



How Intimately SROs and Development in the Textile Sector Related?

by

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Introduction

Import related Statutory Regulatory Orders (SROs) issued by the Federal Board of Revenue decrease the efficiency of the markets by tending the market players to play in line with the SROs issued instead of the actual market prices. The ability of FBR to make changes in the custom tariff lines through SRO, empower them to deal with the vested interests of many entities. The beneficiaries of SROs are then enabled to 'extract rents' and earn extra large profits without having need to produce and compete effectively in the market. Moreover, in such an environment, investors are reluctant to respond well hence the whole market is then shifted to the chosen ones.

As many as 4500 Statutory Regulatory Orders have been issued so far by the Federal Board of Revenue to grant favours in matters of taxation to individuals and entities belonging to the elite class, or targeted audience.¹

As per Article 77 of the Constitution, Federal taxes must be levied by an Act of Parliament. However, the Custom Act grant the government power to give exemptions, concessions and preferential treatment without Parliamentary approval which means parliament can be overruled by Board which is not required (by law) to report the total value of these exemptions to Parliament.

The discriminatory SROs being issued one after another further add up to the sufferings and multiple threats already faced by the industries and businesses in Pakistan creating confusions and uncertainty among investors. Moreover, controversial SROs like SROs Nos. 212(I)/2013, SRO 154(I)/2013 & SRO 98(I)/2013², specifically benefits a privileged class of the society for extracting rents, where rent-seeking SRO culture also brings in anti-consumer and anti-market practices.

86% of the custom Tariff Lines are affected by SROs, reducing effective custom duties while 44% of values of imports are affected by SROs.³

Textile sector is among the top beneficiaries group from the SROs and in the air of misuse and under-invoicing the textile group again tops the list.⁴ There are many cases reported to

¹ <http://customstoday.com.pk/finance-ministry-girds-up-loins-to-issue-sro-about-sukuk-bond/>

² SRO 212(I)/2013 : "In the aforesaid Schedule, in Part-II, after clause (9B), a new clause shall be inserted, namely:- (9C) Tax under section 148 shall be collected at the rate of 1% in case of manufacturers and 3% in case of commercial importers covered under Notification S.R.O No. 1125(I)/2011 dated the 31st December, 2011"

³ "Reforming Tax System in Pakistan", Draft Study, SDPI (Sep., 2013)

⁴ <http://customnews.pk/index.php/2014/03/10/misuse-of-sro-492-mcc-appraisement-west-detains-80containers-of-fabric/>

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FBR over the time regarding misuse of privileged SROs and under-invoicing like import of machinery by textile groups are exempted from custom duty under the SRO 809(1)/2009 and there are reports that the said SRO is among those which are grossly misused.⁵

This indicated a need to explore the question; Are SROs indicative of a coherent development strategy for the textile sector or liable to policy capture by powerful interests groups?

The objectives and economic and political rationale of the SROs were then taken into account to find their impacts on textile sector. The research indicates that although the SRO notifications do not provide any economic or political rationale for issuing any tax amendment, yet the underlying purposes of issuing SROs are supporting sick and falling industries and provided benefits to some influential group and businesses which hampers the growth of the sectors, repels investment making the sector inefficient to compete in international markets.

<http://customnews.pk/index.php/2013/08/26/sros-allowing-concessions-to-e-customs-finalizes-to-sendrecommendations/>

⁵ <http://customnews.pk/index.php/2013/08/26/sros-allowing-concessions-to-e-customs-finalizes-to-sendrecommendations/>

Rationale of Issuing SROs

Custom Act 1969 provides Federal Board of Revenue (FBR) with a vested power to issue Statutory Regulatory Orders (SRO) at their discretion. A statutory regulatory order (SRO) is a notification issued in order to correct, amend, or complete exemption of a commodity or set of commodities from sales tax, income tax or custom duties adding into an existing law or aborting an existing tax rule or SRO for and from a specified period of time.

Custom Act 1969 states that;

Section 19: *“The Federal Government, subject to such conditions, limitations or restrictions, if any, as it thinks fit to impose, may, by notification in the official Gazette, exempt any goods imported into, or exported from, Pakistan or into or from any specified port or station or area therein, from the whole or any part of the customs-duties chargeable thereon and may remit fine, penalty, charge or any other amount recoverable under this Act”*

Section 20: *“Under circumstances of exceptional nature, the Board may, subject to such conditions, limitations or restrictions, if any, as it thinks fit to impose, by a special order in each case recording such circumstances, exempt any goods from payment of the whole or any part of the customs duties chargeable thereon and may remit fine, penalty, charge or any other amount recoverable under this Act”*

Furthermore, Section 13 of Sales Tax Act, 1990 states that, *“The Federal Government can issue exemption on goods specified in 6th Schedule and taxable supplies or imports. The exemption can be from whole or part of levy granted via issuance of an SRO”*.

