed to the worsening of trade imbalance are imports of petroleum products (crude and furnace oils, diesel, and gasoline), edible oil (crude, palm olien and RBD), wheat, cotton, and fertilizer. Starting with wheat issue, it is believed that the need for extra spending on its imports would reduce considerably after a near-bumper harvesting season.

However, given the unscrupulous setup within the country, the food security of general populace, even at an extra cost, will have to be ensured to avoid unpleasant eventualities.

Similarly, swift remedial measures are also desired to discourage conspicuous consumption of items appearing in the import bill. High on priority should be petroleum products. One of the adverse implications of freezing of domestic price of petroleum products for a rather longish period has been that the consumers never felt the heat of the situation and they were never forced to adopt energy conservation measures. At the same time, the government did not offer any serious strategies to curtail the demand for fuel. The time has come to take drastic steps. The first reaction should be to pass through the burden of high oil prices without further delay. Those advocating the opposite must realize that with this level of financial crunch, no country can absorb the huge burden of subsidies. Secondly, Pakistan should do what others, especially the western economies adopted during the oil embargo of 1973. It needs to conserve energy even if it means forceful reduction of vehicular traffic on roads. A thorough review is also required in assessing the real demand for furnace oil and other petroleum products, especially for power generation. The concern that imports are actually exceeding domestic demand and low domestic price is encouraging smuggling to other countries needs to be verified. The same holds true for the imports of edible oils.

Finally, it is disturbing that monetary and exchange rate policies are under increasing stress. The evidence of past year and half confirms that the tight monetary stance has failed to arrest inflation and inflationary expectations, partly due to excessive deficit financing by SBP and also because causes of inflation are non-monetary in nature. While the logic of tight control on money creation is correct, a proper balance between the two objectives of controlling inflation and promoting growth is needed. The persistence with tighter stance has increased the cost of borrowing; that in turn has initiated the growth retardation process in the shape of lowest growth of the manufacturing sector in recent times. On the other hand, the tussle between the banking sector and the small savers and borrowers is hurting the system badly. Rather than promoting, the low return to savings is discouraging private savings, which is disappointing.[3] In addition to this, the speed of currency depreciation requires a careful review of the situation for the simple reason that instability of the rupee has adverse implications for external indebtedness and inflation. In an era where there is pressure on fiscal position, the country cannot afford to have additional expenses on external debt servicing emanating from depreciating currency.

To conclude, the current economic situation may cast a doomsday scenario for some, but for pragmatists, it is an opportunity to do what they were not able to do earlier. May we recall that a similar scare was tactfully handled in 1973 and 1979, when the initial oil price shocks were registered? Similarly, Pakistan's economy survived the worst-ever shock of world-wide sanctions after 1998 detonation. Given this history, there is reason to believe that current downturn can be managed provided appropriate and timely policy interventions are introduced with full cooperation of general masses. The challenges need to be confronted head-on by reassuring ourselves that Pakistan is not alone in this period of confusion and despondency. Like Confucius, we also have to believe that *key to glory is not in never-falling, but in getting up every time we do*, never mind we revert back to old or a new equilibrium when all the dynamics take their full effect.[4]

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[3] At the time of writing of this review, minimum rate of return of 5% was not in place. Notwithstanding the opposition from banking cartel, it is relevant to mention that the real rate of return still remains negative when adjusted for the on-going inflation. Therefore, the question how savings can be motivated to bridge the gap between savings and investment still remains valid.

[4] *The author is grateful to Mr. Mahmood Alam, Member (Customs) for a detailed discussion on this point.*

FBR Revenue Position

The fiscal year 2007-08, was a challenging for FBR as an ambitious target of Rs.1025 billion was assigned. To achieve this target, the required overall growth was 21% over the previous year collection of Rs. 847.2 billion. Unfortunately, the lingering political uncertainty and the events of December 2007 took their toll and the revenue collection faced a shortfall of Rs. 35 billion against the target of first six months. Even though, the collection improved in the months of January and February, for reasons to be discussed later, there was a further setback in March 2008. Resultantly, the gains made in the earlier months were lost and FBR collection suffered a revenue loss of Rs 35 billion at the end of March 2008. Thus, the overall collection of Rs. 679.9 billion in net terms during July-March yielded a growth of 13.9% over the collection of Rs. 597 billion of last year [For latest Position See Box 1]. Moreover, despite the fact that the refund payments had declined by 23.6%, the target for July-March 07-08 has been achieved to the extent of 95.3%.

The overall monthly collection presented in Table 1 indicates extreme volatility in growth. It has varied between 48.7% in January to -16.8% in December. Besides industrial slowdown and worsening law and order situation, these variations have been the result of change in advance tax regime for the banking sector. Under the new system, rather than paying advance tax in four installments in months ending each quarter (September, December, March and June), they are now required to pay it each month. Consequently, the collection appears to be low in quarter-end months and higher in the remaining months, especially from January onwards.

Box 1: FBR collection as of May 2008 and Year-end Prospects

By the end of May 2008, the FBR collection has reached Rs. 856.2 billion compared to Rs. 722.3 billion during the corresponding period of last year. The overall growth in collection has gone up to 18.5% -- nearly four percentage points higher than the cumulative growth of 13.9% till March 2008. Keeping in view this performance, it is expected that FBR year-end collection would be around one trillion rupees.

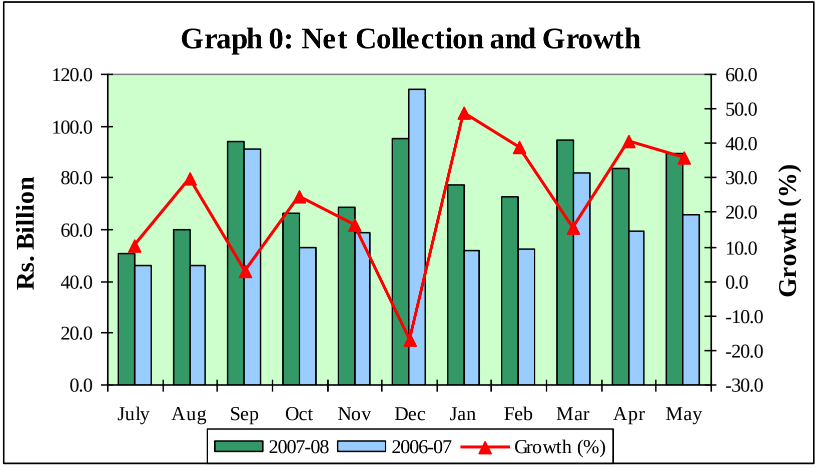

Table 1: Federal Gross and Net Revenue Receipts: A Monthly Comparison

(Revenue Receipts in Rs. Billion)

	FY 07-08		FY 06-07		Growth (%)	
	Gross	Net	Gross	Net	Gross	Net
July	55.9	50.9	54.5	46.2	2.6	10.3
August	63.0	60.1	54.0	46.3	16.7	29.8
September	100.7	94.1	101.5	91.4	-0.9	2.9
October	69.8	66.4	60.4	53.3	15.6	24.5
November	73.4	68.5	67.1	59.0	9.4	16.1
December	106.6	95.0	123.9	114.2	-13.9	-16.8
January	85.2	77.5	55.6	52.2	53.3	48.7
February	75.9	72.8	56.8	52.4	33.5	38.8
March	99.9	94.5	89.3	81.9	11.9	15.4
July-March	730.4	679.9	663.1	597.0	10.2	13.9

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

The tax-wise payment of refunds and rebates is presented in Table 2. There has been an overall decline in these payments by Rs. 15.6 billion with largest share coming from sales tax. However, zero-rated sectors continue to hold the dominant position in refunds payments as 25% of sales tax refunds (Rs. 5.1 billion) have been paid back to these sectors. This highlights the need to further examine as to why these refunds are still being created.

Table 2: Refund/ Rebate Payments: July-March Comparison

(Refunds in Rs. Billion)

	JM: 07-08	JM: 06-07	Growth (%)
Direct Taxes	20.2	25.7	-21.2
Sales Tax	20.9	29.8	-29.7
Federal Excise	0.0	0.0	0.0
Customs	9.4	10.5	-11.3
All Taxes	**50.5**	**66.1**	**-23.6**

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

Detailed Analysis of Individual Taxes

The tax-wise distribution indicates that the major shortfall has been in direct taxes due to significant reduction in voluntary compliance. Similarly GST and FED also suffered due to slowdown in industrial activity. In the case of direct taxes, the change in the advance tax regime that contemplates 'Pay as you earn', grossly affected the tax paid with returns. The leading taxpayers namely from oil and gas, banks, and telecom sectors downwardly revised their estimates of income thereby paid less than projected amount of advance tax. In addition, they also claimed refunds on already paid amount that had to be settled as the system is operating under self-assessment. The adverse affect on sales tax and excise in the months of January through March was due to shortage of electricity and gas that contributed to economic slowdown. Finally zero-rating of crude oil for refineries which was expected to be revenue neutral has actually resulted into revenue loss due to time lag of one and half month between arrival of crude and its processing by refineries.

Direct Taxes: Notwithstanding good performance exhibited by direct taxes during Q3 of CFY, where 40.5% and 42.9 % growth has been attained in gross and net term, the overall performance at the end of third quarter has been short of the target by about Rs. 20 billion. The gross, refund and net collection at the end of 3rd quarter of CFY has been Rs. 277.9 billion, Rs. 20.3 billion and Rs. 257.6 billion, as against Rs. 263.5 billion, Rs. 25.7 billion and Rs. 237.8 billion respectively in the comparable period of PFY, indicating a modest growth of 5.5% in gross and 8.3% in net term. Since most of the refund backlog has been cleared earlier, there has been a negative growth of 21.2% in the refund payments (Table 3)**.**

A number of reasons are there for this slowdown in revenue realization. Apart from political unrest, strikes and load-shedding during the period under review, the major set back has been due to significant reduction in voluntary compliance. The outcome in Q2 was particularly unimpressive as both gross and net collection, registered negative growth of 16.8% and 18% respectively. Resultantly, the first half of CFY has encountered a decline of 7.5% and 4.7% in gross and net basis. Within this perspective, higher than expected revenue realization during Q3 has even though made-up for the earlier losses to some extent, but it was not sufficient to fill the gap, generated during H1: of CFY.

Table 3: Gross and Net Revenue Receipts of Direct Taxes: A Comparison

(Revenue Receipts in Rs. Billion)

	FY 07-08		FY 06-07		Growth (%)	
	Gross	**Net**	**Gross**	**Net**	**Gross**	**Net**
Quarter-I	81.7	77.5	76.6	66.5	6.7	16.6
Quarter-II	96.3	87.1	115.8	106.2	-16.8	-18.0
H1: July-Dec.	*178.0*	*164.6*	*192.4*	*172.7*	*-7.5*	*-4.7*
Quarter III	99.8	93.0	71.1	65.1	40.5	42.9
July-March	*277.9*	*257.6*	*263.5*	*237.8*	*5.5*	*8.3*

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

The monthly figures in comparison with comparable period of last three years are presented in Table 4 to understand fluctuations in tax receipts. It indicates that the months of July, August, November, January and February of CFY were relatively robust when compared with previous year's collections. For rest of the months, the situation has reversed. As mentioned earlier, this outcome is due to the change in the advance tax regime for banking companies. Further more, the higher collection in the month of January and February is also on account of unusual demand creation both at current and arrear levels, which has pushed the overall growth in current and arrear demand to 538.3% and 125.9%. Thereby the monthly overall collection has also jumped to a respectable position at the end of Q3 of CFY. It may be admitted that while the aforesaid explanation is true, it is also a fact that voluntary compliance has indeed declined significantly.

