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PAKISTAN CUSTOMS: MOBILIZING DOMESTIC REVENUES FOR ECONOMIC DEVELOPMENT

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The government depends on the ability of Pakistan Customs to play a significant role in mobilizing domestic revenues, which contribute to the country's economic development. However, the predominant focus on the agency's revenue objective appears to constrain its utilization of facilitation measures that are necessary to expand trade and help the country develop. This *Governance Note* explores pathways Pakistan Customs may take to facilitate trade without compromising its collection of payable duties and taxes. It proposes three reform options for consideration: enhancing the risk management system; improving pre- and post-clearance facilities; and contributing to the broadening of the tax base. Taken together, implementing these reforms could accelerate the advancement of Pakistan Customs, building on its relatively strong cargo management and revenue control capabilities.

OVERVIEW

Domestic resource mobilization (DRM) is vitally important to Pakistan today. Fiscal and current account pressures have widened substantially, and tax revenues are on the priority reform agenda (World Bank 2017). While Pakistan's ratio of tax to gross domestic product (GDP) rose steadily to 12.5 percent (FY17) — a significant 3 percentage points above the earlier 9.5 percent (FY11) — it is still well below the 15 percent tax-to-GDP ratio that is thought to be critical in meeting the basic needs of citizens and businesses (Gaspar, Jaramillo, and Wingender 2016). Customs revenues account for more than 45 percent of overall tax revenues and are essential for Pakistan's effort to increase its DRM.

Reliance on customs for revenue collection, however, impacts the business environment. The World Bank Group's *2019 Doing Business Report* ranked Pakistan 136 out of 190 economies for ease at doing business and 142 for trading across borders. As this *Governance Note* will show, customs relies heavily on controls such as physical examinations that appear to affect the general business climate in Pakistan. While a trade-off is perceived between reducing controls to facilitate trade and increasing revenue collection, ample examples show this hypothetical trade-off does not exist in developing countries. It is possible to drastically reduce controls and generate more revenues at the same time. This note will offer concrete suggestions for Pakistan Customs to achieve this dual goal.

A MODERN CUSTOMS

In most countries, the customs administration performs at least four basic functions. Firstly, it collects revenue for the government, a function which has traditionally been prioritized by many developing countries because import duties are "easy" to collect. Secondly, it protects domestic producers and provides supply chain security. Thirdly, it plays a key role in facilitating legitimate trade through the timely release of goods at the borders. Finally, customs protects societies by preventing the importation of prohibited, dangerous, and unsafe goods (Wulf and Sokol 2005).

The responsibilities of customs are evolving. The fast-growing and increasingly competitive global environment demands gradually more effective and efficient border control without compromising the cross-border movement of goods. Consequently, the challenge is how to manage the increased volume of trade while safeguarding revenue, protecting infant and local industries, ensuring border security and compliance, and facilitating trade at the lowest possible cost to the budget and trading community. To respond to this increasingly globalized environment, a modern customs agency "must organize itself to be a trade facilitator in a rapidly changing world, as well as an efficient provider of revenues" (Wulf and Sokol 2005).

Yet, most customs and finance ministries across low- and middle-income countries often consider whether there is a trade-off between revenue collection and trade facilitation (Raballand et al. 2009). Revenue control is often guaranteed through systematic inspections and checkpoints, relying heavily on physically controlling the cargo. When excessive, this control in turn negatively impacts trade facilitation by increasing the dwell time and costs for traders. It may also introduce corruption into the system through multiple contact points. Reducing physical control of cargo — which would facilitate trade — on the other hand is perceived to reduce control on revenue collection.

The perceived trade-off is influenced by the relatively low administrative capacity and low compliance environment typical of developing countries. In these countries, tax systems are characterized by a persistent and high reliance on indirect taxation as opposed to direct taxation, with an important role for trade taxes and collection at the border. As a rationale for border tax collection, trade taxes are considered "revenue-efficient" when administrative capacity is constrained and compliance is

deemed low because information about the tax base is readily observable and controllable.[1] Large leakages of revenue might result from reliance on the domestic market for taxation when the administrative capacity of tax authorities is limited and taxpayers are noncompliant.