The above laws do not state any economic or political rationale for issuing SROs against any goods. Although the law under section 20 states that the Board must record the circumstances under which the SRO was issued but in practice the regulatory notifications do not contain any rationale.

SROs are issued in textile industry since long but after 2006 the number of SROs released increased drastically under the vision of improving standards and exports share of textile industry in the overall trade of Pakistan.⁵

SRO 809(1)/2009

For understanding the role of SROs in a sector, we are taking the above SRO related to textile industry which states that:

“In exercise of the powers conferred by section 19 of the Customs Act, 1969 (IV of 1969), the Federal Government is pleased to exempt machinery and equipment, if imported by textile industrial units registered with Ministry of Textile Industry, falling under heading or sub-heading numbers specified,

⁵ SRO 231(1)2011 states that: *“if these goods after import or domestic production are sold or purchased between persons registered as manufacturers-cum-exporters or as exporters, for use or utilisation in goods meant for exports,”*

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excluding those manufactured locally, from payment of whole of customs-duty specified in the First Schedule to the aforesaid Act."

The above law exempts a large number of importable textile machinery (Machines for preparing textile fibres; spinning, doubling or twisting machines and other machinery for producing textile yarns; textile reeling or winding) from custom-duty. Although the authorities did not mention any reason behind issuing the SRO but the underlying assumption may be that the government wanted to improve the health of textile industry.

Are SROs beneficial?

Although the SROs are issued to amend/improve existing laws but they have certain consequences (negative or positive) on the host sector. Extensive tax exemptions, concessions and preferential treatments issued through this legal instrument of SRO creates distortions in the routine business of industries and sectors.

Moreover, the SRO culture cuts down competition and repels investment in the sector like SRO. 1125(1)/2011, which states that 17 percent sales tax is charged on the supply of finished imported goods ready for use by the general public, whereas sales tax of 5 percent is charged on supply of locally manufactured finished goods to retailers, and on subsequent retail sale of the locally manufactured goods. Due to this specific SRO local manufacturers of finished goods are privileged leaving importers of those finished products not being able to compete them in prices. Similarly another SRO 230(I)/2011 provides zero rated sales tax on import of certain plant, machinery and equipment and not on the locally manufactured ones. In such distortionary regulatory environment, one cannot expect investment to boom as it hinders level playing field in the economy.

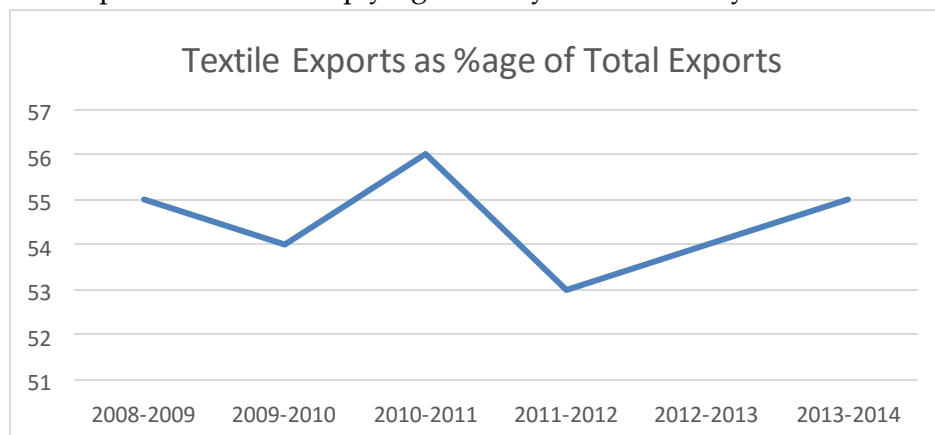
As mentioned earlier the above SRO was issued in 2009 to help improve textile industry in Pakistan, but as a matter of fact the industry, which was once considered as backbone of Pakistan's economy and one of the major contributor to the economy in terms of exports, is now facing a stagnant or no growth.