Table 4: Analysis of Direct Taxes (Net)

(Rs. in Million)

Months	2007-08	2006-07	2005-06	2004-05	Change (%)		
					07-08	06-07	05-06
July	14,110	10,086	7,620	6,215	39.9	32.4	22.6
August	15,007	11,110	9,015	6,656	35.1	23.2	35.4
September	48,415	45,280	31,551	28,863	6.9	43.5	9.3
October	17,161	16,066	11,105	6,754	6.8	44.7	64.4
November	18,720	13,925	10,163	7,376	34.4	37.0	37.8
December	51,182	76,232	34,860	22,523	-32.9	118.7	54.8
January	27,070	12,457	10,070	9,067	117.3	23.7	11.1
February	25,019	13,780	10,519	8,870	81.6	31.0	18.6
March	40,951	38,865	27,793	23,149	5.4	39.8	20.1
Total	**257,635**	**237,801**	**152,696**	**119,473**	**8.3**	**55.7**	**27.8**

Major apprehension behind this unprecedented decline coupled with significant growth in demand is that the taxpayers may have preferred delinquency in anticipation of soft audit, but this has been thwarted through departmental efforts. The mobilization of Rs. 20.1

billion under current demand and Rs. 5.4 billion in arrear demand as against Rs. 3.1 billion and Rs. 2.4 billion during PFY is sufficient to support the point. However, this also warrants targeted audit and punitive action against delinquent taxpayers.

To validate this point further, a comparative analysis is presented in the following. Compared to Pakistan, direct taxes in the region have assumed greater importance by becoming a leading source of revenue for the regional governments. In India, for instance, the proportion of direct taxes to gross tax collection has increased from 30.2% in 1995-96 to 45.1% in 2005-06, going up further to 48.8% in 2006-07. In relative term, the direct tax to GDP ratio has maintained an uptrend as a result of reforms in income and corporate taxes that have not only simplified the tax system, but also provided incentive for better compliance [Box 2]. According to Economic Survey of India 2007-08, the direct tax to GDP ratio was only 2.8% in 1995-96 that improved to 5.6% in 2006-07 and is budgeted at 5.7% for 2007-08. In emerging economies like Singapore Malaysia and Indonesia, the direct tax to GDP ratio ranges between 6% and 7%. In contrast to this, the position of direct taxes in Pakistan has remained at around 3% level, in relative terms, for the last many years.

Box 2: Reform Initiatives in India Related to Direct Taxes

Permanent Account Number (PAN)

The introduction of PAN for all the taxpayers to quote (mandatory) on the returns and compulsory on financial transactions has been a new dimension. Some such transactions are sale and purchase of immovable property or motor vehicle or payments to hotels for bills or payments in cash, of amounts exceeding Rs. 25,000/-, in connection with travel to any foreign country. PAN is also essential for obtaining a telephone or cellular telephone connection, Likewise, PAN has to be mentioned for making a time deposit exceeding Rs. 50,000/- with a Bank or Post Office or depositing cash of Rs. 50,000/- or more in a Bank.

(Continued)

Box 2…. (Continued)

Tax Deduction and Collection Account Number (TAN)
TAN is compulsory for all persons who are responsible for deducting or collecting tax at source on behalf of income tax department. Failure to supply TAN or not quoting the same in the specified documents attaches a penalty of Rs. 10,000. Furthermore, the banks have been authorized not to accept any challan of such withholding agents unless TAN is quoted.

Annual Information Return (AIR)
AIR for 'high value transactions' has been introduced. It is mandatory to furnish AIR by 'specified persons' in respect of 'specified transactions' registered or recorded by them during a financial year. Penalty of Rs 100 per day is levied for delay in furnishing of AIR beyond the due date. For example, banking company is required to furnish AIR if cash deposits are aggregating to Rs one Million or more in a year in any saving accounts etc. Similar arrangement is specified for other specified persons.

Analysis of Components of Direct Taxes

The components of direct taxes are income and corporate tax and other direct taxes. The former broadly consists of Collection on Demand (COD), Voluntary Payments (VP) in the shape of tax with returns, advance tax and withholding taxes (WHT). The other direct taxes include CVT and WWF/ WPPF which accounts for less than one percent of gross collection. Table 5 highlights the performance of these heads during CFY.

Voluntary Payments (VP)

The basic objective behind implementation of USAS was to minimize interface between the taxpayer and tax administration, repose confidence in the system and eliminate the element of corruption. It was anticipated that voluntary compliance will also play an important role in maintaining overall equity in the taxation system as well, because the incidence of presumptive taxes is fairly debatable. No doubt, that the USAS has been successful since its implementation in achieving these objectives. Till last fiscal year 2006-07, VP had emerged as a leading source of revenue. For reasons already discussed, payments with returns have dropped from Rs. 47.9 billion during July-March 06-07 to Rs. 8.5 billion during CFY, yielding a decline by 82.3%.

Table 5: Direct Taxes Collection Up to March

(Rs. in Million)

Revenue Heads	2007-08	2006-07	Growth (%)
Collection on Demand	25,465.0	5,525.9	360.8
Arrear	5,370.1	2,377.5	125.9
Current	20,094.9	3,148.4	538.3
Voluntary payment	97,566.2	132,163.5	-26.2
With Returns	8,503.8	47,925.3	-82.3
Advance Tax	89,062.4	84,238.2	5.7
Withholding Tax	141,629.4	116,010.8	22.1
Misc	99.1	120.1	-17.5
Total Income Tax (Gross)	264,759.7	253,820.3	4.3
Refund	20,229.6	25,295.9	-20.0
Income Tax (Net)	244,530.1	228,524.4	7.0
Other Direct Taxes	13,104.9	9,275.6	41.3
Total Direct Taxes (Net)	**257,635.0**	**237,800.0**	**8.3**

Along with this, the modest growth of 5.7% in collection on account of advanced taxes has left an overall adverse impact on collection vis-à-vis target. The sectoral contribution of advance tax payment has been highlighted in Table 6, which shows the extent of diversity in collection under this head.

It may not be out of place to mention that around 70% of the total advance taxes are paid by three sectors, namely Oil & Gas (40.7%), Banks (25.6%) and Telecommunication (4.7%). However, notwithstanding the contribution, the annual growth in payments by these sectors during CFY has slowed down. The quarter-wise contribution exhibits wide variations. After a healthy growth in advance tax payments in the first quarter, the second quarter registered a negative growth. The reduced payment by the banking sector has been due to change in the forced-sale value regulation under which the forced sale value benefit against all non performing loans for calculating provisioning requirement was abolished altogether from December 2007.[5]

Table 6: Advance Tax Payment by Major Sectors

(Rs. in Million)

Sectors	July-Sept 2007	Oct-Dec 2007	Jan-Mar 2008	Total (July-March) 2007-08	Total (July-March) 2006-07	Change (%)
Oil & Gas	11,180.4	12,346.7	12,796.6	36,323.7	29,831.1	21.8
Banking	5,406.7	11,510.1	5,923.9	22,840.8	21,491.3	6.3
Telecom	1,457.4	1,642.4	104.9	3,204.7	4,181.8	-23.4
Automobiles	676.8	248.1	198.4	1,123.3	1,136.8	-1.2
Engineering	484.2	207.1	472.0	1,163.3	624.4	86.3
Iron & Steel	429.4	7.0	29.3	465.7	504.2	-7.7
Fertilizer	413.2	1,088.8	593.2	2,095.1	1,542.6	35.8
Transportation	411.4	943.7	0.0	1,355.0	470.3	188.1
Pharmaceuticals	358.8	620.0	464.4	1,443.2	1,446.8	-0.3
Chemicals	287.3	266.7	175.4	729.4	1,132.6	-35.6
Sub total	21,105.5	28,880.7	20,758.0	70,744.2	62,362.0	13.4
All others	5,088.4	6,270.5	6,959.2	18,318.2	21,876.9	-16.3
Total	**26,193.9**	**35,151.2**	**27,717.2**	**89,062.4**	**84,238.9**	**5.7**

On the other hand, Oil & Gas sector suffered losses on account of higher cost of extraction, partly due to additional expenses to protect sensitive oil and gas installation in the field. Finally, increased development expenditure in the telecommunication sector and extra spending by PTCL on account of Voluntary Separation Scheme (VSS) has resulted into a decline in taxable income and advance payments. Since most of these have incurred a one-time cost on these sectors, this phenomenon is not expected to be repeated in coming years.

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[5] See the Third Quarterly Report of State Bank of Pakistan for the year 2007-2008 for further details.

Collection on Demand (COD)

It was anticipated that with the introduction of USAS in the income tax structure, voluntary compliance will increase over the years and resultantly, collection under arrear and particularly, current demand will decrease or will have a steady growth pattern. This perception was true for the last few years when voluntary compliance has taken a leading position in income tax collection. However, the situation has changed during CFY when payment with returns declined by 82.3%. However, as mentioned earlier, this has more to do with the change in the advance tax regime. But given that during Q3 of CFY, an amount of Rs. 14.2 billion under COD has been generated, of which Rs. 13.6 billion was collected under current demand whereas last year the collection was only Rs. 1 billion, the possibility of deliberate under-reporting cannot be ruled out. In fact, this change cannot be attributed only to change in regime. The unprecedented increase in collection (361%) on account of demand creation during the first nine months is quite startling. Of the two components of COD, the collection under arrear demand has also increased by 125% over the PFY. Given this outcome, it is expected that additional demand of about Rs. 20 billion is possible in the remaining months of CFY as a result of further scrutiny of the returns.

Withholding Taxes (WHT)

WHT continues to be the leading source of direct tax receipts in view of the large undocumented sector of the economy. However, despite its large contribution, there is ample scope to enhance this collection further. The WHT collection during July-March 2007-08 has been Rs. 141.6 billion against Rs. 116 billion during PFY, indicating a healthy growth of 22.1%. The ten major withholding taxes constituting 91.3% of total WHT collection remain the same as before. These are: contracts, imports, salary, telephone, export, bank interest, securities, electricity, dividends and cash withdrawal (Table

7). The share of contracts (35.2%) remains at the top, followed by imports (14.2%), salary (10.2%), telephones (9.1%), exports (5.5%) bank interest (4.5%), securities (3.4%), electricity (3.1%), dividends (9%), and cash withdrawal (3%).

The highest growth in WHT collection has been from telephones (39%) followed by contracts (36.3%), Salary (27.2%) and cash withdrawal (23.8%). This outcome reinforces the existing belief that telecom sector remains vibrant despite inflationary tendencies in the country [Table 7]. Rationalization of income tax rate for the salaried individuals and enhanced salary packages, especially in the private sector, has yielded higher revenue. Similarly, the recent spike in international trade activities, especially imports, has been instrumental in raising the WHT receipts on account of imports. Contrary to this, the growth in WHT deductions on exports has been negative due to the overall deceleration in exports. Finally, the sharp decline in WHT from securities in Q3 could be due to change in the nature of securities.

