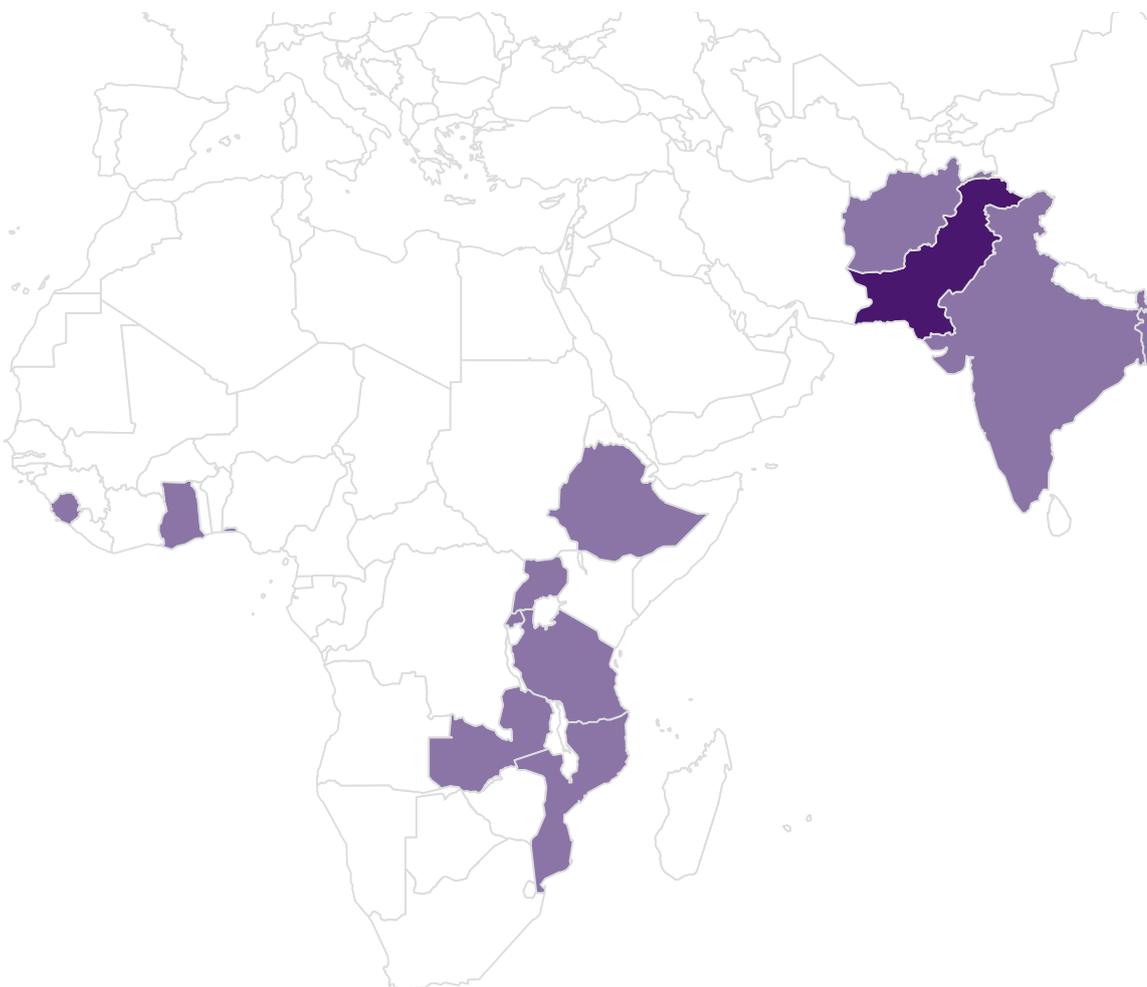


Pakistan's trade policies: future directions

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Acronyms

AD	Anti Dumping
CBU	Completely built up unit
CD	Customs duty
CGO	Customs General Order
CKD	Completely knocked down
DTRE	Duty and Tax Remission for Exporters
EDB	Engineering Development Board
EFS	Export Financing Scheme
EPR	Effective Protection Rate
FBR	Federal Board of Revenue
FED	Federal Excise Duty
FTA	Free Trade Agreement
GFC	Global financial crisis
HS	Harmonised System
LC	Letter of Credit
LTFF	Long Term Financing Facility
MFN	Most Favoured Nation
MINFAL	Ministry of Food, Agriculture and Livestock
MOC	Ministry of Commerce
NTC	National Tariff Commission
PAAPAM	Pakistan Association of Automotive Parts Accessories Manufacturers
PIDE	Pakistan Institute of Development Economics
PITAD	Pakistan Institute of Trade and Development
PSFTA	Pakistan Sri Lanka Free Trade Agreement
RD	Regulatory duty
REER	Real Effective Exchange Rate
SAFTA	South Asia Free Trade Agreement
SKD	Semi knocked down
SPS	Sanitary and Phyto-Sanitary
SRO	Statutory Regulatory Order
ST	Sales Tax
STPF	Strategic Trade Policy Framework
T&C	Textile and Clothing
TBT	Technical barriers to trade
TPR	Trade Policy Review
TRIMS	Trade Related Investment Measures
WHT	Withholding tax (income)

1. Background

Starting in 1996/97 Pakistan embarked on a radical trade liberalisation programme which by 2003 had eliminated nearly all its remaining traditional QRs while drastically reducing the level and simplifying the structure of import tariffs. Some of the more sweeping reforms were in the agricultural sector where government trading monopolies were abolished and other government interventions were reduced. This liberalisation episode was supported by real exchange rate devaluation over the period of about 20%. The reforms enabled exports and the economy to take advantage of the boom in world trade between 2003 and late 2007. During this period (2007/08 compared with 2001/02) exports in nominal US dollars increased by 110%. Although this was an encouraging performance, over the same period the exports of other developing countries grew much faster: for example, India's increased by a factor of three in nominal US dollars. It can be plausibly argued that Pakistan's economic system was still not sufficiently efficient and flexible to take better advantage of this extraordinary opportunity because of continuing failures and rigidities in its economic policies, especially in its trade policies. From the beginning there were a number of important exceptions to the 1997-2003 trade policy reforms, and some backtracking on others occurred later on, especially during 2006 and after the global financial crisis of 2008. These include:

- Reversal of a number of the more important liberalising reforms in agriculture, notably of wheat, sugar and fertilizer policies
- Continuation of the long standing ban on imports from India of products not on Pakistan's limited "positive list"
- Local content policies in the auto industry. These were replaced in July 2006 by very high and steeply escalated tariffs which effectively kept almost the same system in place, and enabled the detailed interventions of the Engineering Development Board to continue
- The use of ostensibly WTO-compatible (TBT and SPS) technical regulations and regulations based on health and safety to restrict imports. These include bans and restrictions on imports of second hand products (e.g. consumer durables such as passenger cars, motor cycles, air conditioners and various types of industrial machinery and equipment) where protection of local industries is clearly the dominant motive
- The introduction of anti-dumping. This started in a small way in 2002, but subsequently expanded rapidly during and after 2008/09.
- Starting in 2006/07 increases in the maximum level, dispersion and complexity of Customs duties, and in August 2008 the introduction of a number of "Regulatory Duties" on top of Customs Duties. Including the regulatory duties (but omitting outliers such as the very high tariffs in the auto sector) there are now at least nine standard "normal" tariffs, ranging from zero to 50%. This compares with just four standard normal rates ranging from 5% to 25% in 2002/03. The new structure has greatly increased the potential for high effective protection rates and bigger distortions across import substitution activities, and has increased the general anti-export bias in the system
- Since 2006 the expanded use of SROs. Most of these provide exemptions or partial exemptions from normal tariffs, but others provide for increased tariffs. In 2010/11 more than half (54%) of the total number of tariff lines were subject to at least one special condition announced in an SRO¹. Most of these are exemptions for inputs and are confined to specified firms or groups of firms. They are not available to other importers, in particular commercial importers. Their administration is a de facto import licensing system run by EDB and other ministries in conjunction with the Customs service

¹ 57% of agricultural tariff lines and 53% of non-agricultural tariff lines,

- Major increases in the complexity of the tariff system resulting from preferential trade agreements, especially the agreement with China effectively implemented in January 2006, and to a lesser extent from the agreements with Sri Lanka (operational from June 12, 2005) and with the other South Asian countries under SAFTA (operational from January 1, 2006)
- The continuation of administratively complex and constantly changing export subsidy programs and policies. Given positive protection for import substitution production, there is general case for both input tariff rebate/exemption programs and export subsidies. But according to some knowledgeable people, as actually administered in Pakistan, these programs disproportionately benefit established exporters, discriminate against small and new exporters, and discourage export diversification

2. Purpose and outline of this study

Against this background, we have been asked to report on the present state of Pakistan's trade policies and to make recommendations for changes that will help improve the efficiency and flexibility of the economy and promote faster economic growth. As requested by the terms of reference for the study (see attached Annex) we are paying particular attention to the level and structure of import tariffs and to trade policies affecting the auto and the textile and clothing sectors. However, since import policies affect exports, we also comment on export policies and trade policies more generally, including the institutional setting for changes in trade policies and the relation of trade policies to the real exchange rate. The rest of the report is divided into the following sections:

- 3 Tariffs: some recent trends and current issues
- 4 Pakistan's trade policies: guiding principles?
- 5 Institutional setting
- 6 The role of SROs and CGOs
- 7 Evaluation of the SRO/CGO exemption system
- 8 Some notes on tariffs and revenue
- 9 Trade policies in the auto sector
- 10 Trade policies in the textile and clothing sector
- 11 Summary of recommendations

As part of the preparation for the report, during December 7-14 2010, we had useful discussions with a number of people in relevant Ministries and government agencies in Islamabad, and with some private sector businessmen in Lahore. Since then, during our preparation of the report, we have had an active email correspondence with numerous people in different parts of the government (including especially FBR, EDB, NTC, and MINFAL) who have kindly responded to many enquires and have provided useful additional information. We have also received very useful comments from a number of people who looked through our interim report that was distributed in early February.

However the potential scope of the topics on which we have been asked to report is very large and it is obviously not possible for our small group to provide detailed studies of all these topics in the short time (about two months) available to do the work. Consequently to varying extents our assessments are preliminary and incomplete and include recommendations to fill in information gaps and to undertake further studies. It is also highly likely that our report contains factual errors and misinterpretations of various situations and rules, especially Customs rules. We would be grateful to hear about those so that they can be taken into account in a later corrected version.

