Policy Research Institute of Market Economy

Prime Report

CUSTOMS TARIFF REFORMS: ONE STEP FORWARD, TWO STEPS BACK

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Introduction

Three years have passed since Pakistan Tehreek-i-Insaaf (PTI) government came to power on a reformative agenda to remove structural inefficiencies in the economy and put the country on a growth trajectory. Strengthening trade, revitalizing industries and boosting exports are part of PTI manifesto. Tariffs on imports being a principal component of the country's trade policy is vital for promoting or discouraging economic activities in the country. Tariffs, if effectively employed, can prompt optimal allocation of resources, transfer of technology, productivity and economic growth; whereas, if excessively employed, could erode competitiveness, cause deindustrialization and decline exports. While realizing the importance of tariff structure in the overall country's trade prospects, PRIME is issuing a brief report[1] on assessing the government's performance in the domain of Tariff Reforms.

In November 2019, a major policy change was approved by the Cabinet for reforming and implementing the tariff policy. The key feature of the new policy was to assign the role of tariff-setting to the Ministry of Commerce instead of the Federal Board of Revenue. This was done to ensure that tariff rates are not set for the purpose of revenue collection but for the furtherance of trade and industrial policies. A Tariff Policy Board (TPB), chaired by the Commerce Minister/Advisor was set-up. Other members of the Board are the Minister for Industries & Production, Secretary Finance, Secretary Revenue, Chairman FBR, Secretary Commerce, Secretary Board of Investment, and Chairman NTC. To assist the TPB, a Tariff Policy Centre was created in the National Tariff Commission (NTC). The NTC was assigned to undertake consultation with stakeholders, analyze the proposals, carry out research and formulate tariff policy. Since then, the TPB and NTC play a major role in setting the tariffs at the time of the annual budget. However, the FBR continues to play a major role in the determination of regulatory and other duties imposed during the course of the year.

Tariff Reforms

The incumbent government came to power on the back of proposed reforms at the policy and institutional level. It is imperative to mention that three years are not adequate to completely reform the tariff structure especially in a country like Pakistan that is confronted with myriad domestic

[1] **Acknowledgement:** Author is grateful to Dr. Manzoor Ahmad (Former Ambassador to WTO) and Mr. Gonzalo Varela (Senior Economist, World Bank) for providing valuable feedback.

and regional challenges. However, the PTI government has made some effort in the rationalization of tariffs and procedures. Furthermore, the government also needs to take into account empirical research and implement the reforms suggested by intelligentsia[2] instead of shelving quality research and adopting whimsical policies to speed up the reform process and achieve desired results.

Progress Evaluation

Trade policy is contingent upon tariff structure, which can either enable or stem the productivity. In the analysis, several cardinal ingredients of customs tariff are assessed to illustrate the contemporary challenges and obstacles presented by them, initiatives taken by the government to ease the operation of businesses and outcomes of those initiatives in terms of higher competitiveness and trade growth (see Table 1). For objective analysis, National Tariff Policy (2019-24), press releases of FBR, finance bills, SROs and World Banks' assessment of country's trade policy are taken into consideration. Exports promotion and competitiveness of industries were the promises made by ruling party before elections and included in party's manifesto, which were to be accomplished through rationalization of customs tariff structure, but insignificant progress has been made in the period under review.

Table 1: Progress on Tariff Reforms

Reform Indicator	Progress	Outcome
1- Policy formulation	• PTI government has formulated National Tariff Policy 2019-24 for the first time in the history of country. • Strategic Trade Policy Framework 2015-18 (STPF) has expired and government initiated formulation of new STPF 2020-25 but could not get it approved from the cabinet.	• NTP initiated the institutional reforms by assigning the responsibility of customs setting to TPB. • Except for some reduction in the tariff rates for industrial raw materials, no other tariff reforms have been carried out. In fact, tariff dispersions and thus anti-export bias[3] has increased. Frequent changes in the tariff rates through SROS are still the norm. Therefore, uncertainties relating to tariff rates still continue.
2- Autonomy of National Tariff Commission (NTC)	• NTC was established to take lead in formulation of tariff policies but its role has remained limited as FBR continues to have a key role in levying regulatory and other duties.	• NTC was instrumental in decreasing customs duties to augment domestic production of industries but FBR increased other regulatory duties, thus making the outcome insignificant.
3- Tariff rationalization	• In 2018, customs duty on 424 tariff lines were reduced. ACD of 1% was levied and later increased to 2%[4].	• Tariff rationalization helped to bring down the input costs and augmented

[2] Pursell, G. G., Khan, A., & Gulzar, S. (2011). Pakistan's trade policies: Future directions. International Growth Centre.