Apart from the above mentioned ten WHT contributors, the relatively minor components have also recorded sizeable growth. For instance, WHT on stock exchange and rental have increased by 74.5% and 49.2%, respectively during the first three quarters of CFY over the corresponding period of last year. Similarly, despite all the resistance, the deductions on cash withdrawal continue to generate sufficient revenue for the national exchequer signifying the fact the Pakistan's economy continue to have a large informal sector, which despite major efforts remains undocumented. The growth in collection from electricity has been erratic during the past three quarters mainly due to abnormal increase in Q2.

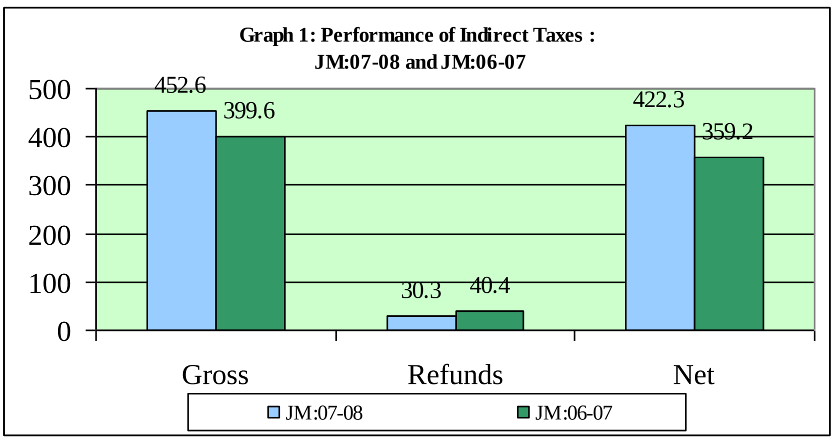
Table 7: July-March Collection from Leading WHT Heads: A Comparison of FY 07-08 & FY 06-07 Collection

(Rs. in Million)

Collection Head	2007-08	2006-07	Difference	
			Absolute	Percent
Contracts				
Q1	13,921	9,884	4037	40.8
Q2	17,454	14,209	3245	22.8
Q3	18,437	12,460	5977	48.0
July-March	49,812	36,553	13259	36.3
Imports				
Q1	6,449	6,843	-394	-5.8
Q2	6,193	6,328	-135	-2.1
Q3	7,431	5,888	1543	26.2
July-March	20,073	19,059	1014	5.3
Salary				
Q1	4,262	3,172	1090	34.4
Q2	4,768	4,188	580	13.8
Q3	5,458	4,032	1426	35.4
July-March	14,488	11,392	3096	27.2
Electricity				
Q1	1,266	1,164	102	8.8
Q2	1,743	1,346	397	29.5
Q3	1,403	1,279	124	9.7
July-March	4,412	3,789	623	16.4
Telephone				
Q1	4,386	2,778	1608	57.9
Q2	4,294	2,979	1315	44.1
Q3	4,236	3,536	700	19.8
July-March	12,916	9,293	3623	39.0
Export				
Q1	2,340	2,542	-202	-7.9
Q2	2,690	2,686	4	0.1
Q3	2,829	2,776	53	1.9
July-March	7,859	8,004	-145	-1.8
Dividends				
Q1	1,073	671	402	59.9
Q2	2,032	1,886	146	7.7
Q3	1,165	907	258	28.4
July-March	4,270	3,464	806	23.3
Cash Withdrawal				
Q1	1,302	980	322	32.9
Q2	1,488	1,258	230	18.3
Q3	1,415	1,159	256	22.1
July-March	4,205	3,397	808	23.8
Bank Interest				
Q1	2,092	1,913	179	9.4
Q2	2,104	1,784	320	17.9
Q3	2,182	1,829	353	19.3
July-March	6,378	5,526	852	15.4
Securities				
Q1	1,159	1,166	-7	-0.6
Q2	2,884	1,725	1159	67.2
Q3	784	1,461	-677	-46.3
July-March	4,827	4,352	475	10.9
a. Sub Total	129,240	104,829	24411	23.3
% Share in total WHT	91	90		
b. Other WHT	12,389	11,182	1207	10.8
c. Total WHT	141,629	116,011	25618	22.1
Share (%) in Gross I. Tax	54	46		

__Detailed Analysis of Indirect Taxes__

The indirect taxes are comprised of three components: sales tax (GST), federal excise duties, and customs duties. The gross and net collection of indirect taxes has recorded a significant growth of 13.3% and 17.6%, respectively during the July-March period due to buoyancy of GST as well as positive impact of reduction in refund payments. The gross receipts have increased from Rs. 399.6 billion to Rs. 452.6 billion during the comparable period of PFY and CFY respectively. Similarly, the net collection has reached Rs. 422.3 billion during CFY from Rs. 359.2 billion during PFY. The refund/rebate payments on account of indirect taxes have declined by 25% during the period under review (Graph 1).



The analysis of indirect taxes (sales tax, customs duties, and excise) confirms that the major chunk of revenue originates from seventeen commodities and utilities only; their share in total indirect tax (gross) collection has been 78.4%. Out of total indirect taxes of Rs. 452.6 billion, the amount generated by this group was Rs. 354.7 billion, constituting slightly over 4.7% of Tax-GDP ratio. These commodities in descending order of revenue generation are petroleum products, telecom, automobiles, edible oil, cigarettes, machinery, iron & steel, natural gas, chemicals, plastic and plastic products, cement, sugar, paper & paper board, beverages, coffee and tea, electrical energy, textiles, and rubber products.

Sales Tax*:* GST is one of the leading sources of federal tax receipts. It has contributed 38% of the total net revenue collection during the first nine months of FY: 07-08. The gross and net collection has been Rs. 279.5 billion and Rs. 258.6 billion, respectively showing growth of 12.4% and 18.2% over the corresponding period of PFY. The refund payments have declined by 29.7% during this period, mainly due to reduction in claims after zero-rating. The target has been achieved to the extent of 96.5% implying that a shortfall of about Rs. 9.3 billion has been recorded till the end of March 2008.

It is evident from Table 8 that the gross and net collection of sales tax has improved significantly during the second and third quarter but the dampening impact observed during the first quarter is yet to be fully compensated. It is pertinent to mention that the target for the fourth quarter 2007-08 has been re-adjusted. It required nearly 26% growth in Q4 collection to reach an overall sales tax collection of Rs. 373 billion. However, given the robust performance during April and May, especially with regard to domestic sales tax, the required growth for June has reduced to only 12.2%, which is expected to be surpassed.

Table 8: Sales Tax Collection:
A Comparison of FY 07-08 & FY 06-07

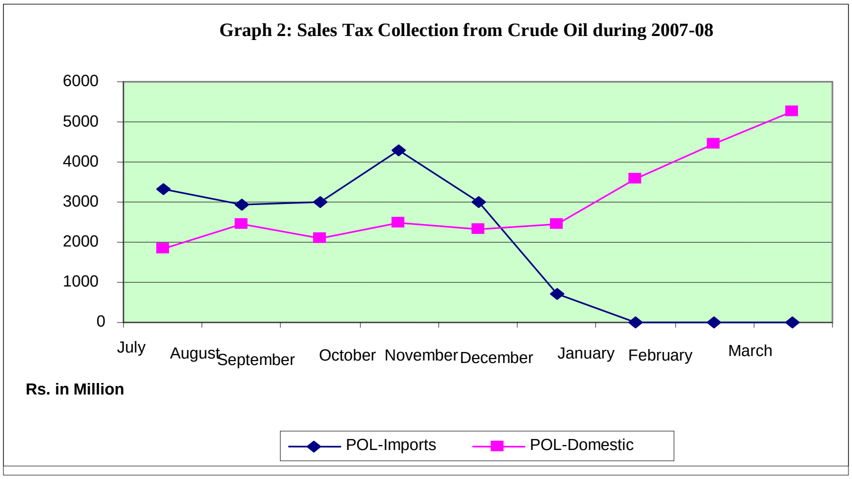
(Rs .Billion)

Description	FY: 07-08		FY: 06-07		Growth (%)	
	Gross	Net	Gross	Net	Gross	Net
Q1	90.4	82.8	86.8	75.6	4.1	9.5
Q2	94.0	86.5	82.5	70.7	13.9	22.3
Q3	95.1	89.3	79.3	72.6	19.9	23.0
July-March	279.5	258.6	248.6	218.9	12.4	18.2

Domestic Sales Tax Collection and Major Revenue Spinners: The commodity-wise details of domestic sales tax collection during July-March 2008 confirms that 81% of gross collection (Rs. 110.9 billion out of Rs. 137.8 billion) has been generated by ten major revenue spinners that include: POL products, services (essentially telephone and tele fax), natural gas, sugar, cigarettes, iron & steel products, services, automobile sector (cars/ motorcycle/ and parts), electrical energy and beverages. However, with the exception of two sectors, the rest of the commodity groups have recorded fairly high growth. The most important being the petroleum sector. The collection from POL products has increased by 47% over last year's collection. This increase is attributed to (i) Gradual de-capping of price effects of international prices increase; and (ii) zero-rating of crude oil for sales tax at import stage which has left positive impact on output tax as input adjustment has decreased substantially.

The crude oil imported by refineries was subject to sales tax at import stage which was later subjected to refund/ adjustment claim at the time of domestic sales of its refined products. Since November 2007, the import of crude oil has been zero-rated for the purpose of sales tax. This measure has not only improved the liquidity strength of the oil sector, it has also improved the tax collection procedure. The tax is now being charged at sales stage. Graph 2 in the following clearly demonstrates the effect of this change. While the former has reduced to zero from January onwards, the GST (domestic) has registered a sharp rise since then. However, despite the perceived 'revenue-neutrality' of this change, there has been a loss of revenue due to time lag between the import of crude and its processing and refining by the refineries.

The far reaching impact of telecom services in social and economic sectors has transformed this sector into a leading industry and a dependable source of sales tax collection. The collection has observed a growth of 25% over the comparable period last year. However going forward, this growth is expected to reduce as the activity in this sector is about to reach the plateau.



A sluggish growth has been recorded in GST receipts from natural gas mainly due to three reasons: (i) there has been a relatively low growth in GST payment by the leading supplier holding 40% share in sales tax collection – the growth from this source has declined from 20.6% to 5.7% during the comparable period of July-March; (ii) Occidental Gas which contributed over one billion of GST last year has withdrawn from the market; and (iii) SSGPL has claimed and received unusual refunds. Similar to electricity, the zero-rating of utilities for export-oriented industrial concerns is reported to be the reason for this claim.

The nominal growth in collection from sugar is partly due to reduction in sales taxable price. However, despite this, the overall contribution remains discouraging. Special audits are already underway to determine the real cause of this outcome in the light of current supply and demand position of the commodity in the country. The significant growth of 18.4% in collection from cigarettes is consistent with projected estimates. Similarly, better collection from the automotive sector (motorcars/ motorcycles and parts) has been due to improved performance of part of the automotive and vendors' industry, even though the production of leading brands has declined for various reasons. On this plea, the assemblers have been successful in achieving temporary suspension of WHT on cars.