In this regard lack of time and resources have obliged us to omit from the report any substantive discussion of a number of topics that we had thought it might be possible to cover when we prepared the interim report. A major reason for excluding these topics from this report is the time and effort needed to understand the SRO/CGO system that turned out to even more complex than we had anticipated. The topics on which we had hoped to write at least short separate sections in this report but to which there are only brief references in other sections or which have been omitted, are the following:

- Preferential trade agreements
- Export policies including export taxes and subsidies
- Anti-dumping
- WTO commitments
- Gas/fertiliser policies
- Agricultural sector trade policies

All of these are important and deserving of separate studies, **provided such studies are carefully focussed to answer relevant current policy questions.**

3. Tariffs: some recent trends and current issues

Analysis of the level and structure of Pakistan's tariffs is greatly complicated by large numbers of exemptions and partial exemptions which are announced separately in SROs and do not affect the Customs duty (CD) rate shown in the Customs duty column of the tariff schedule. A further complication is that many of the exemptions are confined to specific users of the product, so that in principle the same imported product might be subject to two different Customs duties. Yet another complication is that from July 2006² the tariffs on a long list of products were raised *above* the normal CD rate, again without adjusting the normal CD rate shown in the CD column of the tariff schedule. This was done in order to continue the special treatment of the auto sector when, after many delays, Pakistan was finally obliged to drop its QR protection of this sector under the Uruguay Round TRIMS agreement. As far as we know past studies (including WTO *Trade Policy Review* reports and World Bank reports) which have calculated averages and other statistics of Pakistan's tariffs have all used published CDs only. Allowing for the exemption lists, and after July 2006 for the SRO-announced tariff increases, has consistently been put in the "too hard" basket, mainly because the FBR has not provided the required information in a form that can be analyzed without a massive and tedious research effort.

Subject to this important caveat, past studies of the average level and structure of CDs show some interesting and relevant trends. A number of these are summarized in Fig 7. This shows that during the 1996/97 to 2002/03 trade liberalisation period, Pakistan's tariffs were steadily reduced: this brought the unweighted average tariff down from about 42% to 17.3%. The "tops down" process greatly simplified the tariff structure, reducing the number of standard rates ("slabs") from 14 (ranging from zero to 65%) to 4 (minimum 5%, maximum 25%), thereby reducing the potential for escalated tariff structures and very high and variable effective protection rates. It is notable that average agricultural tariffs declined at about the same rate and to an average level in 2002/03 (19.6%) only slightly above non-agricultural tariffs (16.9%).

² SRO 693(I)/2006

³ Some very high tariffs above these normal levels (such as those on cars and motor cycles) were not reduced as part of the reform program.

During the next four years there was a continued but very slight decline in average tariffs and the tariff structure remained about the same, but in the 2007/08 budget many tariffs were increased to 30% or 35% while others were cut to zero. Then in August 2008 374 products were made subject to "regulatory duties" (RDs) on top of Customs duties (Table 2 and Fig 8). Another 23 products were added to the RD list in June 2009, and subject to some minor changes we understand that this list remains in force at present. The regulatory duties only account for about 6% of the total number of HS tariff lines, but a much higher share (about 24%) of agricultural tariff lines. They vary from 5% up to 50% of cif prices and averaged 17.4% in August 2008. When combined with Customs duties they have created a more complex and dispersed tariff structure with at least 9 standard rates ranging from zero to 50%. Because the 2007/08 budget reduced tariffs on many imported raw materials and manufactured intermediates not produced in Pakistan -many to zero or 5%- despite higher top-end CDs and the new regulatory duties, comparing 2002/03 with 2009/10 (Table 1) the average industrial protection rate (CDs+RDs) went down slightly while there was an about equivalent proportionate increase in the average agricultural sector protection rate.

How would these apparent trends in the average protectiveness of Pakistan's tariffs be affected if it were possible to allow for the exemptions and additions announced in many SROs? A priori we would expect the "discount" on the level of the formal CDs resulting from exemptions to be greater when the formal CDs are high, and lower when the formal CDs are lower. This suggests that the de facto decline in average tariffs during the 1996/97-2002/03 liberalisation episode probably started from a somewhat lower level in 1996/97 and declined over the period less steeply, than indicated in Fig 7. Then during 2003/04 and 2005/06 de facto average tariffs were probably somewhat lower than indicated in Fig 7, but probably went up again after the August 2006 SRO increasing large numbers of auto-sector related tariffs. Fig 7 probably provides a reasonably reliable indication of the direction of the changes after 2006/07 up to 2009/10 i.e. average agricultural tariffs rose quite sharply (possibly by about 40%) while average industrial tariffs remained about the same. The increase in average agricultural tariffs during this period was principally due to higher CDs on agricultural products introduced in the 2006/07 budget and to the new regulatory duties announced in August 2008.

However trends in unweighted average tariffs are very imperfect indicators of trends in the economic costs of tariff systems.

If the impact on the exchange rate and production for export could be ignored, the most economically efficient tariff would be a uniform tariff, and it wouldn't matter at what rate it is set, since all import substitution activities would be protected at the same rate and all would be equally efficient in replacing imports. By contrast a non-uniform tariff with different rates for different products opens the way for differences in the efficiency of import substitution production, for two basic reasons. Firstly, if product A is protected by a 5% tariff on its output, while product B is protected by a 50% tariff, it is easy to understand that resources including labour, capital (and especially land in the case of agriculture) will be pulled into the production of B even though its production cost relative to the price of imports is much higher than the cost of expanding the production of A. Secondly, non-uniform tariff structures are heavily influenced by the lobbying of established import substitution producers for low tariffs (and if possible zero tariffs) on their intermediate inputs. The benefit to them of cuts in the tariffs affecting the cost of intermediate raw materials and components (say from 15% to 5%) will often exceed the benefit of increases in the tariffs protecting finished products (say from 25% to 35%). Both sorts of tariff changes will increase the available processing margin (effective protection), but reductions in input tariffs are preferable from the producers' viewpoint because if the producers are to take advantage of higher output tariffs they will have to increase their selling prices, with a consequent reduction in demand. At the same time the reductions in the tariffs on raw materials and intermediates reduce the incentive for domestic production of these products to replace imports, even though some of these products could perhaps be produced more efficiently (relative to the cost of imports) than the product receiving the extra protection.

The above discussion assumes that there is no impact of protection of import substitution activities on the exchange rate and on production for export, but this is manifestly not the case. Firstly, the intent and effect of tariffs aimed at protecting local production is to reduce imports, making it possible to equilibrate the current account at a higher (stronger) Rupee value in terms of foreign currencies. Secondly, even assuming that duty neutralisation schemes (such as DTRE and drawback) could be operated with low or zero transaction costs for exporters, unless explicit export subsidies are paid, exporters have to compete on world markets with no protection i.e. with approximately zero nominal and effective protection. Moreover, production for export is further disadvantaged by the consequent overvaluation of the exchange rate. Thirdly, many exports are typically also sold as intermediate inputs to processors which use them for production which is sold on the domestic market. Unless the exporters of these intermediate exportables have market power and can charge higher prices domestically than when exporting, the processors obtain the inputs at approximately world prices while benefiting from tariff protection on their own sales. This further increases the variability of economic efficiency within the import substitution sector, as measured for example by effective protection rates.

These effects lead to the observations that in the interests of economic efficiency and taking account of political and administrative feasibility, tariffs should be:

- As uniform as possible
- As low as possible

Quite apart from economic efficiency considerations, low tariffs are important in Pakistan in order to at least keep down-elimination seems unrealistic - smuggling and under-invoicing which is generally recognized to be rampant in many products. This comes up repeatedly in official enquiries and reports and is present even when tariffs are relatively low and sales tax is exempted. For example according to NTC's PTA report , in 2008/09 the tariff on polyester filament yarn was 9% and imports were exempt from sales tax , but smuggling was estimated at 43% of total market demand. Smuggling exceeded "imports through regular channels" , was more than double domestic production, and had been occurring on a large scale at least since 2000/01. The incentive to smuggle or under-invoice is especially strong for final consumer goods, since legal imports do not benefit from the sales tax credit that applies to the use or resale of imported intermediate inputs. Presumably for this reason, smuggling and mis-declaration at Customs is reported to be especially common for many consumer durable products and other consumer products such as toilet soaps. Mainly because of smuggling and under-invoicing, a number of well-informed people we have contacted thought that CDs should be no higher than 5%, pointing out that even with a 5% CD, after adding sales tax, the special excise duty, and the income withholding tax , the total tax paid by the importer is about 29%.

Both of these principles-that tariffs should be low and uniform- were by and large observed as objectives over the long period during which Pakistan's trade policies were slowly liberalised, starting during the late 1980s. This was particularly evident during the 1996/97 -2002/03 liberalisation episode, but since then the progress towards greater uniformity has been reversed, because even though the average level over all tariff lines hasn't changed much, *there has been a major increase in tariff dispersion.*

This is illustrated in Figs 1-6, which compare the situation in 2002/03 when the liberalisation episode ended, with the situation in 2009/10. In 2002/03 nearly all tariffs were clustered within a range from 5% to 25%, but by 2009/10 they were much more dispersed, with many more at the bottom end of the distribution (zero or 5%) and more at the top end (from 35% up to 50%), especially in agriculture.

As in the comparison of tariff averages, this comparison of the distribution of tariffs is subject to the caveat that the estimates for neither of the two years compared take account of SRO-announced tariff exemptions and increases. Because of the exemptions there were many-but an unknown number of - zero tariffs in 2002/03, and this fact is not captured in Figs 1, 3 and 5. In 2009/10 there are two possibilities. One is that some of the cuts in CDs to zero (mostly made in the 2006/07 budget) were just replacing tariffs that were already zero as a result of SRO exemptions. Another possibility is that the formally announced cuts to zero supplemented but did not replace tariff lines that were already zero as a result of SRO announcements, in which case the *de facto* number of zero tariffs in 2009/10 was considerably higher than indicated in Figs 2, 4 and 6. At the other end of the distribution the 2006 SRO announcing higher auto-related tariffs would have increased the number and proportion of high industrial tariffs and created an even wider dispersion than the dispersion illustrated in Figs 4 and 6.