Source: Economic Survey of Pakistan 2013-14

The SRO under study was issued in 2009, but the above chart manifests that the privileges through the SRO did not help increasing total production of cloth in Pakistan which indicates that either the industry did not take incentive of the privileges or the privileges alone can't help increasing production of the industry because the textile industry is facing many obstacles like persistent electricity and gas cut to the industry has crippled the production capacities of textile industry. The shortage in energy is not allowing local manufacturers to meet delivery deadlines, which undermines the future relationship with the export markets and affect the good will of the producers.

Provision of exemptions through SRO will not aid increasing the exports by the sector when government on the other hand restricts exports through quotas and other trade barriers when demand of these products are multiplying each day internationally.⁶



Source: Economic Survey of Pakistan 2013-14

As the good intention behind another SRO 231(1)/2011⁷ related to textile industry was to support exports of textile industry, the share of textile exports in the total exports of Pakistan has not increased since FY09, besides of the preferential SROs and it is still 55% of the total exports as in FY09 with slight fluctuations which means SRO privileges did not aid improving exports share of textile industry in the total shares.

Misuse of SRO Privileges

The misuse of concessionary SROs is not new in the FBR. The beneficiary of SRO largely misuse the incentives by faking the information, under-invoicing, rent-seeking etc. FBR

⁶ <http://www.maverickpakistanis.com/2010/03/pakistan%E2%80%99s-textile-sector-invests-23m-in-machinery-import/>

⁷ SRO 231(1)2011 states that: "if these goods after import or domestic production are sold or purchased between persons registered as manufacturers-cum-exporters or as exporters, for use or utilisation in goods meant for exports,"

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registered FIRs against giant textile units for misusing SROs claiming a loss of Rs. 6 Billion to the revenues (under invoicing, fake evidences).⁸

FIRs against over a dozen importers for evading duty and taxes through mis-declaration and claiming undue benefit of SRO 1125 and Pak-China FTA under SRO 659 causing huge revenue loss to the exchequer. Clearance of imported fabrics through misuse of Free Trade Agreement (FTA) between Pakistan and China and SRO 1125(1)/2011 involving evasion of duties and taxes worth Rs 3.4 billion⁹ (As per Customs Lab Reports the consignments were found to contain woven textile fabric composed of blended viscose rayon up to 85% & mercerised cotton 15%, as such the benefit of claimed SROs and Pak-China FTA was not applicable.¹⁰)

If all the players of an industry fall under certain privilege of any SRO, massive misuse of SROs distorts level playing field even between them like domestic steel producers and commercial importers in Pakistan are seeking complete withdrawal of zero rating tariff on all steel products as misuse of exemption-related SROs and mis-declaration was causing massive evasion of duty, sales tax and income tax at the import stage¹¹ which means besides zero rated tariffs misuse is distorting the businesses.

Massive misuses of SRO 809(1)/2009 has been reported and the misuse of this and other SROs in the textile sector are in two dimensions:

- 1) The importers of the textile units falsely represent their imported units among the custom exempted units under SRO 809 and they issue post-dated checks which do not realise later taking incentive of the duty free clearance for the textile units¹².
- 2) The machinery imported under these preferential treatments are then used to supply products to local manufacturers (in cases where law restricts supply to local manufacturers) and un-registered firms.

Instead of twisting the arms of existing taxpayers, FBR must abort the exemptions as conditions are very tough for the growth of business activities and if such anti-business

⁸ <http://www.thenews.com.pk/Todays-News-13-21036-FIRs-registered-against-textile-companies-in-Rs6-bnfraud>

⁹

http://pbc.org.pk/wpcontent/uploads/2014/09/Rs_3.4_billion_tax_evasion_unearthed_in_clearance_of_fabrics.pdf

¹⁰ <http://customnews.pk/2014/06/mis-declaration-misuse-sros-firs-booked-dozen-fabric-importers/>

¹¹ <http://pakobserver.net/detailnews.asp?id=157370>

¹² <http://www.brecorder.com/taxation/666/1142130:provisional-release-of-machinery-equipment-massivem misuse-of-cheques-detected/?date=2013-01-12>

practices were not checked, it will cause the closure of more industrial and business units as these conditions will force the businessmen to look for other safe destinations.¹³

Revenue Loss

54 percent of customs tariff lines have different tariff rates for different importers. 86 percent of customs tariff lines are affected by Statutory Regulatory Orders (SRO) and 44 percent of value of imports are affected by Statutory Regulatory Orders¹⁴

Independent Studies indicate revenue leakage of 3-4% of GDP due to these SROs:

1. The amount of tax liability not collected on time,
2. Revenue loss due to tax exemptions and misuse of SROs.

Losses in 2012 are estimated to be around Rs.600 to Rs.800 billion.¹⁵ Just one SRO issued for the implementation of a preferential trade agreement with Indonesia is likely to cause a loss of Rs3.5bn to the exchequer.¹⁶ The cost of tax exemptions of sales tax, income tax and customs duty has been increased by Rs. 237.6 billion in 2013-14 when compared with 2012-13. Six sales tax statutory regulatory orders caused a cumulative loss of Rs. 230 billion in 2013-14 which is higher than the total income tax expenditure of Rs. 96.634 billion. Sales tax concessions available to the five leading export oriented sectors i.e. textile, leather, carpets, surgical and sports goods caused revenue loss of Rs. 65 billion in 2013-14.