In this context, trade facilitation measures offered by customs, for instance under a reform program, could be interpreted as loosening controls and lead to a reduction of information critical to tax collection. This is particularly the case when no strong domestic tax net is present. As a result, national treasuries might not be willing to endorse this kind of reform because of the uncertainties it might impose on revenue collection. A similar trade-off is unlikely to be perceived in high compliance, high administrative capacity environments. In these environments, the majority of the revenue collection occurs in the domestic market while borders have the primary role of securing the country and facilitating licit trade.

Ample evidence exists, however, that this perceived trade-off between revenue collection and trade facilitation does not exist in developing countries. For example, in Madagascar, a fragile economy and the world's fifth poorest country, declarations cleared through the red channel (physical inspections) were reduced from 60 percent to 20 percent and, in the meantime, revenues increased drastically. This increase in tax revenue was driven by trade volume, with a reduction in average delays, an increase in the number of import declarations, and greater tax revenue per declaration (Raballand et al. 2017).

It is possible, therefore, for customs in developing countries to collect substantial revenue and simultaneously implement trade facilitation measures. While for developing countries the revenue function continues to be by far the most important customs function, it is possible to become more efficient at it and facilitate trade. Considering the ever-expanding global environment, it is widely recognized that many aspects of interest to customs cannot be detected through the traditional singular examination of all (or a majority of) customs declarations. Moreover, to uncover indiscretions such as valuation verification, fiscal evasion, smuggling, and customs fraud, it is often necessary to examine a trader's entire international trading pattern as well as domestic transactions.

Consequently, measures such as advance rulings, authorized economic operators, risk management, and post-clearance audits are needed more and more to not only speed up clearance procedures and reduce the need for physical inspections (especially for low-risk traders), but also to increase the likelihood of detecting fraud (UNCTAD 2016). If properly implemented, administrative measures like these could preserve revenue and concurrently facilitate trade by reducing the time and cost to comply with border requirements.

SITUATIONAL ANALYSIS

Current Role of Pakistan Customs in DRM

A decomposition of historical public revenue data reveals a persistent reliance on customs to collect a sizable portion of taxes in Pakistan. Table 1 shows that customs-collected revenue constitutes a substantial portion of Pakistan's total tax revenue. For the last decade, duties and taxes collected at the country's borders represented over 40 percent of national revenue on average. This observation is consistent with trends in other countries at comparable levels of development. For example, the customs administrations for middle-income countries in Africa similarly collect over 40 percent of government revenue on average. However, the average contributions of customs to tax revenue in the South and Southeast Asia region is lower, at an average of 27 percent (see figure 1).