The regulatory duties introduced in 2008 (listed in Table 2) are important contributors to the increased dispersion of total protection rates discussed above. According to official statements, they were imposed to deal with the severe balance of payments crisis that came with the GFC in 2008, and were meant to curb imports and consumption of "luxuries", but if that was the main aim it would have been better to use excise taxes or a sales tax surcharge which would have also been imposed on domestic production. We have been told that almost all the products subject to regulatory duties are probably produced in Pakistan, in which case they are providing extra protection to local producers. It seems that the local industries that are benefiting most from this extra protection are producers of consumer goods, especially household appliances and food processing firms. The total protective rate (CD+RD) of most of these went up to 50% e.g. producers of products in HS 04 (dairy products) and HS 16-24 (processed foods). Except for fresh fruits (HS 08) which are further processed, very few intermediate products are subject to regulatory duties, so effective protection rates will have increased by even more than the resulting increases in nominal protection.

Imports from countries with which Pakistan has signed preferential tariff agreements are not subject to the regulatory duties. Therefore the RDs have created new preferential margins for imports from these countries, and widened the preferential margins on products already subject to concessions. This could mean for example that product X might be subject to a total protective import tax (CD+RD) of 35%+15% =50% if imported from an MFN source, but to a preferential CD of say 20% if imported from a preferential source. Depending on the competitiveness of the preferential suppliers, such a situation could on the one hand erode all or most of the extra protection provided by the RDs to domestic producers, or if the potential preferential suppliers are not competitive internationally, lead to trade diversion costs for Pakistan in which Pakistan's tariff system in effect protects both its own high cost producers and high cost producers in the preferential supplying country. Whether or not either of these effects are likely to be important would require further study.

In the case of India most of the products are most likely not on Pakistan's positive list nor on the various lists of concessions under SAFTA. In the case of the bilateral agreement with Sri Lanka (PSFTA) Sri Lanka is probably not a very competitive supplier of most of these products and in addition many of its potential exports would probably have trouble in satisfying PSFTA's origin rules. However the bilateral agreement with China is potentially much more important since (like India's) the Chinese economy is very large and diversified so that just about all potential exports from China to Pakistan would easily satisfy rule-of-origin requirements.

Section 6 below extends the above discussion of the tariff structure, paying special attention to the role of the ad hoc exemptions and additions listed in the various SROs and to the effects of preferential trade agreements. For this purpose we were provided with an electronic copy of the first volume of the 2010-2011 Tariff schedule (the second volume contains the currently relevant SROs). The file provided is in pdf format which we converted into computable (excel) format. However the excel format has many inconsistencies which we are informed can only be remedied with a prolonged and time consuming effort which exceeds the time and resources available for our report.

In view of this problem, one of our recommendations in the area of tariff policy is that NBR should develop and make publicly available on its website a computable and regularly updated version of the complete current Customs Tariff schedule i.e. the equivalent of the hard copy schedule which includes for each tariff line entries in separate columns for Customs duties, import taxes other than Customs duties, exemptions and other adjustments under SROs, Customs duties under preferential trade agreements, and whether or not imports from India are banned⁴. This should also be linked electronically to the information on SROs exemptions etc which are listed in Volume II of the hard copy Customs tariff schedule. Only if this is publicly available will it be possible for properly informed discussions and debates on trade policies to take place.

The analysis of trade policies is seriously compromised unless trade data can be linked to the HS classification of Customs tariffs, subsidies and other trade policy measures. Prompt and publicly available information such as this is very important in the interests of transparency. On this we recommend that improvements be made to the trade database on the FBR website. This data base is useful as it provides up-to-date statistics of Pakistan's trade classified by detailed (down to 8-digit) HS tariff lines. Other sources in Pakistan do not provide trade data at this level of disaggregation. However the database is much less user-friendly and comprehensive than for example the Indian Exim Data Bank,⁵ which could serve as a model for future improvements to the Pakistan database. The usefulness of the database could be greatly improved in a number of key ways some of which we summarise here:

- At present it is a web page which as far as we know cannot be downloaded into computable form, for example (as is the Indian Exim data bank) into excel.
- For analytical purposes the data provided is much too detailed ...for a given product it seems to be at the level of individual shipments. Only one aggregation for each product and period (in USD) is provided, and no aggregations by country.
- The export and import data is shown only in USD and there is no quantity data. Rupee data and quantities should be also be provided
- Aggregations by country and region should be provided.

4. Pakistan's trade policies: guiding principles?

As we have been asked to make recommendations on Pakistan's current trade policies, we first of all attempted to ascertain what these policies are, and in particular whether actual decisions on trade policies are being guided by any generally agreed and economically sound general objectives or guiding principles. With this in mind we have looked at NTC's "Criteria ...in Processing Applications" and a few recent publications of the Ministry of Commerce, in particular its *Strategic Trade Policy Framework 2009-12*, and at the Ministry of Industry's and EDB's websites.

⁴ Pakistan's official tariff schedule for 2010-11 and for the preceding three years is on the FBR website. However these files are of limited use as they only list statutory Customs duties, but none of the other import taxes and whether or not the Customs duties for particular tariff lines are subject to exemptions, partial exemptions or increases as a result of SROs which affect thousands of tariff lines. Exemptions and other variations to standard tariffs are not always provided in a transparent manner by other countries, but we think that the extent of the resulting opacity is exceptional in the case of Pakistan. This issue has frequently been noted in the past in various places, for example in the WTO TPR reports and in World Bank reports.

⁵ At < <http://commerce.nic.in/eidb/default.asp>> This data base is freely available without restriction on India's Department of Commerce website. It provides annual trade data both in Rupees and US dollars down to 8-digit level since 1996/1997. The data is presented in a variety of different formats and is downloadable without restriction into excel. The data for the current year appears with a lag of about six months and is published quarterly.

NTC's "criteria"

The NTC's general approach as set out in its "criteria" statement is clear, even if in one basic aspect it is highly questionable. To summarise:

- The role of the Commission is to recommend tariffs that will provide protection against competing imports after taking account of the Pakistan producers' "cost disadvantage"
- The resulting protection is for a "specific period", in addition to which the Commission is supposed to satisfy itself that "the industry is not likely to need the protection or assistance after reasonable period of time"
- The Commission is to satisfy itself that "the additional cost to the consumer will not be excessive"
- Effective protection rates can be used in analysing incentives to producers, and nominal protection rates in analysing the effects on consumers

This approach has two strengths in recommending that the extra protection should be temporary, and requiring that consumer interests should be taken into account. However it also has serious basic problems both of principle and implementability. The first and most egregious of these is the idea that protection levels should be fixed to compensate for production cost disadvantages relative to imports. The obvious danger of this "cost plus" approach to protection is that industries with high costs will get high protection, while lower cost industries which don't "need" protection will not receive it. Secondly, there is no mention of the relation of the tariffs recommended to the prevailing general level of and structure of tariffs. For example, how should NTC treat an application for higher tariffs from an industry currently protected by a 5% tariff, versus an application from an industry currently protected by a 35% tariff? Related to this, as 35% is the current general maximum Customs duty rate, should this be taken into account in dealing with applications for extra protection from industries already protected at this level? Third, the protection recommended is supposed to be temporary, suggesting that the framers of the guidelines had in mind an "infant industry" approach, but no guidance is provided as to what might constitute a "reasonable" time for the industry to no longer "need" the extra protection. On this point we also strongly doubt whether the tariff adjustments actually recommended by NTC have been temporary. Fourth, the Commission is supposed to satisfy itself that the costs of its recommendations to consumers are not "excessive", but no guidance is provided as to what constitutes "excessive", nor whether the consumer interest to be considered refers to intermediate or final consumers.

Finally, the "Criteria" statement does not mention or seem to recognise the basic point that protection is relative. In particular by its nature "cost plus" tariff protection systematically creates differences ("distortions") in protection rates (both nominal and effective) as between different import substitution activities, and reduces the relative attractiveness of export production unless exports are subsidised. It also indirectly taxes all tradeable activities through the effect of protective tariffs on the exchange rate. This effect is especially important for exports which by definition have to compete at world prices, and typically outweighs the positive effects of export subsidies such as low preferential interest rates or tax holidays. It is also important for low- protection import substitution activities which may be held back or never established by the resulting over-valuation of the exchange rate. For example, many intermediate products are currently exempt from tariffs or subject to a 5% tariff, but the incentive to substitute for imports will be negative if as a result of higher tariffs protecting other industries the exchange rate is overvalued by say 10-15%.

In order to understand how NTC staff are applying these criteria in practice and perhaps using other criteria, we have looked through a sample of industry reports which NTC has kindly provided. Statements of principle in one of these (*Report on Monetization of PTA*, dated April 7, 2010) also occur in the others and seem to represent a quite generally agreed approach to tariff setting. The tariffs recommended in the PTA report are based on two “principles” (p.6):

- “NTC will determine *the required protection needed* for the healthy growth of this industry” (our italics).
- The “*cascading principle*” (our italics).

The “principle of cascading” is also the basic approach of the Ministry of Textiles as stated in its Textiles Policy 2009-2014 publication. Under the heading “Tariff Rationalisation” (para 7.6) this states : “The principle of cascading will be implemented while ensuring adequate protection to the local industry and removing anomalies”.

Neither of these “principles” have any basis in economic theory, and if applied generally both will systematically create distorted protective structures as measured for example by effective protection rates (i.e. by protection to value added). The “*cascading principle*” does this by setting relatively low tariffs on “upstream” products and systematically higher tariffs along “downstream” processing chains. For example, following this approach along a synthetic textile production chain might involve a tariff structure such as : basic chemicals 5%, fibres 10%, yarns 15%, fabrics 20%, garments 25%.

One reason structures such as this are so common (not just in Pakistan) is a basic misunderstanding of the nature of protection and the failure to recognise how protection for inputs and outputs combine to protect processing margins or value added. Thus a common misunderstanding is that “protection” is zero if the tariff protecting a final product (say a fabric) is the same as the average of the tariffs protecting the inputs used to produce the fabric (mainly yarns). But in fact in that case the protection to the producer’s processing margin is positive and expressed as a protective rate is the same as the uniform tariffs on the output and the inputs. For example if the output tariff is 15% and the average of the input tariffs is also 15% , then the firm’s processing margin (or value added) is raised 15% above its level with zero tariffs protecting its finished product and zero tariffs applied to its inputs. Table 3 illustrates this and shows how effective protection rates (EPRs) vary according to different combinations of average input and output tariffs.