A healthy increase in collection from iron & steel by 251.6% is largely because of the policy intervention whereby the sales tax is now being charged on the basis of electricity consumption at the rate of Rs. 4.15/unit (Table 9). The tax is being collected through the electricity bills by WAPDA and KESC. This change has significantly reduced the tax evasion which was common earlier on.

Table 9: Sales Tax Collection from Ten Major Revenue Spinners (Domestic) during FY 07-08 and FY 06-07

(Rs. Million)

S. No.	Commodity Groups	Collection Up to March 2008	Collection Up to March 2007	Growth (%)
1	POL Products	33,922	23,105	46.8
2	Services (including telephone/Fax etc)	32,885	26,392	24.6
3	Natural Gas	11,227	10,761	4.3
4	Sugar (Including Baggase and Molasses)	8,568	8,395	2.1
5	Cigarettes	5,447	4,599	18.4
6	Iron & Steel Products	5,429	1,544	251.6
7	Services (other than telecom)	4,265	3,546	20.3
8	Motor cars/ Motorcycles/ Auto parts	3,759	2,840	32.4
9	Electrical Energy	2,801	11,518	-75.7
10	Beverages/ Aerated water	2,640	2,168	21.8
	Sub Total	110,943	94,868	16.9
	Others	26,822	27,943	-4.0
	G. Total	137,765	122,811	12.2
	Refunds	20,859	29,728	-29.8
	Net GST Collection	116,906	93,083	25.6

The collection from services has seen a healthy growth that can be attributed to improved performance of airlines, media and courier services. The negative growth in collection from electrical energy is the expected outcome as FBR has opted for net rather than gross collection thereby reducing the incidence of refund creation. It may be recalled that last year's gross collection included the amount of huge refunds paid back afterward. Therefore, the gross collection comparison with corresponding period indicates a decline. On the other hand, a notable increase in collection from beverages is partly due to arrival of the summer season and partly due to higher consumer spending on soft drinks carrying brand names.

Sales Tax at Import Stage:

The contribution of Sales Tax at Import stage [ST (M)] in gross terms has been around 51% in total sales tax collection during the period July-March 2007-08. However, its share increased to 55% in net terms due to the fact that all refund claims are entertained from the domestic collection of sales tax.

Out of fifteen major commodity groups, a double-digit growth has been recorded in GST collection from edible oil, fertilizers, organic chemicals, electrical machinery, paper and paper board, oil seeds, misc. chemicals and rubber products. The internal structure of sales tax imports reveals that around 39% of collection originates from POL products. Each of the remaining commodity groups has a share of less than 8%. The share from POL products has declined by 2.4 percentage points as compared to last year mainly because of the policy change, as mentioned earlier. Since the two major POL contributors are crude oil and HSD, the zero-rating of crude has reduced the overall growth in ST [M] collection to 6.1% [Table 10].

In order to address the issue of un-equal treatment of organized and unorganized sectors, the sales tax rates of a number of commodity groups were increased from 15% to 17.5% and 20% in the budget 2007-08. The basis of this change was that while organized sector would be able to claim refunds due to higher taxes, those in the unorganized sector will have to pay higher amount for their non-compliance. The outcome of this change is quite as expected; there has been an obvious gain from plastic, chemicals (organic and miscellaneous), paper and paperboard and aluminum articles.

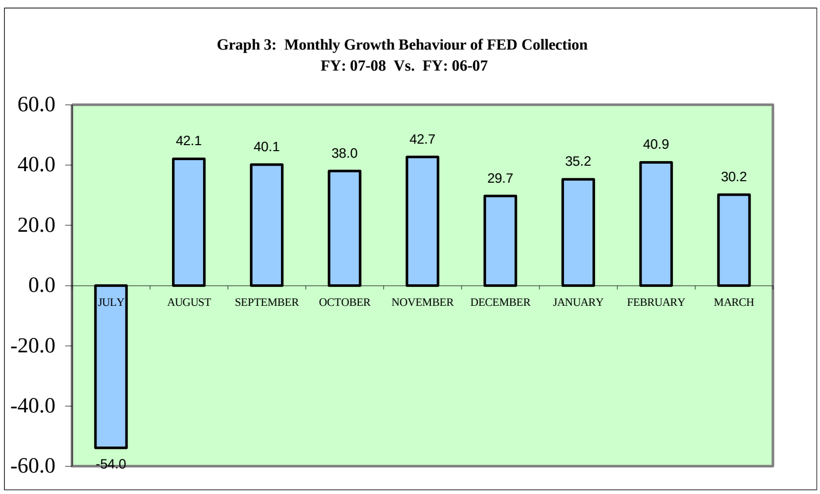
Table 10: Major Revenue Spinners of Sales Tax at Import Stage

PCT Chapter	Tariff Description	Growth in Imports (%)	ST (M) Collection *(Rs. Billion)*		
			JM: 07-08	JM: 06-07	Growth (%)
27	POL Products	47.1	54.7	51.5	6.1
39	Plastic Resins, etc.	17.0	10.5	7.2	45.1
15	Edible oil and Waxes	71.8	10.4	6.6	57.8
87	Vehicles	-9.8	9.7	10.4	-6.9
72	Iron and Steel	29.5	8.0	8.2	-2.0
84	Mechanical Machinery	2.9	5.1	5.0	2.9
85	Electrical Machinery	7.7	5.0	3.9	29.4
29	Organic chemicals	21.3	3.6	2.6	37.8
48	Paper and Paperboard	19.0	3.5	2.7	28.4
12	Oil seeds etc.	33.8	3.1	2.5	21.4
38	Misc. Chemical products	9.2	2.3	1.9	19.7
40	Rubber and articles.	13.5	1.9	1.7	13.1
9	Coffee, tea and spices	-2.3	1.8	1.9	-5.6
31	Fertilizers	179.0	1.7	1.1	58.8
76	Aluminum and Articles	-17.3	1.6	1.5	7.7
	Sub-total	*27.3*	*122.9*	*108.7*	*13.0*
	Others	24.0	18.9	17.1	10.7
	Grand Total	**26.5**	**141.8**	**125.8**	**12.7**

Note: JM stands for July-March

However, the increase in tax rates of a number of sub-commodity groups of iron and steel could not realize the desired result. This outcome is not surprising. Due to zero-rating of scrap, the melters have opted for value addition within the country rather than importing value added products. Thus, the decline is due to anticipated reduced demand. The collection from mechanical machinery is aligned with the value of imports. On the other hand, a significant growth of 29.4% in collection from electrical machinery has been observed mainly due to imports of telecom apparatus and products with higher slab. Finally, the collection from rubber products and coffee and tea, is consistent with their imports.

Federal Excise: The overall performance of FED during CFY has been satisfactory. During July-March 2007-08, Rs. 61.8 billion have been collected against Rs. 47.7 billion indicating a growth of 29.5% over PFY. Even though, the growth attained so far appears to be deceptively high, nonetheless, revenue target of the first nine months has been missed by around Rs. 6 billion. The Month-wise performance is presented in Graph 3, where the impact of shortfall in July due to the procedural change, has not been nullified despite a continuous up-trend in the remaining months. The share of total FED collection in federal taxes has increased from 8% in the PFY to 9.1% in the CFY mainly due to the imposition of special excise duty and extension of base related to non-fund and other services.



The six revenue spinners of FED that have contributed bulk of the revenue are cigarettes, cement, beverages, natural gas, POL Products and services. The combined share of these six items has been 79% against 91% in the corresponding period of last year. This decline in share is because of the levy of 1% FED both at domestic and import stages that has captured around 11% of FED collection. The highest growth of almost 162% has been registered in services, followed by cigarettes (8%), natural gas (2.9%) and beverages (0.6%). On the other hand, items like cement and POL have registered a negative growth of 4.3% and 34.2% respectively during the period under review (Table 11).

Table 11: FED Collection from Major Commodities
FY: 2007-08 and FY: 2006-07

(Rs. Million)

Commodities	FY 07-08	FY 06-07	Difference	
			Absolute	Percent
Cigarettes	18951	17547	1403	8.0
Cement	10522	11000	-477	-4.3
Natural Gas	4546	4415	130	2.9
POL	2222	3377	-1154	-34.2
Beverages	4327	4300	27	0.6
Services	8441	3223	5218	161.9
Sub Total	49008	43862	5146	11.7
Other (Dom + Imp)	12791	3859	8932	231.5
Total	**61799**	**47721**	**14078**	**29.5**

While the negative growth in POL is due to shrinking of its base, but the erratic revenue performance of cement industry remains a concern. The decline in collection in Q3 after 9.3% growth in Q2 appears to be inconsistent with a steady growth in demand for cement and the recent increase in retail price. Even though a similar situation prevails as far as natural gas is concerned, but it has more to do with close down of business by a leading exploring entity. Finally, the reduction in FED collection from beverages and concentrates during Q1 and Q3 appears odd, but it could partly be attributed to the provision of adjustment for concentrate. This situation is expected to reverse in Q4 in view of recent increase in retail price and higher demand in summer.

Collection from FED Services: The introduction of FED on services like International Air Travel (IAT), Non-fund Services (NFS), Franchise and Insurance has been helpful in enhancing revenues substantially. The share of services has increased from 6.8% during July-March 07-08 to 13.7% in the CFY. Within services about 70.8% of collection is realized from IAT, followed by Insurance (15.6%), NFS (11.5%) and Franchise (2.1%). In absolute terms, Rs. 8.4 billion have been collected during first nine months of CFY against Rs. 3.2 billion in the corresponding period last year (Table 12). The realized revenue has exceeded the July-March target by more than Rs. 1 billion. This means that the collection from services shall compensate for the realized and expected loss in revenue from other sources of FED.

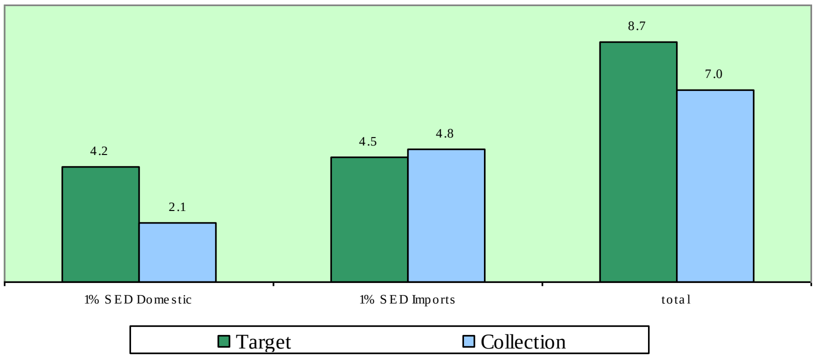
Table 12: FED Collection from Services

(Rs. Million)

Services	FY 07-08	FY 06-07	Difference	
			Absolute	Percent
Non-Fund Services	971	462	509	110.3
IAT	5975	1464	4511	308.1
Franchise	176	92	84	91.3
Insurance	1319	1148	171	14.9
Total July-March	**8441**	**3223**	**5218**	**161.9**

Collection from Special Excise Duty: The 1% special FED levied in the budget 2007-08 has fetched Rs. 6.9 billion during July-March 2007-08 against the target of Rs. 8.7 billion indicating achievement to the extent of 80% only. The evidence confirms that the 1% FED at import stage has been more effective as compared to one levied at domestic stage. At import stage Rs. 4.8 billion have been generated against the target of Rs. 4.5 billion whereas, only Rs. 2.1 billion have been realized from FED domestic confirming that enforcement problems are serious as the collection is short of the target by about 52% (Graph 4).