SRO.1125(I)/2011 relating to concessionary rate of sales tax on raw materials, intermediary inputs and finished goods relating to textiles, carpets, leather, sports and surgical sectors, caused huge revenue loss of Rs. 65 billion to the national exchequer.

Through the exemptions the stated tariff is rendered ineffective and results in much lower effective rate of tax. The potential loss to the revenues can be estimated that almost 2000 tariff lines (roughly 50% of the SROs) are liable of import duties of almost less than 5.1% and almost 900 of them are zero rated items.¹⁷

The financial implication Under SRO 809, textile machinery of Rs. 67.24 billion was imported during 2012-13 and February 2014 and import duty of Rs. 3.362 billion was exempted.¹⁸

¹³ <http://www.icci.com.pk/event/detail/256>

¹⁴ Draft Study: "Reforming Tax System in Pakistan", SDPI

¹⁵ *Tax Reforms in Pakistan: Brief Prepared for Policy Symposium on Tax Reforms in Pakistan*, SDPI, 29th, November, 2013.

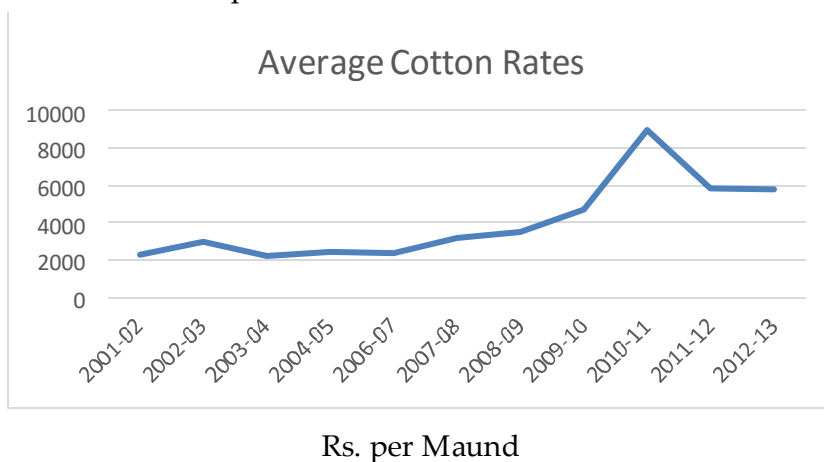
¹⁶ http://epaper.dawn.com/DetailImage.php?StoryImage=27_04_2014_016_003

¹⁷ <http://www.dawn.com/news/773789/the-curse-of-sros>

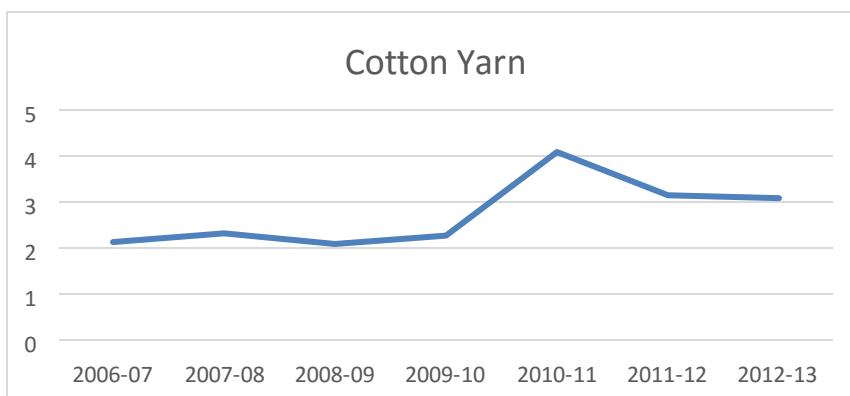
¹⁸ http://www.senate.gov.pk/uploads/documents/questions/1397731093_649.pdf

Prices

Evidence shows that while exemptions and concessions are granted to organisations, the benefits are not passed onto the end consumer.¹⁹ The prices after the duty free regime did not turn out to be efficient and competitive.