[3] Anti-export bias is the rate of effective protection, or the extent of cascading (tariff on final goods – tariff on intermediates or raw materials).

[4] Finance Bill FY2018-2019

	• In 2019, customs duty decreased from 3% to 0% on 1635 tariff lines[5]. ACD on these tariff lines were withdrawn in 2020. • In 2020, customs duty was decreased on 200 tariff lines comprising raw materials.[6] • In Finance Bill FY2022, ACD and FED was removed and Sales tax was reduced from 17% to 12.5% on cars up to 1000cc[7]. • On September 27, 2021 ACD on components of auto industry was raised to 7%[8].	manufacturing activities in the country, thus resulting in higher sales proceeds. • In case of auto sector, uncertainty and confusion is present in government policy which is illustrated by first decrease in duties to augment production and facilitate expansion, and then increase of ACD to 7% to curb surging trade deficit. • So far, there has been no effort to benchmark tariff rates with other competing developing countries. As a result, anti-export bias continues to hurt our exports.
4- Decrease in tariff slabs	• Tariff slabs were increased from 4 to 5, which contained 95% of tariff lines, while 9 slabs were created for nonessential and luxury items such as auto sector parts, alcoholic beverages and precious metals	• The introduction of 0% tariff slab for essential raw materials helped to reduce input prices for domestically manufactured goods and agricultural products but inflation has been on rise continuously. • Secondly, due to existence of numerous exemptions, the customs tariff remains complex and difficult to administer, against the vision of NTP.
5- Decline in average weighted tariff	• The customs duty was reduced on specific tariff lines, which resulted in decline in weighted average tariff [9] from 13.8% to 12.1%.	• The essential commodities and inputs for export oriented industries saw decline in tariffs but did not translate into significant decline in prices.
6- Reducing regulatory barriers to imports	• Imports in the country has been restricted with application of additional customs duty, regulatory duty, sales tax, federal excise duty and withholding tax.	• Incidence of myriad duties has increased the overall cost of imports and subsequently, restricted the transfer of knowledge and technology to enhance the competitiveness.
7- Moving away from revenue generation goals	• Revenue generation takes precedence in tariff setting and no significant reforms have been taken to decrease dependence on indirect taxes and more on direct taxes.	• Revenue collection at import stage was 43% in FY20 and 45% in FY19 as a percentage of total revenues collected by FBR[10]. The cost of import is high for businesses that translates into inflation.
8- Decrease in distortions from SROs	• PTI government promulgated 43 SROs in three years, while PMLN	• Due to absence of comprehensive long term trade policy, the STPF, government is using SROs from time to

[5] Finance Bill FY2019-2020.
[6] Finance Bill FY2020-2021.
[7] Finance Bill FY2021-2022.
[8] S.R.O.1265-(I)/2021, Ministry of Finance and Revenue. https://download1.fbr.gov.pk/SROs/2021928159215021SRO1265-2021.pdf
[9] WTO country profiles and Trade Policy Reviews.
[10] Various issues of Year Book, FBR.