This basic misunderstanding of the nature of protection typically leads to the further misunderstanding that a local industry will only be receiving some positive protection if the tariffs protecting its finished products exceed the average of the tariffs applied to its inputs. Conversely it is typically and wrongly concluded that if the average output tariff is lower than the average input tariff, that the industry is necessarily disprotected. Since the protection available to input producers are also relevant, this line of reasoning leads to the so called “cascading principle” under which tariffs go up along processing chains. However, it is easy to show that this systematically increases protection rates for processing margins along the production chain, starting with low effective protection for upstream “basic” materials and going up in the later processing stages until the maximum is reached at the final “downstream” stage when the product is sold to final consumers.

Since the processing margin is the space available for the producers to fit the cost of labour, capital and other non-tradeable inputs while competing with imports, the protection to the processing margin (or “effective protection”) is the key concept to understand in thinking about protection and protection rates for producers. This is recognized in the NTC “Criteria” statement which notes that protection to producers can be measured by calculating effective protection rates, while the impact of protection on consumers can be measured by observing or calculating nominal protection rates i.e. the tariff on a finished product or the average of the tariffs on a group of finished products. But as already noted, no guidelines are provided as to what might be acceptable (“not excessive”) effective protection and nominal protection rates.

More seriously, as noted in the previous section, the structure of tariffs as set out in Pakistan's official tariff schedule is itself steeply escalated, with high tariffs on final goods and lower tariffs on intermediate goods and raw materials. Should the resulting highly variable protection rates for other industries which are not the subject of NTC enquiries be taken into account in recommending tariffs for the industries which are the subject of an enquiry? If some non-enquiry industries are competing for resources with industry X which is the subject of an enquiry, then a case can be made that the tariffs protecting industry X should provide similar protection rates (nominal and effective) to the non-enquiry industry or industries. But such a decision is of necessity made on the assumption that the basic tariff structure which is creating the protection rates of the non-enquiry industries should not or cannot be changed. In our opinion this would be a serious mistake and if followed in a series of NTC cases with recommendations on tariffs, would just help entrench the highly variable and economically inefficient protection rates created by the tariff schedule. Instead we believe that the distortionary effects of the present tariff schedule should be tackled directly by resuming the tariff liberalisation process which came to an end in 2002/03 and which went into reverse and became more protectionist, especially after 2005/06. Some provisional suggestions on what this might imply for tariff reform are listed in the concluding section.

MOC's Strategic Trade Policy Framework (STPF) 2009-12

This paper was issued in 2009. It seems to recognize at a general level that there are problems with Pakistan's trade policies, and in particular mentions the existence of anti-export bias, the need to withdraw protection "from inefficient, internationally non-competitive and government dependent industry" (p.12) and the need to "rationalize" protection rates which range "between extreme negative protection to excessive positive protection". In view of these and other defects the paper argues that there is an urgent need for "a rational tariff policy and structure". However it then goes on to suggest approaches to trade policies which are both confused and confusing, and which have the potential (and possibly already the effect during the last two years) of opening the door to *ad hocism* and opportunism in actual decisions on tariff, subsidy and other trade policies.

In particular the STPF paper suggests that a "rational" policy should favour (by implication with higher tariff protection and/or subsidies) industries with what are considered to be desirable characteristics. The paper then lists (p11) the following examples where the "existing tariff structure and the concessionary tariff regime" wrongly provide identical tariff treatment":

- Import substitution versus export oriented industries
- Low value added versus high value added industries
- Low tech versus high-tech industries
- Labour intensive versus capital intensive industries
- Small scale industries versus large scale industries

The proposition that the existing incentive system treats industries with these characteristics identically is almost certainly incorrect, and in addition the paper doesn't indicate which of the characteristics is preferable and therefore deserving of special treatment, and if so why. From statements elsewhere in this paper and in other MOC publications it can be inferred that the authors are suggesting that export orientation, high value added, and high tech industries should be preferred, but whether they prefer labour intensive over capital intensive industries, or small scale over large scale industries is far from clear. For example a 2009 MOC publication invited from the public "Proposals...for improving competitiveness and protection levels of the domestic industry...", which included suggestions for "adequate level of tariff protection/assistance" towards the establishment of industries with six different characteristics, two of which are "Large scale industries to achieve economies of scale" and "Labour intensive industries". Clarity is also not advanced by a proposal (STPF p9) "for financing competitiveness development...with the objectives of (1) Moving away

from comparative advantage to competitive advantage based policies (2) ...the provision of 'public goods' for enhancing export competitiveness, and (3) Helping Pakistan up the sophistication ladder". Unhelpful statements such as these are repeated in the website of the Pakistan Institute of Trade and Development (PITAD) which was established in its present form in January 2009 as a training and research arm of MOC.

Most of the rest of the STPF paper consists of a long and detailed list of ostensibly "public good" export promotional subsidies. We believe that the "public good" characteristics of the majority of these are dubious and that there is serious danger that their practical implementation could mainly consist in the distribution of private benefits.

To sum up, we think that MOC's trade policy framework initiative over the past couple of years obscures and confuses rather than clarifies Pakistan's general stance on trade policies, and thereby strengthens protectionist forces and interests that are always present in Pakistan as in other countries. It certainly does not provide a coherent and economically sound basis for the future direction of Pakistan's trade policies. In particular it is not helpful for NTC, which urgently needs a generally agreed and explicit set of criteria if it is to resist and bring some discipline to its treatment of the many requests for extra protection that it processes.

EDB and the Ministry of Industry

EDB was set up in 1995 as a separate agency to manage the large number of industrial "local content" (TRIMS) programs originally sponsored by the Ministry of Industry. As discussed in section 6 below, this was essentially an effort to find ways of continuing the old system of "planned development" which involved discretionary controls over imports, despite the formal removal of import licensing during the 1980s. For a number of years this was done through a large number of local content programs which included the auto sector but also many other manufacturing industries. Despite a prolonged rearguard action at the WTO, eventually all these programmes had to be dropped as they clearly contravened the WTO TRIMS agreement. The non-auto programmes were given up during 2001-03, and the auto programmes in 2006.

As discussed later, EDB replaced the programmes that breached the TRIMS agreement with substitute programmes that achieve the same objectives i.e. high protection and planned development of selected industries-by the use of escalated tariff structures and in particular input tariff exemptions for approved firms and industries that are subject to the system. To implement the system EDB and other ministries are effectively involved in import licensing of the inputs which are subject to the concessionary regime, while high and in some cases prohibitive final product tariffs are used to protect against import competition for locally produced products.

In implementing these programmes EDB works closely with numerous specialised industry-specific committees which include representatives of some of the principal firms and trade associations.

We have not been able to find a general policy statement on the EDB website of the economic justification for these programmes, other than the observations that the programmes are intended to promote industrial development and technological progress. However our attention has recently been drawn to a recent publication⁶ on the Ministry of Industry website which argues that programmes similar to those being implemented by EDB are consistent and appropriate as examples of "Industrial Policy" in action. We have so far only had time to have a quick look over this document, but disagree fundamentally with some of the sections of the document that we have so far seen. This includes especially the report's interpretation of trade policies in relation to the early industrial development of countries such as Korea, and its argument that planned and government controlled development including protective import policies are appropriate for the South Asian countries, including especially Pakistan. This latter discussion in particular seems to us to have little relation to Pakistan realities, including to just take one example pervasive and widespread smuggling and under-invoicing.

6 Abid Burki et al (2010, October). *Industrial Policy, its Spacial Aspects and Cluster Development in Pakistan*

EDB and the concessional input tariff programmes that it promotes and manages seem to be the main drivers of the increasingly protectionist direction of Pakistan's trade policies in recent years. For this reason much of the effort in preparing this report has gone into understanding how these systems operate. What we have found so far is summarised in section 6 of the report which deals with the SROs and the CGO which implement these policies.

5. Institutional setting

In Pakistan, as in most other countries, the general direction and nature of trade policies are announced each year in the budget, and the budget papers list changes in protective tariffs together with changes in other taxes. These changes are then included in the new Customs tariff schedule. This procedure is a normal and legitimate part of any government's fiscal policy, and (in principle at least) is reasonably transparent and open since the tax changes can be debated and questioned in parliament. However for many reasons the government may wish to change taxes after the budget and during the fiscal year. In order to bring some discipline into this process, the 1973 "Rules of Business" requires that no matter who is the initiator of a proposal for a tariff change involving protection (including extra protection through an anti-dumping, countervailing duties or safeguard measures) *must be the subject of a report and recommendation by NTC*. Thus in principle NTC-which is an agency of MOC- has a key central role in this important dimension of trade policy.

However we have been told that *the ground reality is different, and that many changes in tariffs⁷ are being effected without recourse to NTC and without any systematic study being undertaken*. The forum for and sponsor of such changes can be any ministry, including a committee originally set up to look into tariff "anomalies". In this regard EDB has been especially active and influential. As are tariff adjustments that are first processed and recommended by NTC, changes that are decided in this way are all announced in SROs issued by FBR. However it is not possible for outsiders to know the reasons or background for such changes, or even whether or not the changes have been the subject of an NTC report (see discussion of NTC's role below).

Role of the National Tariff Commission (NTC)

NTC is an agency controlled by the Ministry of Commerce. It has two principal functions:

- Processing anti-dumping, countervailing duty and safeguard cases. Of these-as in other countries- by far the most frequent and important are anti-dumping (AD) cases
- Reporting on tariff protection and/or subsidies affecting individual industries.

Observations/recommendations on anti-dumping:

- NTC follows standard procedures and publishes findings and recommendations. But as in other countries the result is (nearly?) always extra protection through AD duties
- As pointed out by many economists and also by the World Bank⁸, such results are more or less pre-ordained by the AD law for well known reasons, including especially the definitions of "normal value" and "injury" and the absence of any clause in the law taking account of buyer/consumer interests
- As in India and other countries, Pakistan's AD measures appear to be mainly benefiting monopoly/oligopoly producers of intermediate materials, thereby disadvantaging downstream and generally smaller firms using these materials

7 We understand that applications to invoke anti-dumping, countervailing duties and safeguard measures are all being processed as required by NTC.

8 For critical evaluations of anti-dumping practice in South Asia (mainly in India) and references to other publications see World Bank (2004), Trade Policies in South Asia: an Overview, Report No. 29949, Vol II, pp 74-79, and also Aggarwal, Aradhna (2010) "Trade Effects of Anti-Dumping: Who Benefits?". Forthcoming in the *International Trade Journal*.