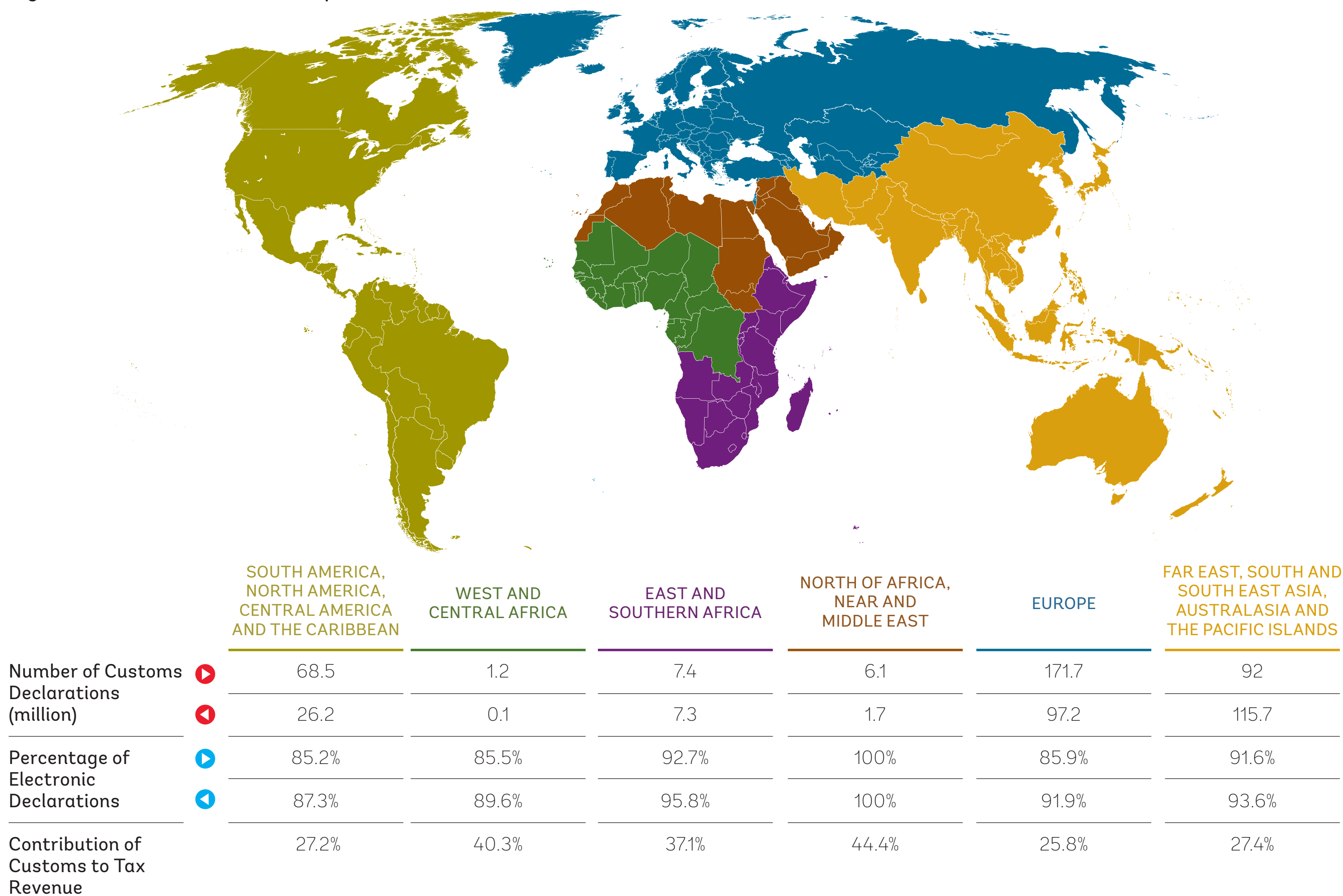
Table 1. Customs Revenue as a Percentage of Total Tax Revenue, FY2010–17

Fiscal Year	Duty (%)	Sales Tax on Imports (%)	Income Tax Withholding (%)	Additional Sales Tax (%)	Regulatory Duty (%)	Excise (%)	Other (%)	Total Customs Revenue (%)	Total Tax Revenue (PRe, millions)
2010–11	12.0	20.9	5.0	0.2	0.3	2.4	2.9	43.7	1,327,384
2011–12	11.9	24.6	5.5	0.7	0.2	2.5	2.3	47.5	1,558,013
2012–13	10.4	20.4	5.6	0.9	0.2	1.8	2.7	42.1	1,882,694
2013–14	10.5	23.2	6.4	1.1	0.2	2.0	2.6	46.0	1,939,424
2014–15	11.3	22.9	6.4	1.1	1.0	0.9	3.9	47.6	2,254,531
2015–16	11.8	24.3	6.8	1.1	1.8	0.4	5.2	51.4	2,589,979
2016–17	11.5	21.2	6.1%	1.0	2.0	0.3	5.2	47.3	3,112,472

Source: Data from Pakistan Customs, Federal Board of Revenue, 2017.

[1] Bachas, P., A. Jensen, and F. Tourek. "International Trade, Domestic Production Networks, and Indirect Taxes: Evidence from Rwanda." Unpublished manuscript, last modified June 2018.