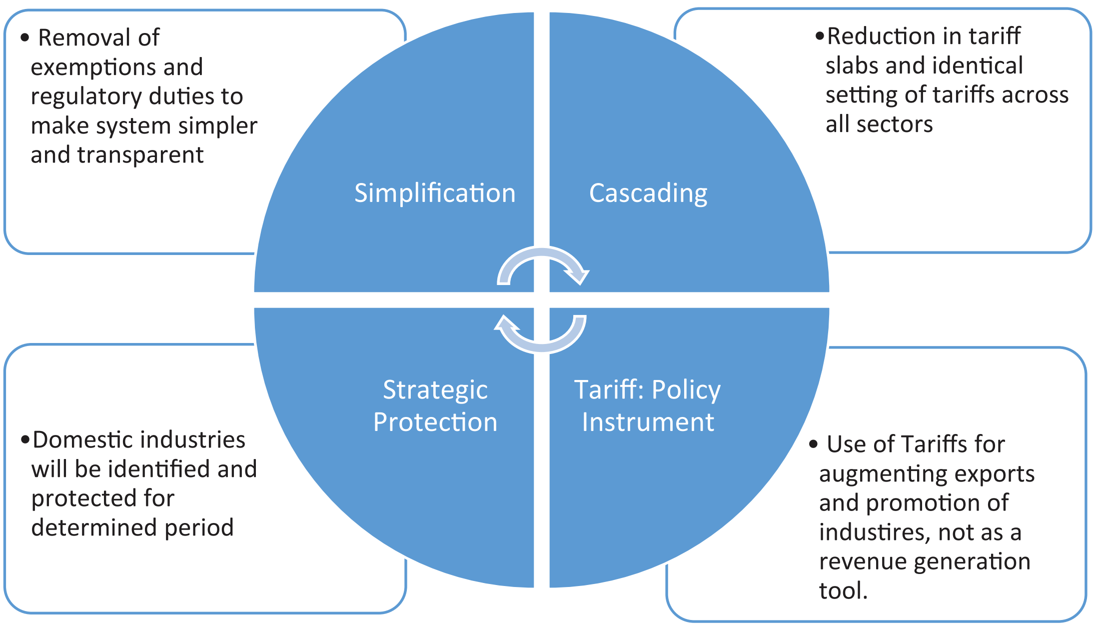
	government promulgated 53 SROs in five years.[11]	time for policy changes, thus creating uncertainty and difficulty in implementation of policy.
9- Competitiveness of industries	• The reduction in customs duty on inputs of exports oriented industries promoted the scale of operation of businesses and augmented productivity but since customs duties on the finished products have not been reduced, local manufacturers find it profitable to sell the goods in the domestic market rather than compete in the international markets	• Pakistan's share in global exports[12] increased from 0.11 % in 2018 to 0.12% in 2020.
10- Impact of high tariffs on smuggling	• High tariffs result in increased smuggling. No effort was made to reduce tariffs on smuggling prone items	• Smuggling seems to be on the rise.
11- Bilateral and multilateral trade agreements	• China Pakistan Free Trade Agreement (CPFTA) Phase II was signed in April 2019 and came into effect in January 2020. • No progress has been made on a number of FTAs which were initiated several years ago such as Turkey, Korea, Thailand, Singapore, etc. • Pakistan has also made no effort to join the Regional Comprehensive Economic Partnership (RCEP). • Pakistan has made attempts to build economic ties with Central Asian States since 2020 but progress has been restrained to MOUs.	• As a result of CPFTA, 93% of product lines will have tariffs reduced to less than 10% • While other regional countries are getting more integrated through trade blocks and bilateral FTAs, Pakistan is getting more secluded.

[11] Ministry of Commerce, Government of Pakistan. https://www.commerce.gov.pk/sros/
[12] Global exports data taken from World Trade Organization datasets and Pakistan's exports data taken from State Bank of Pakistan.

Contemporary Tariff Structure and Trade Regime

PTI government acknowledged prevalent structural complexities in the tariff setting and promised to bring reforms and enhance the competitiveness of domestic industries. In this context, the National Tariff Policy (NTP) 2019-24 was formulated to assess the prevalent obstacles, rationalize tariffs and put forward a path to augment productivity and competitiveness of domestic industries, which will be then translated into higher exports. The objectives and policy directions envisaged in NTP are illustrated in Figure1.

Figure 1: Objectives and Policy Direction of NTP



One of the main feature of NTP was time bound protection, which will be phased out to make the industry competitive for exports, but the industries are still protected and there is no indication of reducing protection in near future. Secondly, NTP envisaged reducing complexity of the entire tariff system, but items are frequently moved from one schedule to another through which application of duties remains consistent along with time to time promulgation of SROs, which negates the purpose of creating tariff slabs and the implementation has become more intricate. NTP acknowledges the distortionary effects of regulatory barriers and envisioned gradual reduction in these, but reality is in contrast and regulatory duties are increased significantly whenever trade deficit increases. Furthermore, made in Pakistan was the ultimate objective but trade barriers have restricted the transfer of technology and knowledge to make this happen, which ultimately resulted in country's lower share in global value chains.