- *Recommendation:* amend the AD law and insert a public interest clause which requiring the NTC to take account of consumer/buyer effects. The 2004 World Bank report also discusses the use of the Safeguards route as an alternative and economically less damaging safety valve for responding to protectionist measures, and has other suggestions
- We were told that so far there have been about 150 appeals from AD decisions. These all went to the Appellate Tribunal, the Supreme Court or the High Court. However no information on these appeals is available either in hard copy or online
- *Recommendation:* information on the appeals and their outcomes should be published on the NTC website (or at least a list of the appeals and links to more information on Court/Tribunal websites).

Observations /recommendations on general industry reports:

- Since 2001/02 there have been 62 tariff cases. 44 of these have been completed and reports issued, and 18 were under study in April 2011 (Table 13). Seven of these cases were initiated by NTC, two by the Ministry of Textiles, one by FBR, and two by MOC. Although government-initiated, at least some of these cases were responses to initial producer contacts. All the others resulted from applications to NTC by individual firms or industries. We have been provided with the NTC reports on eight of these cases, in all of which the applicants were requesting higher protection, either in the form of increases in the tariffs protecting their output, or reductions in the tariffs on imports of materials and components which they use as inputs. We think it is highly likely that this is also true of the 54 cases we have not seen.
- The topics of the tariff cases are not mentioned on the NTC website and NTC's reports on the cases are not available to the public. The list of cases in Table 13 was provided to us following a request to NTC. We have been given copies of 8 of these reports. One (on "Monetization of PTA", dated April 7, 2010) is marked "Confidential". However in discussions at the Ministry of Textiles, other ministries and with private business people the contents and recommendations of this report seem to be well known. As these reports are based in part on opinions and information provided by stakeholders at public hearings, it is difficult to see why they are treated as confidential. In other countries it is normal for industry enquiry reports of organisations such as NTC to be publicly available after making sure that confidential information provided by firms and other stakeholders is not included.
- The reports are passed on to the government via the Ministry of Commerce, and in principle the recommendations are taken into account in decisions on tariffs and related policies. If the decisions involve changes to tariffs, subsidies or other policies these are announced in SROs, but there is no way to compare these outcomes with the recommendations in the original NTC reports, since the reports are confidential.
- A basic objective of organisations such as the NTC is (or should be) to provide objective and economically sound analyses of tariff and protection issues *before* the reports are handed on to government ministries which have to decide whether and how the recommendations will be implemented. If that is done, if the ministry (and ultimately the Minister) decides not to follow a Report's recommendations, the onus is on it/him to publicly explain the decision. In this way the reports can contribute in a major way to greater transparency in a process which can otherwise be distinctly non-transparent and heavily influenced by the businesses with financial stakes in the outcome.
- *Recommendation:* the reports should be promptly published (especially on the NTC website) as soon as they are completed. This should be done before they are forwarded to the Ministry of Commerce (or to the referring Ministry). A complete set of all past reports should be available on the website.

- *Recommendation:* The Ministry of Commerce should be obliged to publicly report on the government's decisions on the topics that are dealt with in the NTC reports, and in particular to give reasons if it decides to follow or not follow the recommendations of the reports.
- In our discussion at NTC we asked whether there are any general criteria for recommendations on the level and structure of tariffs coming out of reports on individual industries and sectors. There was no clear answer to this question, other than the suggestion that recommended tariffs should be within "normal" ranges. However in the PTA report and also in the other reports we have seen, it seems that the NTC follows two of the basic principles discussed in the previous section i.e. (1) Tariffs should provide "adequate" protection for the survival and "healthy growth" of the affected industries (2) they should conform to the "cascading principle" i.e. that tariffs should systematically rise with the degree of processing. As already pointed out, there is no good economic rationale for either of these approaches to tariff policies.
- *Recommendation:* the government should formulate and make public some general trade policy principles. Some preliminary suggestions on what these principles might be are outlined in section 6 below and in the concluding section of this report. The role of NTC in responding to requests/complaints of individual industries should be to ascertain that the level and structure of tariffs and subsidies affecting these industries are consistent with these general principles, and to recommend changes if they are not.

6. The role of SROs and CGOs

Starting in about 1988 many products (e.g. motor cars, motor cycles, air conditioners, refrigerators) were subject to "local content" or "indigenization" programmes. These programmes were initially drawn up and managed by a wing of the Ministry of Industry and after 1995 by EDB which was set up for that purpose. The programmes required firms producing specified products to agree to arrangements with mandated levels of "local content". Local content included in-house production and the purchase of materials and components from other domestic producers. The local content share of production was usually supposed to increase over time. In return for agreeing to a programme, EDB would authorize the firm to import specified parts and components at zero or much reduced Customs tariffs. The lists of materials and components subject to these reduced tariffs were passed on to FBR and routinely incorporated in SROs amending the CDs imposed when the materials and components were imported by the firm subject to the indigenization agreement.

These agreements gave EDB a great deal of power not only over the operations of individual firms but more generally over the industries subject to the agreements, essentially because the zero or discounted CDs on materials and components allowed to be imported were essential for firms to be profitable, and to compete with other local firms and with imports of the final product (if any). This meant that:

- EDB had discretionary control over which of the materials and components used in the industry could be imported, since if a material or component was deleted from the list of permissible imports it had to be produced domestically. The programmes in effect acted as a non-tariff barrier to imports and were a *de facto* continuation of the old "License Raj" system of import licensing
- EDB had considerable discretion as to the permitted local content levels of particular firms and which materials and components each firm would be allowed to import
- EDB had discretionary control over new entrants to the industry, since all potential entrants would need to negotiate with EDB and agree on an individual indigenization programme and how that would be phased in over time

During the Uruguay Round, mandatory local content programmes of the kind operated in Pakistan were considered to be non-tariff barriers to trade, and the TRIMS agreement required developing countries to remove them over five years i.e. by 2000. Pakistan applied and obtained at the WTO a further three year extension and formally phased out all its programmes other than its auto programmes-86 programmes in all- between July 2001 and December 2003. Its 16 auto sector programmes were formally removed in July 2006.

It seems that these changes were sufficient to satisfy the WTO members which were principally interested at the time (the US, EU and Japan), but Pakistan immediately looked for ways which would as far as possible continue the same policies and also retain an industrial planning role, especially for EDB but also for other ministries. Essentially this was done by using escalated tariff structures combined with the continued use of tariff exemptions⁹ and partial exemptions for specified lists of raw materials and other intermediate inputs. How this system has developed for the erstwhile non-auto sector TRIMS arrangements and also for other products not previously subject to local content requirements, is discussed below. We discuss the auto –sector arrangements separately in section 9.

For non-auto related products, the key measures are set out in three SROs originally issued on June 5, 2006 and a CGO (Customs General Order) which gives a list of “locally manufactured items” not eligible for reduced CDs. The updated versions of the three SROs are published in Vol II of the 2010-2011 Customs tariff schedule and represent the current rules. The SROs list very large numbers of products –nearly all material inputs and machines used by domestic producers-with zero or reduced Customs duties which are lower than the normal statutory duties given in the Customs tariff schedule.

SRO 565(I)/2006 (“Survey based”) provides a long (45 page) list of 154 domestically manufactured products. For each of these products there is an associated list of inputs (“raw materials, sub-components, components, sub-assemblies, and assemblies”) which can be imported at specified low Customs duty rates-mostly zero, 5% or 10%. Some of the input lists are very extensive and detailed (e.g. for car air conditioners 6 raw materials and 42 different sub-components and components), others are relatively short (e.g. for ceramics 6 raw materials). Most of the finished products are “engineering” products classified in HS 84 or HS 85, but the final product list also includes non-engineering products, for example certain chemicals, paper products, pigments and dyes, agricultural pesticides, fatty acids and footwear.

The SRO just gives a general description of each of the 154 products and a detailed list (including HS codes) of the concessionary input tariffs for raw materials and components, but does not provide the HS code or tariffs for the final products. To get a better idea of how this system works, Table 4 lists finished products for which we have provisionally identified the corresponding HS classification and tariffs, and Table 5 spells this out in detail for air conditioners. Note that our product listing in Table 4 is not complete as we have not succeeded identifying the HS classifications of a number of the products included in the SRO. This is just one of many examples of the non-transparency of the protective system being implemented through these SROs.

⁹ In SRO-speak, “exemption” means that all the CD in excess of a specified level is exempted. Only if the specified level is zero is the CD zero. So the actual CD could be zero or any other rate that is lower than the statutory duty.

To understand Table 4 we can take the example of air conditioners. The first column is the product description as given in the SRO. The third column is our insertion of the probable corresponding HS classification. The fourth column is our approximation of the likely MFN tariff, which in this case seems to be a 35% CD plus a 15% RD (Regulatory Duty) = 50%. The fifth column is the preferential tariff on imports from China, which we have assumed for all products is the most competitive preferential supplier, and in most cases is also subject to the lowest preferential tariff, in the case of air conditioners 37.5%. Note in this regard that RDs are not imposed on imports from preferential sources, and so would not be applied to imports from China. Under SAFTA India would also be a highly competitive preferential supplier of many products, but this is irrelevant since imports of most of the Table 1 products from India are banned under Pakistan's "positive list" system. Columns 6 and 7 summarise the concessionary tariffs listed by the SRO, which distinguishes raw materials, and sub-components and components. Details of these lists for the air conditioner example are shown in Table 5, which shows that all the concessionary CDs on raw materials are 5%, while all the concessionary sub-component and component tariffs are 10%, with the exception of the gas compressor CD which is zero.

What is the likely net protective effect of the tariff structures created by this "Survey based" SRO and summarised in Table 4? Taking the example again of air conditioners, the resulting effective protection of air conditioner manufacturers' value added depends on the (known) tariffs on finished imported air conditioners, average input-output ratios in air conditioner manufacturing and the weighted average of the input tariffs including the concessionary input tariffs and the CDs on inputs not included in the concessionary lists. Using the information on air conditioners summarised in Table 5, our rough guesstimate of the resulting effective protection of air conditioning producers' processing margins provided by this tariff structure would be about 110%-120% in relation to MFN imports, and about 70% to 80% in relation to imports from China.

With a great deal of work it would be possible to estimate the approximate effective protection rates of other 153 products included in this "survey based" list, but just glancing over the list it is apparent that there is a very large range of effective protection rates: extremely high-probably 100% and above- for many products such as air conditioners, refrigerators, washing machines, ceramics etc, around 50% for products such as artificial leather suitcases, possibly about 25% for products such as dry battery cells, and for a few products (e.g. textile spinning machines) approximately zero.