Graph 4 : 1% SED Collection Vs. Target (Rs. Billion)



Customs Duties: Over the years the role of customs duty has diminished gradually on both counts, as a major source of revenue, and protecting domestic industry from undue competition. Actually, it is an international phenomenon that the world is transforming into a global village and customs duties are being slashed down significantly, in line with the WTO arrangements. However, despite this diminishing role, customs duties still contribute nearly 24% of the indirect taxes and 15% of the total taxes. The performance during the CFY has been mixed. The first two quarters of current year recorded a decline due to modest growth in its base, namely dutiable imports. However, it has picked up significantly in the third quarter due to sharp increase in imports. This improvement in collection has not only compensated for the 'loss' of first six months in gross collection, it has also contributed positively towards the overall growth in collection. Whereas the gross collection during Q1-Q3 has increased by 7.8%, the net collection has grown by 9.9% due to reduction in refund/rebate claims and payments. In absolute terms, the collection of customs duty has reached Rs. 101.9 billion as compared to Rs. 92.7 billion in the corresponding period of PFY. With this outcome, the net collection has surpassed the target by 4%.

The commodity-wise information presented in Table 13 reveals that the collection lacks diversification as only fifteen commodities groups have contributed 79% of the total gross receipts. The sectoral analysis is as follows.

Auto sector is a vital source of customs duties. Since the import of vehicles and parts has declined, the collection from this source has decreased by 11.9%. One of the reasons for this decline is the change in policy stance to restrict import of old and used vehicles to only 3 year age. This has discouraged demand for the import of second-hand motor cars and Jeeps. The number of imported cars and jeeps in CBU condition has declined by 30%, while the value of import has also dropped by 22%. Consequently, collection of CD has decreased by 3%. Despite this policy restriction, the import of CKD/ SKD units has not received a boost as import of these units has also dropped by 26% during the period causing a loss of Rs. 1.3 billion in duty. Besides this policy change, the other factors that have contributed to a decline in demand are restrictions on car-financing due to accumulation of bad debt, and significant increase in borrowing cost. With an apparent slowdown of the economy, the demand for automobiles is expected to decline further.

POL products classified in chapter 27 have exhibited a robust growth in the value of imports and dutiable import by 47.1% and 36.6% respectively mainly due to phenomenal increase in prices of Petroleum. This has resulted into an improved customs duty by 42.1%. Like POL products, the prices of edible oils have also gone up this year to a significant level. As a result, the value of import has recorded a colossal growth of 71.8%. However, due to application of specific rate structure, it has manifested a low growth of only 5.4% in CD during July-March 2007-08.

While the growth in the import of electrical machinery has been 5%, it has exhibited 12.9% growth in the CD mainly due to substantial growth in the collection from generating sets, wires and cables, electrical transformers etc.[6] Similar pattern has also been observed in mechanical machinery (CH: 84) where the growth in base has been lower than the collection of CD. The growth in dutiable imports recorded at 2.2% while CD grew by 8.3%. This was due to higher growth in CD from engines, centrifuges, machines tools. The collection of CD from plastic, tanning, articles of iron and steel, and paper & paper board has been consistent with the growth in their respective tax bases.

Table 13: Growth in Collection of Customs Duties and Effective Rates during 2007-08

(Growth and Effective Rates in percent)

PCT Chapter	Tariff Description	Growth During July-March (%)			Effective Rates with Dutiable Imports	
		Value of Imports	Dutiable Imports	Customs	Up to March 08	Up to March 07
87	Vehicles	-9.8	-8.4	-11.9	34.8	36.2
27	POL	47.1	36.6	42.1	10.2	9.8
15	Edible oil and Waxes	71.8	74.3	5.4	17.0	28.1
85	Electrical Machinery	7.7	0.6	12.9	8.3	7.4
84	Machinery	2.9	2.2	8.3	7.3	6.9
39	Plastic Resins, etc.	17.0	14.6	15.2	8.0	8.0
72	Iron and Steel	29.5	1.2	9.1	11.6	10.7
10	Cereals	3202.0	21377	38208	9.5	5.3
48	Paper and Paperboard	19.0	24.1	21.8	20.7	21.1
29	Organic Chemicals	21.3	9.0	3.5	7.7	8.1
73	Iron & Steel Articles	4.6	9.9	11.4	11.0	10.8
32	Dyes, Paints etc.	21.4	19.1	21.5	12.6	12.4
9	Coffee and Tea etc.	-2.3	-6.1	3.7	11.1	10.0
38	Misc. Chemical Prod.	9.2	-11.1	-1.1	9.3	8.4
40	Rubber Products	13.5	-8.4	5.2	12.7	11.1
	Sub-Total	*28.5*	*19.5*	*12.6*	*12.0*	*12.7*
	Others	20.8	1.7	-7.2	18.1	19.8
	Grand Total	**26.5**	**16.5**	**7.8**	**12.9**	**14.0**

[6] It is relevant to mention that mobile phones and telecom apparatus are classified in PCT Chapter 85 related to electrical machinery.

Iron and steel has posted a significant growth of 29.5% and its dutiable component has increased by 1.2% only. Compared to this, the collection has gone up by 9.1%. The apparent discrepancy is due to the reason that higher imports include scrap of iron and steel which is zero-rated for customs purposes. Therefore, the growth in collection is mainly driven by import of flat-roll of iron and steel. In case of organic chemical (CH: 29), dutiable import has increased by 9% leading to CD growth of 3.5%.

Concluding Observations

The current fiscal year is a challenging one for the economy as a whole and tax collection is linked with it directly. Better economic performance is the prerequisite for realization of ambitious target set for 2007-08. The prevailing instability in economic and political sphere on account of impact of international high oil prices, inflationary pressure and uncertainty in policies provide significant reason for the decline observed in overall revenue collection. Apart from the economic picture, the detailed analysis presented in the preceding paragraphs highlights some of the weaknesses that if addressed properly, may lead to not only adequate realization of the target but also to reduce volatility in collection behavior in future. Proper implementation of law to restrict the misuse of USAS, particularly, by major taxpayers, speedy and transparent audit to ensure adequate realization of taxes as per potential, proper realization of 1% SED through effective enforcement, and in-depth examination of continued refund claims related to the zero-rated sectors, all these avenues are, to a great extent, within the domain of the department. Therefore, extra effort will be required to recoup the shortfall registered in the preceding months and achieve the revised target of Rs. 1000 billion.

II
Industry Profile
Petroleum Industry in Pakistan[7]

Introduction

The sustained availability of energy at affordable price is critical in present day and age in view of rapid industrialization, expansion in trade activities, and mounting pressure of energy shortages. Pakistan, like many other developing countries, is deficient in supply of energy vis-à-vis demand.[8] Its energy strategy (2007) envisages adequate and affordable energy supplies through optimum utilization of indigenous resources, promoting renewable energy, providing energy security, and achieving balanced energy mix to fulfill energy demand of an expanding economy. As part of this strategy, the petroleum policy of Government of Pakistan (GOP) has assumed the central position. The main thrust of petroleum policy is to accelerate exploration and production (E&P) activities for greater degree of self-reliance by ensuring protection and continuity of rights granted to oil and gas sectors.[9] The most recent Petroleum Policy 2007 includes some of the following attractive features:

a. FDI to be promoted by increasing the competitiveness of its terms of investment in the upstream sector;

b. Strengthening the involvement of Pakistani Oil and Gas companies in the upstream industries;

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[7] Authors: Dr. Ather Maqsood Ahmed, Member (FR&S) and Mir Ahmed Khan, Second Secretary (FR&S) FBR. This is part I of a two part study.

[8] Some of the reasons for sharp increase in energy (Petroleum) demand are: rapid economic growth in the world, especially in China and India, rebuilding of depleting stocks by industrialized countries, unstable supply and high risk premium on oil, and entry of speculators in the oil sector due to geopolitical uncertainties and tight market conditions. See Afia Malik (2007) PIDE unpublished manuscript.

[9] The first Petroleum Policy was announced in 1991.

c. Focus on HR – training of Pakistani professionals in E&P sector and creating favorable conditions for their retention within the country;

d. Increasing E&P activities in the on- and off-shore areas; and

e. Enabling a more proactive management of resources through establishment of a strengthened office of DG Petroleum Concessions.

Petroleum products constitute around 30% of demand for energy despite the availability of natural gas as substitute. As a result, the petroleum industry has made significant strides to fulfill the demand requirements in Pakistan by attracting bulk of the foreign direct investment. Currently, the industry is an important source of economic activity in the country. It not only promotes employment but also generates significant revenues for the Government.

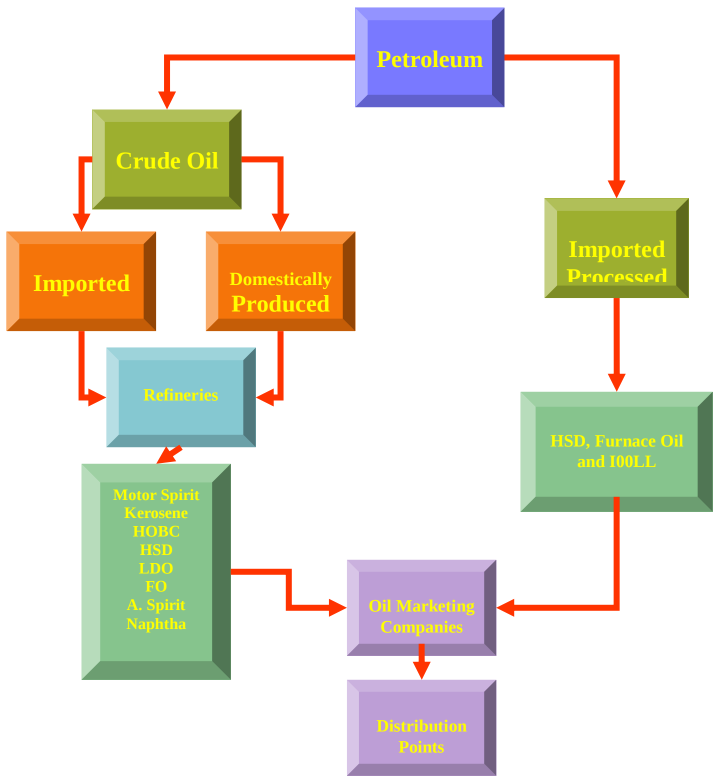
The purpose of present study is to undertake a comprehensive review of the petroleum sector in the country with a detailed focus on fiscal matters. A cross-country comparison vis-à-vis Pakistan is undertaken to determine the tax burden in retail price. A detailed analysis of the fiscal regime is essential to comment on the price setting mechanism currently in vogue. Besides elaboration on taxation structure and collection, the article also seeks to provide an inquisitive discussion on such critical issues as the circular debt, inter-fuel substitution, and subsidies on petroleum vis-à-vis tax component which are vital for the overall strength of economy and the society at large.