I. Incidence of Duties

Figure 2: Incidence of Duties

A. Import Value of Commodity

B. Customs Duties on Import Value (CD, ACD, RD)

C. Application of Sales Tax (A+B)

D. Additional Sales Tax Levied on C

E. Application of Federal Excise Duty (A+B+C+D)

F. Application of Withholding Tax (A+B+C+D+E)

Total Duty and Taxes (B+C+D+E+F)

The analysis of tariff application is imperative to understand the trade regime of the country. The trade in the country is marred by myriad duties (see Figure 2[13]), which upon application exponentially increase the value of imports, translate into higher cost of production, deprive manufacturers of necessary capital, and subsequently, diminishes the competitiveness of commodities internationally and causes inflation domestically. Moreover, the incidence of sales tax and withholding tax is completely unrealistic at the import stage for the output that will be produced later. "The optimal allocation of resources takes place in the absence of distortions such as tariffs i.e. CD, ACD and RD because they are discriminatory by origin and hinders the promotion of exports", Gonzalo Varela.

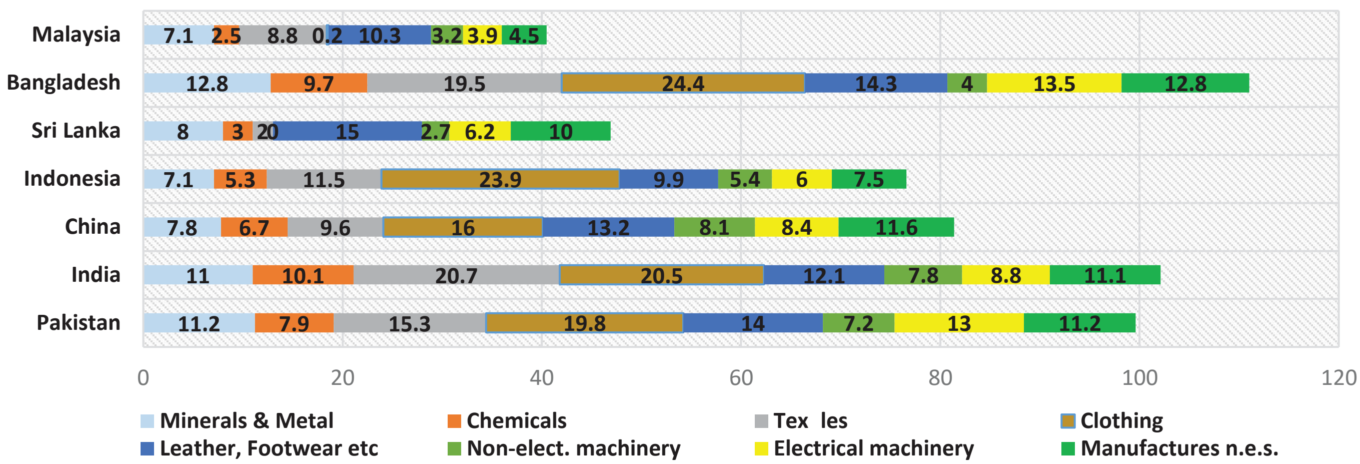
II. Regional Trends

The fastest growing exports oriented economies have decreased import tariffs, while in Pakistan, the trend has been in contrast[14]. Currently, Pakistan maintains one of the highest average weighted tariffs i.e. 12.1% amongst the 70 countries having more than US$ 20 billion annual exports except India and Bangladesh (see Figure 3[15]). Additionally, the imposition of regulatory duties has

[13] Figure 2 is taken from PIDE Working Paper: The Tariff Tripod of Pakistan: Protection, Export Promotion, and Revenue Generation.
[14] National Tariff Policy 2019-2024.
[15] Data for Figure 3 is taken from WTO Pakistan Tariff Profile 2019.

increased the effective tariffs even higher. The resultant failure to keep pace with the regional export growth is primarily linked with anti-export bias in Pakistan's economic policy paradigm, the tariff regime on imported inputs being one of the major drivers of anti-export bias. China, Indonesia, Malaysia and even Sri Lanka have lower tariffs compared to Pakistan and experienced significant growth in their exports.