Figure 1. Customs: A Global Snapshot



		SOUTH AMERICA, NORTH AMERICA, CENTRAL AMERICA AND THE CARIBBEAN	WEST AND CENTRAL AFRICA	EAST AND SOUTHERN AFRICA	NORTH OF AFRICA, NEAR AND MIDDLE EAST	EUROPE	FAR EAST, SOUTH AND SOUTH EAST ASIA, AUSTRALASIA AND THE PACIFIC ISLANDS
Number of Customs Declarations (million)	import	68.5	1.2	7.4	6.1	171.7	92
	export	26.2	0.1	7.3	1.7	97.2	115.7
Percentage of Electronic Declarations	import	85.2%	85.5%	92.7%	100%	85.9%	91.6%
	export	87.3%	89.6%	95.8%	100%	91.9%	93.6%
Contribution of Customs to Tax Revenue		27.2%	40.3%	37.1%	44.4%	25.8%	27.4%

Source: WCO 2017.
Note: Reproduced with permission from WCO with the following disclaimer — numbers are aggregate figures based exclusively on information provided by members.

import
export

Pakistan's Trading and Business Environments

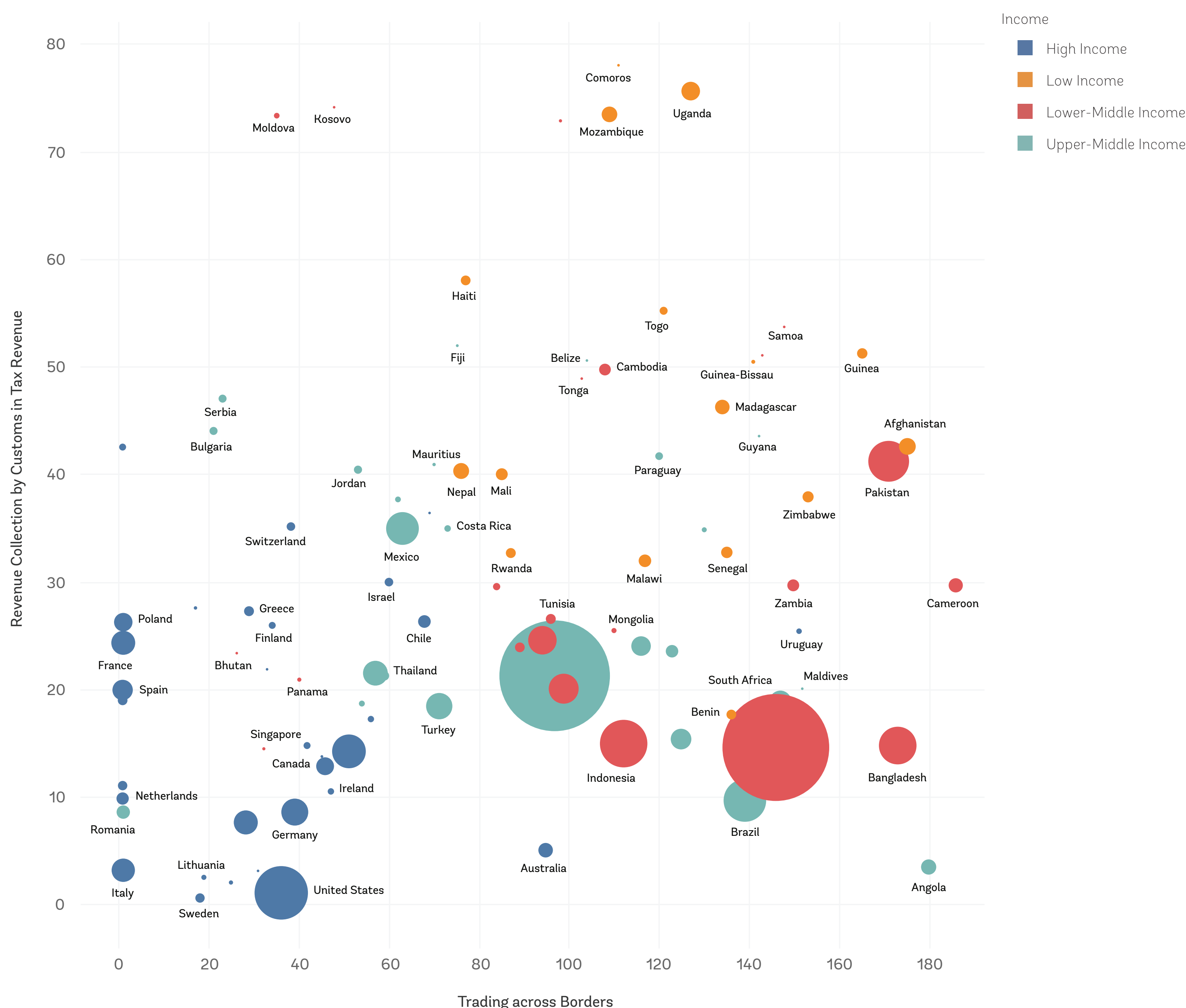
Strong dependency on customs-collected revenue is a concern for trade facilitation and thereby Pakistan's business climate. The *2019 Doing Business Report* ranked Pakistan at 142 out of 190 economies for trading across borders, which was a significant improvement in comparison to earlier years, but remains a challenge. For example, it is more expensive, by more than 200 percent ($256), to comply with border requirements for importing when compared to more competitive neighboring economies such as Singapore. Singapore only collects 15 percent of tax revenue at the border and levies no customs duties (WCO 2017).