SRO 567 (I)/2006 ("Non-survey based") gives another long (28 pages) list of products for which the normal statutory CDs have been reduced, mainly to zero or 5%, but others (e.g. various textile and garment products) to 3%, 6.5% and 9%. Many of the listed products are organized by industry e.g. Sl. 4 consists of 33 inputs for the poultry sector, and there are similar groups of surgical sector, textile and clothing, and pharmaceutical products. Tables 6 and 7 give some idea of how this works for the poultry industry and the pharmaceutical industry. The information in these two tables has been copied from SRO 567 and supplemented with information on the MFN and preferential (from China) statutory tariffs on the inputs which are subject to concessions under the SRO.

SRO 575(I)/2006 similarly gives a long (about 40 pages) list of machines & "capital goods" for which the normal CD is reduced, nearly all to either zero or 5%. As for the other SROs, the machines listed in SRO 575 are mostly listed by user industry e.g. machines used in horticulture and floriculture. While many of these machines are specialised and would probably not have uses outside the specified user industry, others (e.g. gen-sets) certainly have alternative uses. This immediately raises the possibility of diversion when (as is typical) the CD for the specified users under SRO 575 is very low-zero and 5% are common-while the general statutory CD for the same product is considerably higher.

CGO 11/2007. In principle, none of the CD exemptions provided in the above three SROs are available if the product in question is locally manufactured. To facilitate observance of this condition at Customs clearance, EDB “in consultation with stakeholders” has compiled and regularly updates a list of locally manufactured products. At present there are 906 products on this list which is published in CGO 11/2007. If there is a dispute as to local availability, this is decided by EDB after consultation with “the renowned local manufacturers” of the same or similar products.

Table 8 gives some statistics of the information in CGO 11/2007. Note in particular that the listed products are all manufactured products, three quarters of which are basic metal and engineering products classified in HS 72-85. Most of them are inputs into, or machines used in, the production of other products. Note also that the list includes very few textile and clothing producers or auto producers: the trade policy frameworks of these sectors (and also agriculture including food processing) are treated separately. Finally, note that there is only one local monopoly producer of 91% of the listed products. We believe that this is usually an accurate characterisation of the market structure, but it is also possible that for some listed products small scale and informal sector producers are not counted, possibly because they don't receive special treatment under the various SROs providing input tariff exemptions.

Given that statutory CDs are higher than the CDs set under the SRO exemptions (in some cases considerably higher—see for example Tables 6 and 7) there is an obvious danger that some of the imports at low exempted CDs will be diverted to uses and users that the SROs are not intended to benefit. To prevent or at least control this, firms which are allowed to import at the low tariffs are in principle subject to fairly onerous conditions and procedures. For firms coming under the “Survey based” SRO 567, these include the provision of information on input-output ratios and the required quantities of the specified inputs in the light of expected production levels, controls to ensure that the claimed quantities used are “in accordance with the prevalent average of the relevant industry”, the verification of stocks which presumably may involve physical inspections, and special procedures and controls when the firm manufacturing the final product obtains the imported inputs from another (“vendor”) firm. In addition to all this, SRO 567 as well as the other SROs list “Special conditions” which are specific to individual products or product groups. In the case of many engineering products, these include requirements for the manufacturing firm to have and presumably use specified types of equipment, and to conform to IORs (input-output ratios) determined by EDB.

7. Evaluation of the SRO/CGO exemption system

The basic objective of the system is to provide extra protection to the processing margins (i.e. effective protection) of local producers by cutting the cost to them of some and in some cases most of the imported inputs which they use in production. For example, if the final product is protected by a 25% tariff, as a result of SRO exemptions the average protection rate of raw material inputs and components is reduced from say 15% to 5%, and if the cost of inputs at world prices is 60% of the world price of the finished product, then the effective protection rate for the process is 42.5%. This means that the processing margin (value added) is raised 42.5% above what it would have been if the same final product had been sold at world prices—for example if it had been exported while obtaining all its inputs at world prices. In the absence of the reduced input CDs resulting from the SRO, in this example the effective protection rate would have been 27.5%.

As noted above, there is probably a very wide range of effective protection rates (EPRs) across different industries as a result of this system...ranging from well over 100% in some cases to zero or possibly even negative EPRs in a few others. There are many possible reasons for such a large variance in EPRs, but it undoubtedly has a lot to do with difference in lobbying power, including the lobbying power of both producers and buyers of the products affected.

As already discussed, the quantities of products imported at the low exempted CDs have to be controlled, otherwise without any limit the low preferential CD would become the *de facto* general CD and the statutory CD would be irrelevant. Therefore *the system is in fact a continuation of the old ostensibly abandoned system of import licensing*, with EDB and other responsible ministries deciding on the quantities allowed to be imported at the concessional rates.

For most of the inputs dealt with in SROs 565 and 567, the concessions are only available to manufacturers and other producers which plan to use the products in their own businesses¹⁰. Commercial importers would have to import these products at the full statutory tariff rate, which for many products is 10% to 15% higher than the concessional rate.

Moreover, commercial importers are further disadvantaged because (1) their imports are subject to a 19% sales tax rate rather than the normal 17% rate¹¹ (2) they are subject to the full income withholding tax (WHT) rate of 5% which in their case is presumptive i.e. not adjustable against their actual income tax liabilities, whereas manufacturers importing for their in-house use pay at an adjustable rate of only 3%. This discriminatory treatment is more than may seem to be the case at first sight, because the tax base for the sales tax is (cif price+CD) while the tax base for the WHT is (cif price+CD+ST). According to our calculations this means that a manufacturer- importer subject to an "exemption" CD of 5% would pay a WHT rate equivalent to 3.69% of the cif price, whereas the same product imported by a commercial importer subject to (for example) a normal statutory 15% CD would be subject to a non-adjustable WHT rate equivalent to 6.84% of the cif price. In total, including all import taxes including the 1% federal excise duty (FED), the industrial importer in this example would be subject to an import tax of 27.8% whereas the same product imported by a commercial importer would be subject to a total import tax rate of 45.1%.

This discriminatory treatment may be enough to preclude commercial imports altogether, and has a number of serious economic costs.

Firstly, the system forces manufacturers to get involved in importing even though importing (especially in the case of smaller firms) may not be their forte and they would prefer to concentrate on manufacturing and to buy from intermediaries. Importing is a highly specialised knowledge-intensive activity requiring lots of paperwork (negotiation with foreign suppliers, arranging finance and LCs, arranging port and Customs clearance etc etc). In addition, the input requirements of an individual manufacturer will frequently be less than the quantity which it is economical to import, thus adding to importing costs, especially international freight and port clearance costs. Importing also ties up working capital both in advance payments for the imports and in stocks, both of which involve costs that most manufacturers would prefer to avoid. We presume that manufacturers subject to these arrangements will try to minimize these inconveniences and costs, perhaps by appointing specialised trader/importers as their agents, but substantial additional transaction and negotiation costs would seem to be inevitable, both for the manufacturers on one side and on the other side for Customs officials, EDB and the relevant sections of other ministries.

10 This restriction also applies to machines, with the proviso that there is a general provision (SI 23 of the SRO) setting a 5% CD applicable to "any other importer" of HS 84 and 85 machines, except for machines listed in a separate note.

11 These sales tax rules are given in SRO480(I)/2007 dated June 9, 2007, (Chapter X), which amends the Sales Tax Act. The extra 2% paid by importers other than industrial importers for in-house use is called the "Value addition tax".

Secondly, commercial importers play very important roles in the efficient functioning of any economy. In particular they cater to the needs of small manufacturers and new entrants. By excluding commercial importers from the concessionary customs duty regime, and also subjecting them to higher sales and income withholding taxes, the system therefore discriminates against SMEs and confers market power on the generally larger firms that are able to negotiate input tariff concessions.

On this last point, of the 1006 products which EDB lists as “locally produced”, 91% have only one local producer, about 4.5% have two producers, and only about 4% have three or more producers (Table 8). The producers of these products-nearly all monopolies- receive special treatment in that their output is protected against import competition by normal (and in some cases above normal) statutory tariffs, while in many and perhaps most cases their inputs are subject to the general exemption regime. For many of these products, economies of scale and specialisation relative to the size of the Pakistan market may be such that total production costs are minimised with just a single producer. That is all the more reason to expose these firms to import competition over low tariff barriers and to competition (potential or actual) from new entrants. But our impression is that current policies are doing the opposite: insulating most of these firms from import competition through high effective protection rates, erecting barriers to new formal sector (including especially SME) entrants as a result of the discretionary powers of EDB¹², and finally excluding the informal sector altogether. This is even more of a worry since EDB works very closely with and is presumably influenced by industry level committees, mostly consisting of representatives of the major firms in each industry. These committees are unlikely to welcome increased competition, whether from imports, from new entrants, or from the informal sector.

Administering this system of import licensing involves transaction costs both for the firms that hope to benefit and for the government bodies that administer it, notably the Customs service and in the case of engineering products EDB. The transaction costs incurred by the firms reduce the value to them of participating in the system. Because the transaction costs will tend to be lower relative to their output, the system very probably benefits larger established firms more than smaller firms. Likewise incumbent established firms are likely to know and manage the system better than new and recent entrants.

Both Customs and the associated agencies such as EDB have considerable discretion in administering the system. To take just one example, in unspecified circumstances (condition (x) of SRO 565(I)/ 2006) “any of the conditions” may be relaxed. As another example, most products come in many specifications and qualities, and deciding whether or not a product is “locally manufactured” and therefore whether or not it is eligible for a tariff concession is frequently not at all straightforward. As in any other discretionary regulatory system, this opens many possibilities for the generation and sharing of economic rents, especially as the agreements in this case are specific not only to particular industries but also to individual firms.

Pakistan's concessional tariff regime has much in common with India's long abandoned import licensing system¹³. EDB resembles in many ways India's erstwhile DGTD (Directorate General of Trade and Development) which also came under the Ministry of Industry and was also largely staffed by engineers who had close contacts with the principal established manufacturing firms. These contacts were needed to implement the principle of “indigenous angle clearance” i.e. that is to ensure that import licences were only issued when the product was not available from

12 According to some people interviewed, approval for the concessionary CD regime by EDB and other ministries is automatic if the firms applying register for sales tax. However the relevant SROs and other people interviewed are explicit that the applying firms are required to meet “indigenisation” and related criteria, down to the types of equipment installed in their factories. If this is correct, approval for the concessionary regime is far from automatic. We were also told that access to the concessionary regime is being used as an incentive to register for sales tax. If so, this seems to be an inappropriate and economically costly way of extending the sales tax net and sales tax compliance.