The Processing and Distribution of Petroleum Products

Crude oil is the basic input in producing processed petroleum products, like gasoline (Motor Spirit – MS), High Speed Diesel (HSD), and furnace oil etc. The refineries in Pakistan rely on locally extracted as well as imported crude oil. After processing the petroleum products are routed through the Oil Marketing Companies

(OMCs) for distribution across the country. Since the output of refineries for certain refined products is not sufficient to meet domestic demand, the OMCs also import processed products directly. The entire chain of petroleum from crude to processed products and ultimate distribution is explained through the following Flow Chart 1.

Flow Chart 1: Processing of Petroleum Products



Demand and Supply of POL Products in Pakistan

Pakistan imported 8.23 million tonnes of crude oil in 2006-07 while its indigenous production was only 3.1 million tonnes. There are seven oil refineries to process crude to produce different products of petroleum like MS Ron 87 motor spirit, HSD, Light Speed Diesel Oil (LDO), furnace oil, aviation fuel, High Octane Blending Component (HOBC), and kerosene. These are: National (NRL), Pakistan (PRL), Attock (ARL), Pak-Arab (PARCO), Dhodhak (DRL), Bosicor, and ENAR Petrotech Refinery. Whereas ARL, DRL & ENAR refine only local crude, Bosicor and PARCO refine only imported crude, and PRL, and NRL refine both imported and locally available crude. Nonetheless, due to insufficient production capacity, the country has to import three processed petroleum products namely, HSD, furnace oils and aviation fuel (100/LL). Table 1 depicts the overall production, import and demand for 2006-07.

Table 1: Production, Import, and Demand for Petroleum Products during 2006-07

(Million Tonnes)

POL Products	Production	Import	Consumption	Difference
Motor Spirit	1.218		1.319	-0.079
Kerosene	0.207		0.211	-0.004
HOBC	0.010		0.009	0.001
HSD	3.235	3.972	7.247	-0.040
LDO	0.148		0.137	0.011
Furnace Oil	3.193	4.309	7.389	0.113
Aviation Spirit	1.165	0.049*	0.716	0.498
Total	**9.176**	**8.330**	**16.847**	**0.659**

*Source: Pakistan Energy Yearbook, 2007; *Jet fuel (100/ll)*

The refining capacity has improved over the years. It was 11.28 million tonnes per year in 2002 which grew by ACGR of 2.7% and reached 12.87 million tonnes per year in 2007. This slow expansion of refining capacity has been one of the bottlenecks for heavy dependence on the import of the refined products. This situation is further complicated by the fact that refineries are not operating at their full capacity. It is evident from Table 2 that only 87.1% of the capacity has been utilized in crude oil processing. As per available data in Pakistan Energy Year Book (2007) only two refineries, i.e., Attock and National are operating at their full capacity. While Bosicor has started reporting its output since 2004 but it is not immediately clear why its capacity utilization is only 47.3% in 2007.

Furthermore, except for ENAR, which has started its operation only recently, the rest are operating at more than 80% capacity.

Table 2: Capacity Utilization of Oil Refineries in 2007

(Capacity and crude oil in Million Tonnes and utilization in (%)

Categories	Refining		
	Capacity	**Crude Oil Processing**	**Utilization**
Attock Refinery	1.82	1.82	100.0
Besicor Refinery	1.50	0.71	47.3
Dhodak Refinery	0.12	0.10	83.3
ENAR Petrotech Refinery	0.12	0.09	75.0
National Refinery	2.71	2.79	103.0
Pak Arab Refinery	4.5	3.70	82.2
Pakistan Refinery	2.1	2.00	95.2
Total	**12.87**	**11.21**	**87.1**

Source: Pakistan Energy Yearbook, 2007

Price Structure of POL Products in Pakistan

Historically, petroleum was a tightly regulated sector and the prices were administered by the GOP. However, through major reform initiative in 2000, the tight control of the GOP has been relaxed and now its involvement is restricted to policy formulation. The pricing and regulatory responsibilities are entrusted to newly constituted Oil and Gas Regulatory Authority (OGRA). Another important policy shift has been the way prices are determined within the country. Earlier on the refineries were working under a fixed return formula where return was capped in the range of 10-40% of their equity. The GOP was responsible to compensate any loss in the profitability of the refineries. In 2001, the GOP had entrusted the Oil Companies Advisory Committee (OCAC) to review, fix, and announce prices of petroleum products on fortnightly basis through an approved formula as part of the regulatory policy. Recently, this responsibility is now shifted to OGRA. The mechanism of computation of ex-depot sale prices according to the pricing formula is as below:[10]

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[10] This has been extracted from the OGRA Annual Report 2006-07.

- Ex-refinery import-parity price, computed per formula approved by ECC December 23 2000 and subsequent modifications made from time to time;
- Federal Excise Duty (FED) on petroleum products as per notifications;
- Petroleum Development Levy as notified by Ministry of Petroleum and Natural Resources (MP&NR);
- Inland Freight Equalization Margin (IFEM) as recommended by Oil Companies Advisory Committee (OCAC) under self-management system;
- 3.5% Distribution Margin and Dealer Commission at 4% per formula decided by the federal government; and
- General Sales Tax (GST) @15% of depot price on the amount including all above elements.

For instance, the maximum ex-depot sale price of one liter of motor spirit is Rs. 68.81 [OGRA notification of June 21, 2008]. This price has three major components i.e. Rs. 55.88 per liter is prescribed price; Rs. 8.98 per liter is tax component, and Rs. 3.95 per liter is inland freight margin. It shows that the tax component in per liter price of MS is only 13%.

Taxation of POL Products in Global Perspective

The tax component in price is attracting lots of backlash every where in the world. Here we present a comparative position of Pakistan vis-à-vis other countries to see the extent of tax burden in retail prices. Table 3 shows that tax as percent of retail price is generally higher in developed countries except the USA. Compared to this, the tax proportion is low in developing countries including Pakistan, Nepal, Bangladesh, and Sri Lanka. The only exception within SAARC is India where the ratio of tax to retail price is similar to that of the developed world. In case of gasoline (MS), the tax is comparatively higher in Pakistan than Nepal, Bangladesh, and

Sri Lanka. On the other hand, the tax on diesel is very low in Pakistan than other countries with the exception of Sri Lanka.

Table 3: Taxes on POL Products Relative to Retail Price (%)

Countries	Petrol	Diesel
France	65	47
Germany	66	50
Italy	62	43
Spain	54	37
UK	68	60
Japan	45	34
USA	33	25
India	55	34
Pakistan	**42**	**20**
Nepal	31	22
Bangladesh	24	24
Sri Lanka	37	5

Source: Report of the Committee on Pricing and Taxation of Petroleum Products (India) February, 2006.

Tax Structure of POL Products in Pakistan

Petroleum industry is subjected to all the federal taxes administered by Federal Board of Revenue. The collection of revenues from POL products depends on a number of factors like prices, the exchange rate, sales, profit, level of exemptions, and tax rates. The customs duties and federal excise are the historic taxes on petroleum products in Pakistan contributing bulk of the revenue for the Government.[11] In order to extend its base, GST was imposed on POL products in 1999. It was levied in a manner that the sale price was not increased, rather the amount of tax was adjusted by reducing PDL by the same amount. Thus, the move was, in a way, beneficial for the federating units.

[11] The petroleum development surcharge is not treated as FBR revenue source because it is meant for price equalization and reimbursement of Price Differential Claims (PDC) to OMCs.

The rates of individual taxes vary for different POL products in variety of ways. For example, customs duty rate varies from item to item in the range of 0-25% of duty. On the other hand, uniformity of tax rate between import and domestic taxes on same items has been ensured in sales tax and federal excise. The corporate income tax is 35% for the corporate sector excluding companies dealing with oil and gas sector. However, higher rates are applicable according to the 5th schedule of the Income Tax Ordinance 2001 for onshore and offshore companies. The specific details of tax rates are as follows.

Customs Duty (CD)

Except for HSD which faces 10% of duty on major petroleum items, there is no CD duty on furnace oil, motor and aviation spirit, JP-4 kerosene oil, and light speed oil. Some other items like lubricating oil, petroleum naphtha, and white spirit have been subjected to CD at 25%, 20% and 10% rates, respectively. Concession in CD has been granted for exploration and production (E&P) companies on the import of machinery, equipment, specialized vehicles/ vessels and helicopter etc., through SRO 678(I)/2004 dated 07.08.2004.

Sales Tax (GST)

Currently, the standard rate of 15% is applicable on petroleum products either imported or domestically supplied on all the items described in customs duties tax base. Recently, crude oil has been zero-rated through SRO 1164(I)/2007 dated 30th November, 2007. Before that the applicable rate of GST was 15%. The idea of zero rating of crude oil was to reduce the volume of input adjustment and payment of refunds. This measure is a step forward towards simplification of taxation of POL. As a special tax incentive, the PDC is excluded from the value of import and supply of HSD for the purpose of sales tax. Similarly, zero-rated sales tax is granted to exploration and production (E&P) companies on import of machinery, equipment, specialized vehicles/vessels etc., through earlier mentioned SRO 678(I)/2004 dated 07.08.2004.

Federal Excise

The federal excise on relatively insignificant petroleum products is a potpourri of *ad valorem* and specific rates (Table 4). With a few exceptions where *ad valorem* rate is applicable, all other items are subjected to rate variations. While this arrangement has its own merits and demerits, it is being pursued not only in Pakistan but also elsewhere.[12] Thirsk (2008) has rightly pointed out that there is a need to re-visit and improve upon this tax structure to avoid complexity and possible misuse.[13] It is relevant to mention that beside the regular tax structure, special exemptions to selected institutions are also available. For example, lubricating oil, if used in the manufacture of transformers supplied to Pakistan Navy for its vessels is exempt from FED.

Direct Taxes

Currently, the uniform corporate tax rate of 35% is applicable for all companies except the Small and Medium Enterprises (SMEs). However, the 5th schedule of Income Tax Ordinance, 2001, states that the aggregate of the taxes on income and other payments excluding royalty paid by an onshore/offshore petroleum exploration company and production undertaking for a tax year shall not exceed the limits provided for in the agreement provided that the said aggregate, shall not be less than 40% for onshore and offshore

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[12] Wide variations in the excise tax rates on POL products have been pointed out in India by the Committee on Pricing and Taxation of Petroleum Products. See the Committee Report (February, 2006).

[13] See W. Thirsk (2008): Tax Policy in Pakistan: An assessment of Major Taxes and Options for Reforms. Policy Paper prepared for FBR under the FBR/ World Bank/ Andrew Young School of Georgia State University, USA. According to the author, 'In rem excises … easier to administer but have the defect that they are susceptible to inflationary erosion ... Too many fine distinctions within a commodity category prices open the door for the type of tax evasion that is hard for administrators to detect. Most countries operate with a much simpler system of tax rates for petroleum products and their derivatives.'

companies. Presumptive withholding tax @ 10% is deducted from the commission on discount allowed to the pump operators.