A deeper look reveals that the high transaction cost of trading with Pakistan corresponds with lengthy port-site processes to which most shipments are subjected. For example, physical examinations are excessive, and documentary reviews are numerous. During FY2016–17, about 46.9 percent of goods declarations (GDs) were cleared through the red channel and underwent physical examinations that lasted 16 hours on average. Worse yet, few seizures were found through those inspections (less than 2 percent), which suggests controls are ineffective. Import values for the red channel were adjusted 18.4 percent of the time.[2] Moreover, pre- and post-clearance facilities or fast track channels are rarely utilized. Shortcomings in the execution of these and other core functions are negatively affecting the regulatory environment for businesses in Pakistan, as evidenced by its rank of 136 out of 190 for ease of doing business.

In summary, Pakistan Customs' apparent focus on revenue control may be at the cost of trade facilitation. As figure 2 illustrates, Pakistan is among those countries that are classified in the upper-right quadrant of the graph, which all feature high customs-collected revenue relative to total tax revenue as well as low scores in trading across borders. In contrast, countries that rely the least on customs-collected revenue also tend to be associated with more efficient cross-border movement of goods.

[2] Adjusting import values signals weak compliance by traders through under invoicing. It also acts as a distortionary measure to trade facilitation when valuation rulings are complex and outdated, as is the case in Pakistan.

Figure 2. Association Between Customs-Collected Revenue and Facilitating Trade Across Borders



Sources: WCO 2017; World Bank Group 2017 Doing Business Indicators.
Note: While more recent Doing Business results are available, for purposes of comparison, 2017 results are used.

To better understand what effective levers for reform may be to improve trade facilitation without losing revenue, it is useful to examine why the two outcomes of relatively high collection of revenue at the border and poor trade facilitation are emerging.

At least three underlying factors are identified. Firstly, Pakistan Customs continues to play a key role in DRM, albeit tariffs are reducing. Administering taxes at the border is easy, comparatively. Consistent with international trends, Pakistan is reducing its reliance on import duties to boost trade. Three decades ago, taxes on dutiable goods constituted a significant portion of total revenue, about 44 percent in 1990.[3] In stark contrast, duties (including regulatory duties) represented less than 13.5 percent of tax revenue in FY2016–17 (see table 1). This figure is average for the country's level of development.