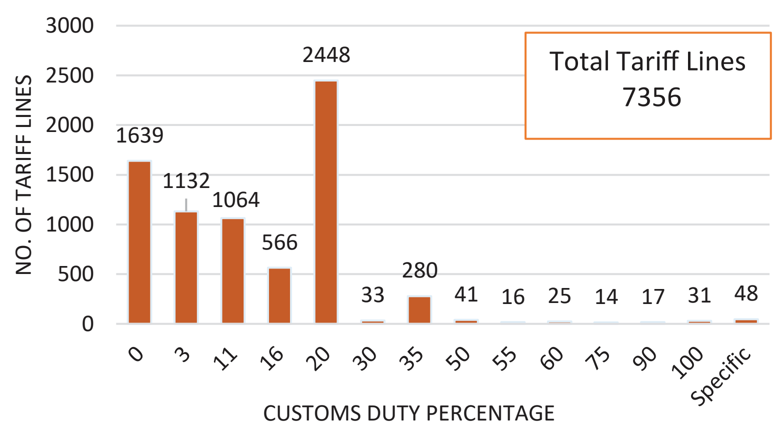
Figure 3: Country wise Average Tariff Rates of Products (2020)



III. Revenue Generation

The tariff policy in the country is designed on the back of three goals: protection of local industry, export promotion and revenue generation. In this regard, different tariff slabs comprising tariff lines were constructed (see Figure 4[16]). Tariffs are based on the principle of cascading, which means that import

Figure 4: Coverage of Tariff Lines



[16] Figure 4 is taken from PIDE Working Paper: The Tariff Tripod of Pakistan: Protection, Export Promotion, and Revenue Generation.

duty on raw materials shall be charged at lower rates; whereas, final goods are subjected to higher duties. Around 95% of the tariff lines fall in first five slabs while rest of the nine slabs comprise non-essential and luxury items. Furthermore, the imports are also subjected to other regulatory duties to generate revenues (see Figure 5[17] & Table 2[18]). Revenue generation through raising tariffs has an inverse relation to the volume of trade. In case of Pakistan, the imports are subjected to higher tariffs to restrict the trade deficit, as country's exports have remained insignificant compared to imports and remittances play a vital role in balance of payments. Whereas, it has been observed that decreasing tariff and non-tariff barriers though increases trade deficit in short term, but then translates into higher exports in long term, which compensates the temporary lost revenues and high deficits. Furthermore, the decrease in the customs duty of 1635 tariff lines contributed to higher sales tax collection, an indication of higher productivity and output. Vietnam is such an example whose imports as a percentage of GDP is 103.6 percent while exports as a percentage of GDP is 106.8 percent, an illustration that higher imports can be morphed into higher exports.

Figure 5: Regulatory Duties on Imports (FY 2019)

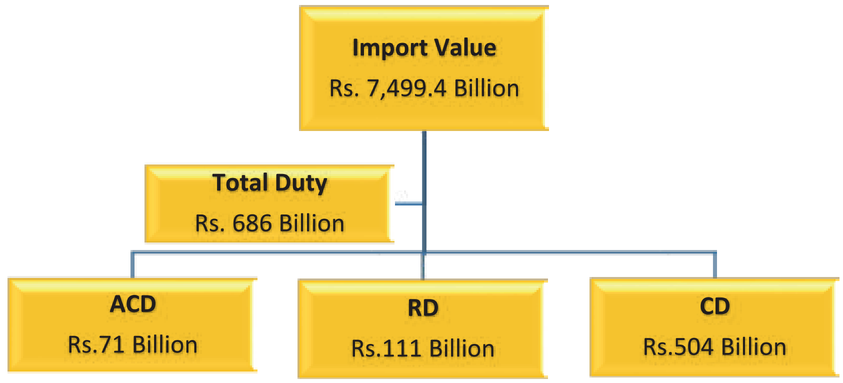


Table 2: Revenue Collection at Import Stage

Year	Total Revenue Collection of FBR (Rs. in Billion)	Revenue collection at import stage (Rs. in Billion)	Revenue collection at import stage (%age)	*Part of CD in revenue collection (Rs. in Billion)	Part of CD in revenue collection (%age)
2014-15	2059	1023	50	306	15
2015-16	3112	1273	41	405	13
2016-17	3361	1371	41	497	15
2017-18	3844	1651	43	608	16
2018-19	3828	1732	45	686	18
2019-20	3997	1754	43	627	16
2020-21	4732	2129	45	747	16