Although the SRO (809) provided zero rated duty on textile imported machineries after 2009, yet the prices kept on increasing there after which means the privilege through SRO is not sufficient enough to make the prices efficient in the sector or the producers did not pass on the benefits to the customers.



Unit Value of Cotton Yarn in \$/kg

The above chart shows unit value of Cotton yarn exported to different countries for the last few years. The prices tend to increase even after the sector was supported by multi zero rated SROs.²⁰

¹⁹ Draft Study: "Reforming Tax System in Pakistan", SDPI

²⁰ <http://www.ptj.com.pk/Web-2014/02-2014/Spinning-Review-Dr-Noor.html>

Policy and Conclusion

Pakistan is one of the countries known for an SRO culture where businesses get exemptions from customs duty and taxes. Such legislative instruments have remained a big source of rent-seeking not only for the particular businesses but also for those who were directly or indirectly instrumental in the issuance of such SROs.

It was under the Customs Act of 1969 that parliament had delegated powers of issuing the SROs to the FBR. But since it is more than manifest now that these powers have been and are being misused, the parliament should revisit the law and, if found necessary, it should be repealed.

The SROs were meant to be an instrument for running the day-to-day affairs but, unfortunately, over the years these have assumed the status of a policy in the country. According to the FBR website, 39 SROs were issued in 2012 alone.²¹

Frequent shifts in policy (through SROs) are not sending a positive signal to foreign investors who are not willing to invest in the country due to uncertainty in policy. Major concern in declining investment is lack of consistency in policy for making investment in Pakistan and not the law and order situation in the country.²²

The revision of SRO by FBR in second half of FY14 was merely an amendment and adding description to the existing SRO but no SRO was aborted.²³

The business community has deep concern over the controversial SROs issued unilaterally by the Federal Board of Revenue keeping the genuine stakeholders (Chambers/ All Pakistan Associations) in isolation and taking on board only few non-representatives with whom FBR officials meet and made decisions.²⁴

The government has agreed to provide tariff concessions on the import of items by textile sector, poultry, surgical and pharmaceutical sectors and slash duty on many locally

²¹ <http://www.dawn.com/news/778508/battle-against-sro-culture>

²² <http://www.brecorder.com/top-news/1-front-top-news/96643-pac-briefed-on-sro-culture-frequent-policyshifts-impeding-fdi-.html>

²³ <http://www.brecorder.com/taxation/181:pakistan/1180373:fbr-reviews-number-of-concessionary-sros/>

²⁴ <http://nation.com.pk/business/21-Mar-2013/businessmen-demand-withdrawal-of-fbr-s-controversial-sros>

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manufactured goods aimed at ensuring level playing field, to be announced in the federal budget 2014-15.²⁵

And the textile minister said that in view of the need to take full advantage of GSP plus facility, the duty free import of textile machinery must be allowed for another two years,²⁶ which is extended for a period of two years in National Assembly.²⁷

All Pakistan Textile Mills Association (APTMA) has made a proposal under the new textile policy (2014-19) asking the government that the Federal Board of Revenue (FBR) should not be allowed to formulate tax policy of textile sector²⁸ which means even the textile sector which is taking a lot of benefits from SROs issued by FBR are now against this act due to inconsistency and distortions created by these orders.

Approximately half of the target in achieving medium term budget deficit, fiscal consolidation of about 1.5% of GDP/year, can be achieved by just eliminating SROs. The potential loss to the revenues can be estimated that almost 2000 tariff lines (roughly 50% of the SROs) are liable of import duties of almost less than 5.1% and almost 900 of them are zero rated items.²⁹

Instead of twisting the arms of existing taxpayers, FBR must abort the exemptions as conditions are very tough for the growth of business activities and if such anti-business practices were not checked, it will cause the closure of more industrial and business units as these conditions will force the businessmen to look for other safe destinations.

²⁵ Textile, poultry and pharma: government to provide tariff concessions on imports. May 31, 2014
MUSHTAQ GHUMMAN, Business Recorder

²⁶ <http://www.mag4pk.com/blog/?m=201406>

²⁷ National Assembly, 18th Session:

http://www.na.gov.pk/uploads/documents/questions/1423035734_241.pdf

²⁸ <http://www.apmta.org.pk/News%20Clippings/News%20Clippings%2027-08-2014.pdf>

²⁹ <http://www.dawn.com/news/773789/the-curse-of-sros>