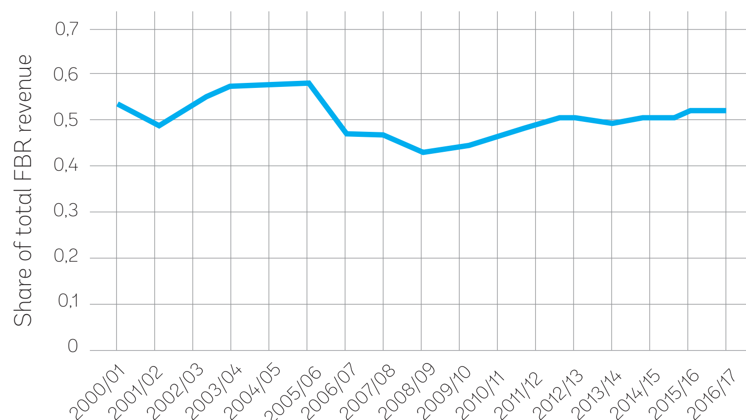
Notwithstanding the sharp decline in import duties as a share of revenue, Pakistan Customs collects a sizable portion of noncustoms and sales taxes at the border — nearly 30 percent). Imports appear to be used as a convenient "tax

[3] World Bank Open Data, accessed at https://data.worldbank.org/.

handle." More generally, Pakistan relies disproportionally on tax collection from federal sources as compared to the provinces, which are responsible for sales tax on services and have been underperforming on this front.[4] This implies that the pressure to collect taxes from customs duties, federal sales taxes on goods, and personal income tax is very high compared to provincial sales taxes on services.

Given a relative weak ability to tax goods and people in the domestic market, a large share of this responsibility to collect tax revenue has shifted to customs. Since imported goods cannot be landed until liable duties and taxes are paid, border taxes — whether in the form of import duties, sales tax, or income tax — are relatively easy to collect and difficult to avoid. Consequently, customs has been consistently collecting more than 40 percent of total tax revenue (figure 3). This reliance on indirect taxation at the border, however, has increased the burden on imports as illustrated by the Doing Business indicator.

Figure 3. Customs Collection as a Percentage of Total Revenue, FY2000/01 to FY2016/17



Source: Data from Pakistan Customs, Federal Board of Revenue (FBR), 2017.

Secondly, Pakistan Customs relies heavily on excessive physical controls to safeguard revenues. The focus and frequency of control mechanisms seem geared toward minimizing undervaluation. For instance, Pakistan Customs adjusted the aggregate value of self-declared taxes and duties by 18.4 percent for GDs that were cleared through the red channel in FY2016–17. These adjustments yielded 1.91 percent in additional revenue for the Federal Board of Revenue — PRe 59,530,359,831, which is equivalent to $567 million. Similarly, in the same period, 20.6 percent of GDs were processed through the yellow channel wherein the declared amount of duty and taxes was raised by 3.54 percent, amounting to PRe 7,963,290,903 ($75.8 million).[5] These high rates of physical and documentary inspection delay the clearance of goods and are also cumbersome, expensive activities to engage in, particularly when trade volume is high. Like other customs at this level, it seems a control mentality has permeated in Pakistan Customs that ensures that all duties are assessed and paid, regardless of whether this causes delays in the release of imports (Wulf and Sokol 2005).

Thirdly, the focus on preserving revenue and physically controlling goods occurs against a background of significant increases in volumes of trade. The World Bank estimated that Pakistan's Import Volume Index increased by about 50 percent between 2002 and 2014. Correspondingly, the number of import and export GDs increased by 41 percent and 64 percent, respectively, between 2010/11 and 2016/17, whereas the value per goods declaration has risen by 14 percent and 17 percent, respectively.

Achievements and the Remaining Challenges

Pakistan Customs uses a robust information technology (IT) system to cope with growing trade volumes and ensure its focus on protecting revenue through maximum cargo control. Since its introduction in 2011, the Web-Based One Customs (WeBOC) system has significantly improved the efficiency and effectiveness of customs operations in Pakistan, eliminating some of the most vulnerable points of a manual system. An automated selectivity system helps the Customs office manage the growing volumes of trade, which accounts for more than 1.8 million of processed GDs annually (1 million for imports and 0.8 million for exports).

While the current risk management system (RMS) does enable customs to identify which GDs to examine and which to release, risk-based targeting of suspect consignments is limited. A key issue is that the RMS is not very efficient at identifying (major) misclassifications, misdeclarations, or threats to sanctity and security of international supply chains. For example, in addition to the high proportion of GDs selected for examination, the RMS does not guide examiners to be more targeted with their inspections, as it lacks a complete risk profiling for all authorized operators. The result of this is a low number of seizures (less than 2 percent). In addition, no annual post-clearance audit plan is in place to systematize the detection of misdeclarations post entry into the country.