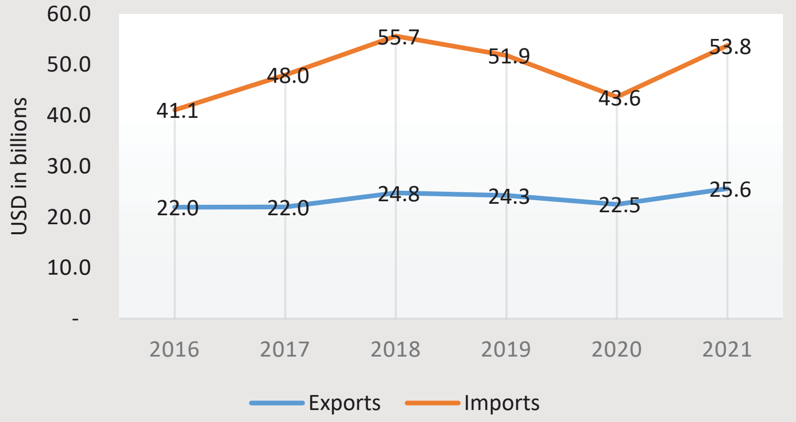
* It includes amount of ACD & RD as well.

[17] Segregated data of ACD and RD for FY20 and FY21 is not publically accessible.
[18] Data has been taken from editions of Year Book, FBR and FBR press releases.

IV. Trend in Trade

Trade plays a cardinal role in augmenting the productive and allocative efficiency of resources through transfer of knowledge and technology associated with the goods. However, the protectionist policies have hindered the efficiency and competitiveness of the domestic industries, which resulted in stagnation of exports. There is a correlation between imports and exports; exports have been higher in the years when imports were high (see Figure 6). Country's exports have also been marred by lack of diversification of goods and markets, which present avenues to boost trade. Consequently, country suffered to maintain balance of payments and remained stuck in vicious circle of current account deficit.

Figure 6: Trading Pattern of Pakistan



Prevalent Issues in the Tariff Policy

- **Revenue Generation Tool:** Application of myriad taxes for revenue generation has created distortion; raised cost of business and resulted in the loss of competitiveness of domestic industry especially the exports oriented sector.

- **Loss of Competitiveness:** The continuous protection of industries has rendered them inefficient, as it eliminates incentives to upgrade and innovate. Consequently, country's share in the global market has remained insignificant.

- **High Protection:** High tariffs have created an anti-export bias because producers of goods find export markets less attractive than the protected domestic market. Therefore, burden is borne by the domestic consumers in the form of high prices and lower quality.

- **Complexity:** Multiple duty slabs, high tariffs, concessionary SROs and regulatory duties have made the tariff structure complex and its implementation cumbersome. Frequent changes in the regulatory duties have created uncertainty, which shy away investors and foreign investment in the country.

- **Corruption:** High tariffs have prompted smuggling, under-invoicing, and mis-declaration of quantity and quality of goods. The literature suggests that tariff rates have positive effect on import tax evasion (Mishra et al, 2008[19]). Findings of another study suggest that one-percentage-point increase in the tax rate is associated with a three-percentage-increase in evasion (Fisman & Wei, 2004[20]).

Conclusion

Pakistan's complex and progressive tariff policy contributes to stagnancy in exports and requires reforms. The cardinal purpose of tariff policy should be augmenting trade and promoting competitiveness, which only happens from the transfer of technology and exposure to international competition. In the three years in office, PTI government formulated first ever national tariff policy and initiated rationalization of tariff structure, which resulted in a slight increase in exports amid disruptions caused by pandemic. But, the tariff structure is still complex and predatory, hinders the opportunities to expand trade and creates incentives for corrupt practices. The government, needs to move away from the policy of using tariffs and other regulatory duties to generate revenues for budgetary requirements and implement NTC's recommendations, which are based on objective analyses and empirical evidence. The provision of exemptions manifests absence of a comprehensive trade policy, creates uncertainty and reluctance among the business community. Furthermore, domestic industries need exposure to international competition through elimination of protection to create incentives for improvement. Lately, the progress on tariff reforms has been stemmed by the ongoing pandemic and intermittent business closures. However, it is hoped that the reforms will gain momentum and translate into economic development.

[19] Mishra, P., Subramanian, A., & Topalova, P. (2008). Tariffs, enforcement, and customs evasion: Evidence from India. *Journal of public Economics*, *92*(10-11), 1907-1925.
[20] Fisman, R., & Wei, S. J. (2004). Tax rates and tax evasion: evidence from "missing imports" in China. *Journal of political Economy*, *112*(2), 471-496.