13 For a description of India's import licensing system as it was in the late 1980s, see World Bank (1989): *India: An Industrializing Economy in Transition*.

Indian producers. As at present in Pakistan, import licensing decisions for some products were the responsibility of other "sponsoring agencies" e.g. the Ministry of Textiles or the Ministry of Agriculture. An important part of the Indian system was also the "actual user policy" which disallowed imports for resale by excluding intermediaries from importing, and involved detailed surveillance and controls over manufacturer-importers to ensure that the raw materials and machines that they had imported were not illegally resold.

India's DGT and also the "actual user" policy were abolished 20 years ago during its 1991 reforms which lifted import licensing from intermediate materials and capital equipment. The remains of its import licensing system were finally removed in 2001 when the erstwhile office of the "Chief Controller of Imports and Exports" in the Ministry of Commerce became the present Directorate General of Foreign Trade, whose predominant role since then has been to free up the import regime and promote exports rather than restrict imports. Together with systematic pre-announced tariff reductions, these reforms were essential precursors to the transformation of the Indian economy, and especially to the rapid growth of both manufacturing production and exports during the 2000s.

What to do? Some recommendations

In our view Pakistan's present concessionary tariff regime is further increasing the average protectiveness of the statutory tariff structure while creating a large and economically inefficient dispersion of effective protection rates across different import substitution activities which has no obvious rationale. It is also creating and supporting market power situations in many industries in which incumbent and for the most part organised- sector firms not only receive substantial protection against import competition, but also against competition from new entrants, including in some industries competition from small and medium enterprises, and in others competition from informal sector enterprises which are excluded from the concessionary regime. None of this is consistent with the development of a competitive, progressive and we would also add an equitable industrial sector. How to change direction? We have the following recommendations:

- As a basic principle, if Customs duty concessions are given, they should be available to everyone, including trader/importers
- The additional discrimination in favour of manufacturer-importers through the sales tax and the income withholding tax when importing should be removed. All importers including trader-importers should be subject to the same sales tax and income withholding tax rates and conditions
- If input Customs duty concessions announced in SROs are intended to be permanent, they should replace the corresponding statutory tariffs at budget time.
- Most of the concessionary tariffs are presently either zero, 5% or 10%. Some of these are not far below the statutory MFN or preferential tariffs (see for example some of the input tariffs for air conditioners –Table 5–and for pharmaceutical inputs –Table 7). It should be possible to unify these with little disruption to user- manufacturers or other importers.
- However many statutory tariffs considerably exceed the concessionary tariffs by a substantial margins...commonly by 10%, 15% or 20%. In these cases we recommend reducing the statutory tariffs to the same rates as the concessional tariffs
- This means that most raw material and input tariffs will be in a range of about zero to 10%.
- To reduce tariff escalation, this should be accompanied by "tops down" reductions in final product tariffs to the same range of zero to 10%

8. Some notes on tariffs and revenue

As well as protecting local industries against import competition, customs duties are an important source of government revenue. The relation between trade policies (including the level and structure of tariffs) and government revenue is on its own a large topic which we have not attempted to tackle in the report. However, while recognising that this is only part of the story, we think it is worth pointing out that the present basic approach to tariff determination in which local producers are protected by high tariffs on their finished products but pay low or zero tariffs on their inputs, is very expensive for government revenue. This is because this combination of output and input tariffs is designed to encourage the substitution of domestic production for imports, and this involves the loss of the Customs revenue on the replaced imports. Imports of inputs go up, but little compensating Customs revenue is collected since the CDs on these inputs are very low and in some cases zero. In addition, for many products with high effective protection on this pattern, smuggling is already important and will tend to go up further if output tariffs are increased, leading to a further loss of government revenue.

These general points are spelled out in more detail in the following notes on regulatory duties and “Tax expenditure” calculations on the revenue losses resulting from CD exemptions.

Regulatory duties These duties have been justified in official statements on the grounds that they helped deal with the 2008 balance of payments crisis by cutting imports of “luxury” products, while at the same time contributing to government revenue and helping manage the government’s fiscal deficit. The regulatory duties were imposed in August 2008 following an increase in the normal maximum CD rate from 25% to 35% in the 2008/09 budget that became effective on July 1, 2008. Table 9 summarises some statistics provided by FBR on imports and duty collection trends of the products which became subject to the RDs in August 2008. Imports of these products fell sharply between 2007/08 and 2008/09 and again between the first 8 months of 2008/09 and the corresponding period of 2009/10. A large and possibly the major part of this drop in imports over these three years, was due to declining domestic demand associated with the GFC and its aftermath, including recessionary domestic conditions and high consumer interest rates. However another part was also very likely due to the combined effect of the increased CDs and the new RDs. These would have pushed up consumer prices and hence cut the demand for these products (all of them seem to be final consumer products) while at the same time leading to substitution of local production for some of the imports. Initially –between 2007/08 when there were no regulatory duties and 2008/09 when CDs were higher and RDs were imposed- total government revenue from CDs and RDs on this group of products went up by about 12%. Comparing the first 8 months of 2008/09 with the same period in 2009/10 however, there was a substantial drop in revenue from CDs and RDs-about 17.5%, and in 2009/10 total revenue was probably about 5% lower than it was in 2007/08 when there was no regulatory duty and CDs were lower. This revenue decline was associated with a continuing decline in imports which in turn was probably attributable to a combination of weak final consumer demand, continuing substitution of local production for imports, and very likely increased smuggling and under-invoicing.

We think that increasing CDs and using a regulatory duty imposed only on imports was and remains an extremely inefficient way of cutting imports of “luxury” products and also a counter-productive method of generating government revenue, which is likely to fall rather than increase even in the short run, and definitely in the medium to long run. A far better method of achieving these objectives would be to impose a general indirect tax (say an excise tax?) on both imports and domestic production of these products. Doing that would cut consumer demand and also imports in the same way, but would not provide additional incentives for already heavily protected import substitution producers. The net effect would be a somewhat smaller reduction in imports, but this could be easily offset by a minor downward adjustment in the real exchange rate, which would also benefit exports.

As regards government customs revenue, the increased protection of local import substitution producers resulting from the increased CDs and the RDs will reduce revenue to the extent that local production replaces imports, and theoretically in the limit CD+RD duties collected would fall to zero if substitution for imports were complete. In that case the only offsetting increase in Customs revenue to balance the lost revenue on the final product imports would be the import duties on intermediate inputs-most of which are very low and certainly not subject to RDs- used to produce the increased import substitution production. By contrast a neutral tax such as an ad valorem excise tax imposed on both imports and domestic production at the same rate as the combined CD+RD increase, would generate far more revenue, since (a) import substitution production wouldn't change and there would be no associated loss of Customs revenue on reduced imports (b) the excise duty is applied to total domestic production.

We have done some very rough back-of -the-envelope calculations on the likely revenue effects of the RD. These suggest that replacing the present RD on imports with an equivalent *ad valorem* excise duty on the same set of products would produce government revenue two to three times as great as the government revenue at present being received from Customs duties plus the regulatory duties. Based on the annual equivalent (about Rs 11 billion) of revenue from CDs and RDs received in the first 8 months of 2009/10 (Table 9) this would represent extra revenue of Rs 11 to 22 billion.¹⁴ Put another way, very large losses of revenue of this rough order of magnitude are being incurred each year by continuing to impose the present regulatory duties. It would be possible to provide more accurate estimates with more detailed disaggregated modelling of the likely reactions of the products subject to the RDs, but we think that this is hardly worthwhile as all such exercises will still come up with large revenue losses.

We stress that the revenue losses associated with the RDs compared to the revenue that would be earned from equivalent ad valorem excise taxes on the same products, don't imply that a complicated structure of excise taxes at the same rates as the RDs and on the same set of products would be the best alternative tax. There are many other ways of compensating for the revenue generated by the RDs, and which of those (or which combination) should be used is not part of the terms of reference of this study. The main point we would like to emphasize is that if indirect taxes are part of the solution, the least efficient and especially counterproductive way to do that is to impose them on imports only but not on domestic production.

Two final notes. First, it is important to recognise that for the group of products at present subject to RDs, the revenue from CDs and RDs is likely to decline over time, because the longer the RDs stay in place, the more (mostly high cost) import substitution production is likely to be generated. This is another reason for removing the RDs as soon as possible.

Second, both the present RDs imposed on imports only, and an alternative in which equivalent excise taxes would be imposed on both imports and domestic production, further raise domestic prices above cif import prices and add to the already substantial incentive to engage in under-invoicing and smuggling. A number of products that are subject to RDs are on FBR's list of products that are especially susceptible to under-invoicing¹⁵, and knowledgeable people we interviewed said that these and other products subject to RDs were also being smuggled. For example, air conditioners are one of these products, but despite known substantial under-invoicing and smuggling the protection rate for the local industry was went up from 25% to 35% in the 2008/09 budget and then by another 15% to 50% with the imposition of a 15% RD on air conditioner imports in August 2008. The corresponding increases in the total import duty rate (including CD, RD, Sales tax, Special Federal excise tax, and withholding tax) were from

¹⁴ These are rough guesstimates on various assumptions about the share of domestic production in total demand, average CDs and RDs and the supply elasticity of domestic production. Assuming that during 2009/10 domestic production was supplying three quarters of the total production of the products subject to regulatory duties, that the average CD was 20% and the average RD was 10%, and that the supply elasticity of domestic production was about 4.3, the annual loss of government revenue was about Rs 18 billion. Changing these assumptions still gives large revenue losses from the RDs. For example, with a supply elasticity of 2.2 and keeping the other assumptions above the annual revenue loss is Rs 14 billion. The annual revenue loss goes up with the current share of domestic production in total demand and with the supply elasticity of domestic production.

¹⁵ In SRO 487(I)/2003

55% to 67.5% and then to 86.1%, thus substantially increasing the incentive to under-invoice or smuggle. This obviously has negative consequences for government revenue, and would also occur with a neutral excise tax. However in that case the resulting net revenue loss should in principle be lower as the excise tax would also be levied on domestic production (providing of course that the tax is effectively collected from the local producers).