More generally, Customs has not exploited the full potential of WeBOC, as it still relies heavily on high levels of physical examinations and revenue-biased controls. For example, WeBOC is typically applied only after goods have arrived in the country, and it does not permit pre-arrival clearance. Added to this, no mechanisms are in place to migrate from physical to post-clearance control. In addition, there is limited use of data mining and exchange of electronic information with other public agencies to draw up risk profiles. As a result, the prospect of preparing relevant and comprehensive profiles is greatly reduced.

REFORM OPTIONS AND RELATED POLICY CHANGES

A few observations can be made. First, reforming customs is

[4] World Bank Open Data, accessed at https://data.worldbank.org/.

[5] Based on interviews with Pakistan Customs officials.

central to boosting domestic revenue mobilization in Pakistan. Historically, reforms in customs have been realized by focusing on its revenue collection function. While this focus has ensured that customs collection as a portion of revenue remained stable over time, this approach has had its implications for the business environment.

The central question Pakistan Customs faces today is how to continue to generate revenue while improving its role in facilitating trade. International experiences provide examples of several ways to do this. More specifically, three reasonable reform options are to: (i) enhance the RMS, (ii) improve pre- and post-clearance capabilities, and (iii) contribute to broadening the tax base. Taken together, these three reform options should enable Pakistan Customs to achieve the next level of maturity, building on its relatively strong base of goods and revenue control. Table 2 provides an overview of the sequencing that may be pursued for the aforementioned administrative reforms.

Table 2. Sequence of Proposed Reform Priorities for Pakistan Customs

	First Priority Enhancing the risk management system	Second Priority Improving clearance facilities	Third Priority Broadening the tax base
Enablers	*Strong laws and clearly established processes*		
	Sufficient and competent workforce		
	Supportive and fully utilized information technology systems		

The first reform priority is to enhance the RMS. A system focused on risk profiles of authorized operators (i.e., carriers, brokers, and traders) will over time allow customs to ensure only those GDs posing noteworthy risk to revenue, safety, or security are selected for physical examination. Excessive controls will need to be reduced, for example, by imposing a cap on the number of GDs selected for physical and documentary inspection. Simultaneously, enhanced capabilities to analyze economic sectors along with improved feedback mechanisms would contribute to enriching the RMS and its targeting of risky transactions. The internal feedback mechanisms between the RMS and the operational staff, especially the inspectors and appraisers, are critical for sound checks and balances about the performance of both: the central RMS and the expected outcomes from the field.

An improved RMS will subsequently help customs manage large volumes of trade more effectively while relying less on physical and documentary inspections. In this way, the same (or increased) trade volumes can be effectively managed while largely guaranteeing revenue collection. It would also facilitate effective pre- and post-clearance mechanisms, the second reform priority, by shifting the focus of information flows from goods (i.e., the Harmonized System [HS] of Coding) to the tracing of operators and their behavior, including their association to HS codes.

Important to note here is that RMS improvement will not imply trade facilitation for all. Rather, it will imply a more effective, targeted facilitation for those who comply, while applying effective enforcement measures to fraudulent operators. Over time, this will help customs create a positive feedback loop with compliant operators, building trust and encouraging and rewarding compliance through facilitating trade. A trusted trader program, allowing pre- and post-clearance facilities for compliant traders, would be a first step in the direction of a positive feedback loop.

The second reform priority is to strengthen pre- and post-clearance facilities and enforcement capabilities. Post-release control and audit regimes represent the safety net for the entire facilitation approach. In this regime, traders can clear their goods without inspection upon arrival, but audits take place post-clearance and can be done at the aggregate firm level, rather than at the single GD level. Audit and enforcement capabilities are one of the most effective trade facilitation strategies available to border agencies. It can enable the immediate release of imported cargo but ensure compliance through the subsequent use of audit-based regulatory controls. Pakistan Customs has the institutional set-up in place to facilitate pre-clearance, but further effort is required to expand utilization and robustness of such facilities.