Table 4: FED Rates Applicable During 2007-08

Tariff Description HS Code	Tariff Description	Federal Excise Duty Rates
2710.1150-0000	Solvent Oil(Non Composite)	Thirteen Rupees Per liter.
2710.1190	Other	Eighty Eight Paisas per liter
2710-1949	Other fuel oils	One Hundred Eighty Five Rupees per metric ton
2710.1951	Lubricating oil in packs not exceeding 10 liters	Ten per cent of the retail price
2710.1952	Lubricating oil in packs not exceeding 10 liters	Ten per cent of the retail price
2710.1953	Lubricating oil in packs not exceeding 10 liters	Seven Rupees and Fifteen Paisa per liter.
Respective Headings	Lubricating Oils manufactured from reclaimed oils or sledge or sediment etc	Two Rupees per liter
2710-1993	Base Lube Oil	Seven Rupees and Fifteen Paisa per liter
2710-1997	Transformer Oils	Ten percent of the retail price or Seven Rupees and Fifteen Paisa per liter, which is higher.
2710-1999	Other Mineral Oils excluding Sewing Machine oil	Fifteen percent *ad valorem*
2710-9100 and 2710.9900	Waste Oil	Ten percent of the retail price or Seven Rupees and Fifteen Paisa per hundred cubic meters

** Special Excise Duty1% is effective from 2007-08*

** For details see, first Schedule, Federal Excise Act, 2005*.

Special Incentives Related to Direct Taxes

i) Besides 50% general initial depreciation allowance, 100% expensing is allowed in case of below ground installation while 20% depreciation allowance for offshore platform and production installation.

ii) In determining the income of such undertaking for any year ending after the date on which commercial production has commenced, an allowance for depletion shall be made equal to fifteen percent of the gross receipts representing the well head value of the production, but not exceeding fifty percent of the profit or gains of such undertaking before the deduction of such allowance

iii) The exemption from withholding tax is granted to:

a) Payments received by a person (including permanent establishment of non resident petroleum exploration and production (E&P) companies on account of supply of petroleum products imported by the same person under the GOP's deregulation policy of POL products.

b) Any payments received by an oil distribution company or an oil refinery for supply of its petroleum products.

v) The exemption from withholding taxes is allowed on import of petroleum business:

a) Petroleum (E&P) companies covered under SRO 678(I)/2004 dated 07.08.2004 except motor vehicles imported by such companies.

b) Companies importing high speed diesel oil, light diesel oil, high octane blending component or motor spirit, furnace oil, JP-1, MTBE, Kerosene oil, crude oil for refining and chemical use in refining thereof in respect of such goods.

Revenue from the Oil Sector

Petroleum sector is the leading revenue source in Pakistan. Its contribution to total tax collection of FBR (both direct and indirect) in 2006-07 has been 19%.

Indirect Taxes

Due to substantial share of POL products in indirect taxes, any fluctuation in the tax receipts from this source, for whatever reason, seriously affects the overall collection of taxes. Table 5 highlights that revenue generation from POL products has improved significantly during 2004-07. In particular, the collection of sales tax at import stage and customs duty have recorded phenomenal increase in 2005-06 due to strong growth of 71% in the value of imports and 111% in dutiable imports of POL products. This growth in import was mainly driven by huge imports of HSD oil that increased by 147%. Moreover, perpetual increase in international price of oil was the additional factor that contributed to this increase in the value of imports. Since the import of HSD was dutiable, therefore, higher growth in CD was also achieved. Similarly, in 2006-07, a double-digit growth of 18.4% was recorded in total indirect tax collection largely due to constantly rising prices. The increase in sales tax collection was close to 20%. Similarly, after attaining new pedestal, the CD registered a modest increase. Finally, notwithstanding the relatively minor share of federal excise, it also showed an increase during this period.

Table 5: Collections of Indirect Taxes from POL Products

	FY 04-05	FY 05-06	FY 06-07	Growth (%) in FY 05-06	Growth (%) in FY 06-07
Sales Tax	53,960	83,202	99,890	54.2	20.1
Domestic	22,776	26,211	31,661	15.1	20.8
Import Stage	31,184	56991	68,229	82.8	19.7
Customs	5,954	14,164	14,891	137.9	5.1
Federal Excise	3,868	3,576	4,783	-7.5	33.8
Indirect Taxes	**63,782**	**100,942**	**119,564**	**58.3**	**18.4**
Tax/GDP Ratio	1.0	1.3	1.4		

Direct Taxes

According to returns filed by the petroleum companies during tax year 2004-2006, there has been a flurry of activity in the oil sector. Consequently, an accelerated growth in tax collection has been recorded. The collection has increased from Rs. 12.7 billion in 2004 to Rs. 35.6 billion in 2006. It may, however, be added that this amount pertains to only those companies whose sales tax number has matched with the National Tax Number (NTN) available with the Pakistan Revenue Automation Ltd. (PRAL) – the technical arm of the FBR.

Pressing Issues related to Petroleum Industry

Inter-fuel Substitution and Revenue Implications

A continuous substitution in consumption of different POL products is taking place for the last many years. The three sectors where this substitution is evident are transport, industry, and power generation. The fuels being substituted essentially by natural gas and to a lesser extent by LPG and coal are MS, HSD, and FO. According to Energy Year Book (2007), the consumption of natural gas in the transport sector has increased from 0.17 million TOEs in 2001-02 to 1.32 million TOEs in 2006-07, indicating ACGR of 50.3%. On the other hand, the growth in MS during this period has been 1.2% only, and in HSD -0.7%. Given that the number of motor vehicles has increased tremendously during this period, the growth in consumption of different fuels confirms that natural gas has assumed a clear preference over other fuels. Why this has been the case? The answer lies in the simple fact that natural gas is relatively cheaper than its substitutes. A comparative position of price changes further highlights this position; the price of MS Ron has increased from Rs. 33.3 per liter in 2002 to Rs. 62.81 per liter in 2008 registering an average annual growth of 14.2%. Similarly, the price of HSD has increased by 18% during this period. Compare to this, plying of automobiles on natural gas was not only relatively cheaper to start with, the rate at which its price has increased over the years has also been much lower and slower than other fuels. As a result, the consumers have rightly shown their inclination towards natural gas than MS or HSD. A similar preference for cheaper fuel also prevails in the industrial and power sector where natural gas is substituting furnace oil. Since the tax component on MS and HSD is relatively higher, this switch has serious revenue implications that have not been adequately addressed so far.

The Issue of Circular Debt

Due to soaring prices of petroleum products and a near freeze on retail prices, the GOP is providing relief to the end consumers since

2004. The subsidizing of HSD, kerosene oil and LDO has resulted into huge Price Differential Claims (PDC) by the Oil Marketing Companies (OMCs) over the years. However, despite substantial payments to OMCs, a large sum remains unpaid due to financial constraints faced by the Government. Similarly, the Government, at times, has been successful only partially on its obligations to power generating companies for the subsidy to domestic consumers on their electricity use. As a result, this arrangement of subsidizing POL products and electricity and belated disbursement has created a serious circular debt problem.

The whole chain of events is as follows. The delay in payments by the Government to the OMCs creates complications in the whole fabric of the energy sector. Due to short liquidity of OMCs, it cannot properly fulfill its obligation to the refineries. In turn, it makes difficult for the refineries to pay for the crude oil. On the other hand, delay in the release of payments to WAPDA constrains it to pay for fuel supply to OMCs and purchase of electricity from IPPs. Due to pending amount of IPPs with WAPDA, these companies, in turn cannot make full payments to OMCs for supply of fuels affecting their electricity generation. Thus, each and every stakeholders enters into indebtedness, which in totally becomes a serious issue. While every effort is being made to address this issue, it still requires further attention to have uninterrupted power supply to final consumers.

Subsidies vis-à-vis Taxation

As discussed, while on one hand, government is providing subsidy to the consumers of electricity and petroleum, taxes are also being charged on these items on the other hand. Thus an idea of no-tax no-subsidy is being floated from certain quarters. Just to understand the whole issue and to find out who is the real gainer, an effort has been made to estimate the volume of indirect taxes realized from subsidized POL products. It has been found that around Rs. 179

billion of tax has been collected from mainly HSD during a span of four years ranging between May 2004 and March 2008. Compared to this, Rs. 156.7 billion have been paid as PDC to OMCs. Thus, 87% of the taxes received have been returned to OMCs.[14]

The question is should Government continue to subsidize HSD? The recent evidence suggests that due to prolonged subsidy to HSD, it has become so cheaper in the region to have encouraged smuggling to neighboring countries. It means that in-a-way residents of these countries are benefiting from the subsidies on HSD by Pakistan. Should this approach be continued or a prompt remedial action is desired is left for the readers to decide.

Concluding Remarks

Petroleum products are the top revenue generating sources in Pakistan. However, due to rising international POL prices, the policy makers throughout the world and, particularly, in the developing world are faced with the dilemma of how to deal with the situation. Neither it is possible to fully pass on the whole increase to final consumers, nor these economies in a position to continue to subsidize POL products. The inflationary considerations and rising deficits are the primary considerations. Pakistan is also badly impacted by the price hike because it relies heavily on imported petroleum products.

An attempt has been made in this study to evaluate the demand and supply situation in the country to determine the rationale for price. Contrary to popular perception, it has been shown that the tax burden in price is much lower in Pakistan than endured by the

[14] It is pertinent to mention that out of total tax collection from subsidized items, only 2.8% (around Rs. 5 billion) is contributed by kerosene and LDO, and the rest goes to HSD. The low collection by these two items is mainly due to their exemption from customs duty and insignificant import. The only source of their indirect tax collection is sales tax domestic. The exemption of these two items from sales tax vis-à-vis withdrawal of subsidies would benefit the government due to low contribution in tax revenues.

residents of the developed world. On the other hand, it is fairly comparable to countries in the region. However, given the inadequacy of resources within the country and increasing expenditure needs, total withdrawal of taxes on POL products appears to be a difficult proposition. The effort of the Government to lessen the burden of rising international prices onto final consumers by subsidizing these products has backfired. The consequential worsening of fiscal deficit has sent awful signals to 'economy-watchers'. Some of them have created so much of scare that the economy is virtually been driven by speculators and exploiters.

How this situation could be reversed is a critical concern for everyone? One option is to rationalize prices by revisiting the price fixation formula. The alternative is to put in place a strict program of energy conservation. Within the former option, the foremost consideration should be to revise the margins of OMCs and dealers. The currently applicable specific rates of 3.5% and 4% have put serious pressure on the overall per liter price. Similarly, the policy of uniform price throughout the country requires a 'rational' decision on inland freight equalization margin. Thirdly, the tax component in price should not be treated as a sacred cow. While POL may continue to be a significant source of revenue for the Government, it should not be exploitative. A system of tax and subsidy going hand-in-hand cannot continue on sustainable basis. Finally, the role of oil refineries and OMCs is critical in the overall growth of the energy sector. However, the super profitability of petroleum sector at the expense of weakening economic fundamentals of developing economies is a sure recipe for disaster that needs to be avoided.