Similarly, the institution has the basics in place to support post-clearance audit (PCA) activities but lacks the capacity to execute on a systematic basis. Ultimately, pre-clearance and PCA should be designed to broaden auditors' review of the trader's overall transactions and provide a clear indication of levels of compliance with tax and regulatory requirements. In this context, strengthening the central RMS is critical to ensure there will not be major revenue losses, as compliant traders and taxpayers will benefit from PCA controls.

Strengthening PCA should be accompanied by reforms to address the weaknesses of Inland Revenue.[6] Typically, the value added tax (VAT) may be used as a safety net to safeguard against leakages in the domestic market. The VAT is charged on all domestic sales by registered firms, including imports (Keen 2008). A mismatch between import records and VAT records can point the revenue administrations to leakages and address those in PCAs. For this mechanism to work, however, attention should be paid to strengthening Inland Revenue's capacity to administer such taxes and conduct audits. Moreover, in a context of increased green channel clearances and reduced border checks, effective administration of VAT will preserve public revenue since it is essentially a tax on the purchase of informal operators and on their imports.

[6] See Lopez-Calix and Touqueer (2013) and World Bank (2017) for a summary of prevailing weaknesses.

Once improved RMS and PCA are being fully utilized, physical inspections and documentary checks at the borders may be reduced. This will flow naturally from reforms to the RMS and PCA capacities. A well-designed RMS will allow customs to move away from traditional time-costly clearance approaches to more effective trade facilitation strategies that enable the immediate release of imported cargo. In addition, the adoption of pre-arrival clearance together with more intense use of PCA should help customs facilitate high volumes of cargo transactions in a timely manner while ensuring that traders maintain elevated levels of compliance. Together, these improvements will result in lower costs to the business community, while simultaneously promote revenue generating activities through an improved business climate.

The third reform priority is to contribute to broadening the tax base, linking traders into the domestic tax net through joint audits and joint registries between Customs and Inland Revenue. Rich trade data can be linked to business activities to bring traders into the domestic tax net, thus reducing informality in the domestic market. Take for example the transfer pricing (TP) practices of multinational companies. Multinational companies in Pakistan are responsible for about 60 percent of imports. Analyzing trade, sales, and income data in an integrated way can better inform customs valuation and TP studies, as well as contribute to improving capacity to detect avoidance and undervaluation. Ultimately, such enhancements will improve compliance, reduce the tax gap, and thus increase revenue. Clearly, close collaboration between Customs and Inland Revenue is critical for these reforms to be implemented successfully, and to avoid risking a loss in revenue collection.

Overall Reform Context

It is important to highlight three cross-cutting components — strong laws and clearly established processes, competent human resources (HR), and a supportive IT system — that are critical enablers to facilitate this reform agenda. An HR team that is well guided by clear strategic goals, standard operating procedures (SOPs), and streamlined business processes that are automated will ensure that reforms are consistently implemented as necessary. However, strategic planning and performance measurements are rarely used to direct customs operations. Secondly, while Pakistan Customs has a well-trained, highly esteemed cadre that inhabits higher level functions, other staff could significantly benefit from additional, systematic training. In addition, internal incentive structures for staff is important. Experience of other customs offices shows that inspector performance contracts that reward good performers (e.g., through merit rewards, training opportunities at home and abroad, and accelerated career progression) and sanction poor performers are effective (Raballand et al. 2017). Thirdly, critical departments like PCA are under-resourced. These, among other shortcomings, point to an urgent need for customs to rehabilitate its workforce and SOPs.

The WeBOC system is performing well on basic functions such as streamlining goods declarations. To support reforms, the information it captures could be further exploited using business intelligence. For example, physical examination of goods could be better directed by making more efficient use of trader histories, average assessed values, correlations between declared weights and goods, and so on. In addition, WeBOC's functionality could be enlarged to include better cargo management. All these activities are key to successful improvements of the RMS, audit, and enforcement capabilities.

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