III

FBR Tax Policy Program: An Overview of Tax Policy Initiatives[15]

Introduction

Designing and implementing a tax system in developing countries is a challenging task. Many such countries not only have large traditional agriculture sectors, hard-to-tax small business, and the informal or shadow economy, but are also faced with administrative and political environment that constrain their ability to tax. However, as the countries develop; and production and consumption activities increase, the need to bring wages, and personal income, and corporate profits of these entities into the tax net without overstraining administrative capacity or unduly discouraging the expansion of such activities also increase.

Pakistan's tax policy is confronted with a similar challenge. Unfortunately, the processes of tariff rationalization and base broadening that started in the late 1980s had not produced the desired results of raising the revenue to the required level. One of the reasons is that complete inter-tax substitution has not taken place. While, domestic taxes, particularly GST and income & corporate taxes have gained prominence, they have failed to fully compensate for the loss of revenues rendered due to massive slashing down of customs duty rates and shrinking of FED base. Furthermore, this change has not been able to keep pace with the growing services and industrial sectors in the economy. There are also concerns that the system is inefficient and inequitable.

The recent tax administration reforms project (TARP) is an effort to address some of these challenges by improving the administrative

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[15] This note is prepared by Robina Ather Ahmed, Chief (Fiscal Research and Statistics).

capacity of the system through automation of business processes, and human resource initiatives. However, it is equally important that the tax policy framework is also designed in a manner that it satisfies the multi-prong objectives of transparency, equity, and simplicity. For this, it is essential to have (as right as we can first by) a comprehensive review of the existing federal tax system and then looking at the tax policy reform options for Pakistan. This exercise should have a straightforward extension of developing a medium to long-term policy framework for next five to ten years.

In view of this, the GOP requested the World Bank in January 2006 for assistance on a comprehensive design of tax policy in Pakistan. As an initial response, the Bank supported a consultancy report on a preliminary review of the federal tax system, finalized in June 2006.[16] The on-going Pakistan Tax Policy Program has been built on this initial yet path breaking work and designed to give a tax policy road map for Pakistan.

Objective of the Program

The Tax Policy Program (TAP) started in March 2007 as a 22-months project. It involves a partnership among three parties: the Government of Pakistan represented through FBR, the World Bank, and the Andrew Young School of Policy Studies of Georgia State University USA, an institute of international standing specializing in tax policy in developing countries. The objectives of TAP are threefold:

a) To provide a comprehensive assessment of Pakistan's tax system;
b) To learn lessons from countries involved in successful tax policy reforms and lay out tax reform options for Pakistan; and

[16] See J. Martinez-Vazquez (2006) 'Pakistan: A Preliminary Assessment of the Federal Tax System' Georgia State University, USA.

c) To build capacity at FBR and other collaborating institutions for fiscal policy analysis.

Policy Papers

The first component comprises of a comprehensive review of Pakistan's tax system. The appraisal involves a series of seven tax policy papers and a comprehensive synthesis which will constitute the Pakistan Tax Policy Report.

Policy Paper 1: Tax Policy Options for the Budget 2007/08

The starting point for the work was a paper to investigate measures which could be introduced in budget 2007/08. The emphasis was on policy changes that are supportive of the medium term goals of a simpler, fairer and less distortionary tax system. The paper was presented by the team of researchers in April, 2007. It has suggested some short term options to expand the direct as well as indirect tax base. In indirect taxes, the report recommended excise tax on fee and commission of banks and leasing companies on certain services, withdrawal of GST exemption on some duty free imports and lowering of GST threshold for retailers. In direct taxes, the report suggested elimination of exemption on short-term capital gains, taxation of pension income as ordinary income and taxation of employee perquisites at market value. Some, but not all, of these suggestions were incorporated in the budget 2007/08.

Policy Paper 2: Review of Major Tax Instruments

The second policy paper entails comprehensive review of Pakistan tax system. Two tasks would be carried out for each major tax in the system (personal income tax, corporate income tax, consumption taxes and international trade taxes). The first part will be a description of the present system, and a review of issues and problems surrounding the tax. The review would be both qualitative and quantitative in nature, and would match up each tax against the norms for "good" taxation, the best international experience, and against the GOP goals. The second part of the policy paper would evaluate the choices against the same norms as suggested above, as well as estimate the revenue yield and elasticity and impacts on the distribution of tax burdens. While the analysis will not carry out a hands-on analysis of administrative procedures, it will pay close attention to current administrative practices as well as the ongoing tax administration reform efforts.

Policy Paper 3: Federal Tax Gap Analysis

Low compliance and high exemption are two factors that drive a wedge between the potential and actual tax yield from economic activity. First, weak compliance leads to a tax gap between what taxpayers owe, as determined by the tax law through the statutory tax rates and what the fiscal authority actually collects. Such tax evasion involves intentionally underreporting income, revenues or wealth, overstating those items subject to tax benefits or by failing to file appropriate tax returns. Second, tax policy itself contributes to lackluster collections by granting widespread exemptions and special treatment regimes. This policy paper will quantify the shortfall in tax collection relative to its potential due to non compliance and exemption. The calculations will draw on estimates of the tax base using information from national income accounts, household and labor surveys, and other sources. In addition, this policy paper would identify selected tax policy changes and quantify the impact through tax revenue simulation models for tax reform. Lastly, the report would provide a set of policy options and recommendations for the short, medium and long-term.

Policy Paper 4: Sub national Tax Reform Options in the NWFP and Punjab

While some provinces have been more successful than others in raising their own funds, nonetheless the overall own source revenue mobilization is quite weak. According to the 1973 Constitution, agricultural income, capital gains on physical assets, the consumption of services and urban property are exclusively in the provincial domain as tax bases. Yet negligible tax is collected from the first two heads and also little is mobilized from wholesale, retail, and transport. Similarly, Pakistan's housing market boom over the last few years appears to have been bypassed completely by the sub-national exchequers. The poor provincial performance is linked to weaknesses in tax design and tax administration. Designing a coherent tax policy for sub national levels requires an assessment of the revenue generation, efficiency and equity aspects of the tax instruments, based on a review of the overall tax burden on a particular base or sector. The sub-national policy paper will focus on the economies of the NWFP and Punjab. An attempt will be made to estimate the tax gap due to low compliance and exemptions for the sub-national tax system, quantify the revenue impact of selected tax policy changes, and propose policy options for revenue-enhancing reforms. The study will also investigate related tax administration issues, including the bifurcation of provincial tax authorities into the Excise and Taxation Department and the Provincial Board of Revenue.

Policy Paper 5: Enterprise Taxation and Investment Climate

Taxation inevitably distorts the allocation of resources in the economy, but some of the interventions are more distortionary than others. Reforming the tax structure to minimize the excess burden of taxation can increase taxpayers' welfare without lowering the tax yield. The main tax factors contributing to the economic distortions include the differences in tax bases, tax rates, and tax allowances across and within sector. The indicative findings illustrate that the marginal effective taxation of different businesses can differ quite significantly depending on the regime they are under and depending on the type of asset in which these businesses are investing. In addition, differences in compliance introduce a wedge between the formal and actual tax rates, further accentuating economic distortions. Several methods are used to measure efficiency loses due to these distortions. Average effective tax rates (AETR) and marginal effective tax rates (METR) are the commonly used measures. Whereas, AETR is the taxes paid as fraction of net corporate income METR, is the level of tax arising for a firm when it decides to invest in an additional unit of capital. The purpose of this paper will be to calculate both AETR and METR as well as examine the overall investment climate in Pakistan based on various business practices and investment climate surveys. The paper will then identify issues in corporate tax structure that need immediate attentions and suggest various reform options.

Policy Paper 6: Household Taxes and Equity

Vertical equity concerns the issue of how taxes are distributed among taxpayers with different levels of income. Martinez-Vazquez in his report, "Pakistan: A Preliminary Assessment of the Federal Tax System" (2006) concluded that taxation system is mildly progressive in Pakistan. Employing a number of simplifying assumptions (full compliance, no welfare loss due to distortion in economic behavior) and including personal income tax, corporate tax, GST, federal excise and import duties the study suggested that the top quintile contributes 19 percent more than its gross income share, while bottom quintile contributes 10 percent less than its gross income share. Rafaqat (2003) also finds modest progressivity for GST, as items heavily consumed by poor are exempt from GST. A second principle for assessing the equity of a tax system is that taxpayers with the same income pay the same amount of tax. While no study on the horizontal equity of Pakistan's tax system is available, Martinez argues that it is likely to be low because of widespread exemptions, a large informal sector and substantial under reporting by the professionals and self-employed as compared to salaried individuals subject to withholding taxes. The task of this paper is to perform a comprehensive tax incidence analysis of the entire tax system. Additionally, it would provide a set of policy options and recommendations for improving equity in the tax system.

Policy Paper 7: Pakistan's Tax Treatise

Developing countries sign double taxation treaties in order to attract more foreign investment. These are conventions between two countries that aim to eliminate the double taxation of income or gains arising in one territory and paid to residents of another territory. Typically, developing countries agree to restrictions on their ability to tax corporate income from foreign investors, as taxation in the foreign country on top of taxation in the home country could represent a barrier to foreign investment. To date, Pakistan has signed 51 bilateral agreements for the avoidance of double taxation, including with the USA, UK, Japan, and India. This policy paper will evaluate the current double taxation treaties and make recommendations with regard to the need for additions to the list of treaty-countries and re-negotiation of treaties.

Policy Paper 8: Comprehensive Synthesis Report

Pakistan's economy has changed considerably over the last decade and its fiscal needs have also changed. The current tax system faces significant problems in revenue adequacy and the impact of the system on economic development and overall fairness. The main objective of this paper is to provide a consolidated position for the reform of Pakistan's tax structure by bringing together the individual analyses. The synthesis report will spell out the tax policy related reform options for short, medium and long term with a view to raising Tax/GDP ratio by 5 percentage points over the next decade.

Country Case Studies

Tax Policy Program's second pillar relates to undertaking study tours of developing and emerging economies that have had some success in the reforms of their tax systems. Since theoretic principles based on developed country circumstances provide little guidance, an exchange of practical experiences is important. While many developing countries have undertaken unsuccessful tax policy reforms, there are a number of countries that have made substantial headway in improving the revenue buoyancy and efficiency of their tax systems. Study tours for senior government officials to meet counterparts from tax authorities and Ministries of Finance as well as tax policy researchers from other countries can provide important lessons to Pakistan. Country case studies provide a rich laboratory for studying tax reform in practice. The three countries selected for this purpose are Turkey, Egypt and South Africa. FBR team comprising senior management visited the Revenue Authority of Turkey in September 2007.

Capacity Building

The third component of TAP relates to fostering institutional development and capacity building of FBR for greater ownership and sustainability of research activity and effective implementation of policy design. Pakistan's capacity to undertake fiscal policy analysis is very limited, despite selective strong points at the FBR and elsewhere. The TAP process can serve as a "teaching tool" for capacity building and "collaborative tool" to build ownership. First, the policy papers are developed involving the FBR officials through "learning by doing". Three officers have visited Georgia State University and worked with the consultants on Tax-Gap Analysis, Enterprise Taxation and Tax Incidence. In addition, training has been provided throughout the TAP process. Consultants and Bank staff working on the TAP team have provided such training and discussion by holding methodology and results seminars during missions. This form of capacity building will be reinforced by offering capacity building training programs for officials, experts, and other stakeholders of tax policy reform in Pakistan.