Notes on "Tax Expenditure" (as reported in *Economic Survey 2009-10 Annex 2*). This is intended to provide estimates of the cost to government revenue of the various tariff exemptions as set out in SROs. The revenue loss is probably calculated as the difference between the revenue actually collected with tariff concessions and what the revenue would have been with the same quantity of imports but with the normal tariff i.e. assuming zero demand elasticity.

Apparently calculated in this way, for the estimated reduction in CD collected under the "Survey based" exemptions the total reduction was Rs 2.839 billion during 2008/09 or only about 1.9% of total CD revenue. For the "non-survey based" exemptions the total was Rs 18.12 billion in 2008/09 or about 12.2% of total CD revenue.¹⁶

However, assuming that our interpretation of the methodology is correct, these and the other "Tax expenditure" estimates greatly underestimate the revenue losses because they do not recognise that the purpose of the exemptions is to get local production to replace imports of the final product. So the main loss of revenue from the exemptions is *the CD lost on the imports replaced*. As normal final good tariffs in Pakistan are higher than normal intermediate good and raw material tariffs and are applied to a higher tax base (i.e. the cif price of final goods > cif price of intermediate goods used in its production) the revenue losses from the SRO exemptions are far larger than given in the "Tax expenditure" estimates.

If the industry receiving the extra (effective) protection from input tariff exemptions expands its output as a result of the extra protection, the revenue loss includes the reduced revenue resulting from the lower input tariffs PLUS the reduced customs revenue on the imports that are replaced by the expanded production. (This is the competitive model with some imports prior to the input tariff reduction).

Probably a more common case in Pakistan are industries where economies of scale and specialisation are important so that there is only room for one monopoly import substitution producer. If before the input tariff exemption the firm's scale is too low and its costs are too high to be viable with the existing output and input tariffs, there will be no domestic production and customs revenue will be collected on the imports. Then the input tariff exemption is provided and the firm now becomes profitable and will in general supply the entire market at the import price plus the output tariff. Then customs revenue declines by the customs duty previously collected when imports supplied the entire market, minus the revenue now collected on the imported inputs. Unless the exempted input tariffs are on average considerably higher than the average output tariffs, there must be a net loss of customs revenue---usually substantial since the output tariffs protecting such industries are always in practice much higher than the exempted input tariffs ...in fact the latter may be zero, in which case the customs duty loss is simply the CDs previously collected on the displaced imports. The "tax expenditure" estimates say nothing about this case.

Other probably fairly common examples in Pakistan are industries with economies of scale and specialisation which already supply the entire domestic market before the input CD exemptions are given. Then if input tariff exemptions are given, in plausible circumstances the profit maximising price and output also won't change, so the result of the input exemptions is simply to transfer the reduced CD revenue on inputs to the firm's profits. This is the only case where the "tax expenditure" as apparently calculated in the Economic Survey represents the actual CD revenue loss.

¹⁶ *Economic Survey 2009/10*, p262. Annex 2, Table 3, S. Nos 2 and 3

9. Trade policies in the auto sector¹⁷

Background. As discussed previously, starting in about 1988 motor cars, motor cycles, trucks and other vehicles were among the industries which were subject to “indigenisation” programmes which since 1995 have been managed by EDB. One of the purposes of these programmes was to attract investment by foreign firms under which they received tariff and non-tariff protection in the domestic market in return for commitments to provide specified and usually increasing levels of “local content” in their domestic operations, in their own factories or preferably by supporting local producers (“vendors”) of parts and components. In the car industry, these policies succeeded in attracting investment in Pakistan by a number of multinational auto firms. At present the market is shared by local affiliates of three Japanese multinationals, Suzuki, Honda and Toyota. Their respective market shares (numbers of vehicles produced in 2010) are 49%, 11% and 39%. Each of these of original equipment manufacturers (OEMs) is supplied with parts and components by large numbers of vendor firms.

The Uruguay Round TRIMS (Trade Related Investment Measures) agreement required developing countries to remove their TRIMS arrangements and after a series of extensions Pakistan formally removed its auto TRIMS programmes in July 2006. In anticipation of this policy change, in March 2004 the Ministry of Commerce asked the World Bank to do a study of the industry including especially an economic evaluation of the indigenisation programmes managed by EDB, and recommendations on policy. A World Bank team (in which one of the authors of this report-Garry Pursell-participated) left a fairly detailed *Aide-Memoire* document with the Ministry in March 2004¹⁸, and this was followed later in 2004 by a World Bank supported study prepared by Dr A.R. Kemal of PIDE.¹⁹

Policies. Both the *Aide-Memoire* and the Kemal report²⁰ were critical of the policies then being followed under the so-called “deletion programmes”²¹ managed by EDB and recommended :

- Removal of the deletion programs, including the assembler deletion programs and the subcomponent deletion programs;
- Initial reduction of the then auto Customs duties to a considerably lower uniform single rate that would be the same for all models e.g. to a uniform rate somewhere between 60 and 70 percent;
- Announcing a phased tariff reduction program: for example, starting at 60%, reductions of 5 percentage points a year, over say 5 years, to 35%-45%, or 5% annual reductions to say 25%-35% in 7 years' time;
- General permission for the import of second hand cars, but subject to more rigorous valuation rules at Customs than the present rules;
- Unification of tariffs on CKD packs, original equipment components and replacement parts at a single rate (for example at 25%);
- Imposition of excise taxes on expensive and luxury cars in order to compensate for revenue losses from Customs duty reductions on these cars.

At about the same time that these recommendations were conveyed to the government, the auto parts producers (represented by PAAPAM) proposed an alternative policy scheme, ostensibly

¹⁷ We are grateful for a very informative PPT presentation by Dr Muhammad Zubair at EDB which has greatly helped in the preparation of this section

¹⁸ World Bank Preparatory Mission 6-12 March 2004. *Aide Memoire: Study on the Auto Industry in Pakistan: Trade Policies and Performance.*

¹⁹ A.R. Kemal (2004-September?). *The Auto Industry in Pakistan: Trade Policies and Performance*

²⁰ It was discouraging that none of the officials at FBR, MOC and EDB whom we met in the course of our study were aware of the earlier World Bank Aide Memoire or of the Kemal report. Both were done at the request of, and delivered to, the then Minister of Commerce, but despite several requests copies could not be located in Ministry of Commerce files.

²¹ “Indigenisation” of production was implemented under these programmes by requiring local production of items which were deleted from the CKD kits of components which could be imported for assembly in Pakistan.

TRIMS- consistent, which would enable the deletion programs to continue. Subsequently, when the TRIMS arrangements were formally dropped in 2006, the government replaced them with the PAAPAM proposal. The industry still operates under this policy framework. It currently consists of the following principal elements:

- Prohibitively high CDs on the import of CBUs (i.e. finished cars). At present these are respectively 50%, 55%, 60%, 75%, and 100% depending on engine cylinder capacity. CDs at these levels amount to an import ban.
- Setting very high tariffs (currently 50%) on most components and auto spare parts produced in Pakistan, except components-mostly not produced in Pakistan-which are listed in carefully defined standard kits of “non-localised” parts. The additional high tariffs protecting “localised” production are set out in 40 pages of detailed product lists in SRO 693(I)/2006.
- Setting lower tariffs on the kits of “non-localised” parts. Currently this tariff is 32.5%. Thus, there is no conditionality in the form of mandatory deletion targets, but only different tariffs for the two sets of components, “non-localised” and “localised”.
- Setting low tariffs –mostly between zero and 10%- on raw materials and components that are used as inputs by parts and component manufacturers registered with and approved by EDB. Given that their outputs are in principle protected by a 50% tariff, this provides very high effective protection rates-in the region of 100% or more- to the local parts and components producers. But it is doubtful whether this actually happens in practice...see later discussion.
- A ban on the import of second hand cars, except for limited imports allowed to Pakistanis returning from residing abroad, and cars received as gifts from Pakistanis living in other countries
- Rules which effectively block new firms from setting up in Pakistan unless they are substantial auto producers elsewhere and unless they come with a plan for “progressive manufacturing” and the intention to produce parts locally i.e. unless their entry is approved by EDB. We believe that the principal objectives of this provision is to prevent the entry of low volume, low cost firms (local or foreign based) assembling imported engines and other components purchased from other countries, especially China. This has happened in the motor cycle industry where it has created intense competition for the major established motor cycle producers (also Japanese), declining prices, and rapidly growing demand and production.

Because of the absence of conditionality on local content, the proponents of this system believe it does not fall into the TRIMs “illustrative list” of arrangements that violate the TRIMs agreement. However, in practice, the system operates in a very similar way, with the EDB negotiating the periodical removal of specified components from the low-tariff “non localised” lists to the high tariff component list, to encourage local production of that component. In addition, the system of concessionary input tariffs that are for approved local “vendor” companies only, means that EDB/Customs are in fact operating an import licensing system.

We have not had time to comprehensively review the current state of the auto sector and the policies affecting it, but from what we have been able to learn the findings and recommendations of the 2004 Aide-Memoire and Kemal reports are if anything more pertinent and relevant than they were in 2004. These reports started with a vision of a future auto industry with efficient low cost domestic production of models with high domestic demand, substantial exports of finished cars and a variety of components, and with low volume or specialised car models that would be expensive to produce in Pakistan being imported. The trade policy framework needed to support this vision, would consist of the same or relatively uniform tariff rates applied to imports of built up cars, SKD units, CKD units, components and replacement parts. There would be no non-tariff or administrative barriers to imports except for normal safety and registration rules that would not discriminate between imports and domestic products; second hand cars would be freely importable but subject to transparent valuation rules at Customs; and normal drawback and other export facilitation measures would apply to auto industry exports.

Consequences. The 2004 reports then discussed the Pakistan auto sector's proposal to continue the prohibitively high CBU tariffs, the deletion programs and the ban on the import of second hand cars, and noted the hope that if car model volumes were to continue expanding very rapidly (as they were at that time) it would be possible for more complex components to be sourced domestically at acceptable costs, and that the deletion programs could be used to speed this process up. As it turned out, actual demand growth since 2004 has been far below these earlier projections, but we believe that deficiencies of this policy framework pointed out by the 2004 reports have been largely verified by subsequent events and are equally pertinent now. In particular:

- If tariffs remain prohibitive or very high, and especially if demand is growing rapidly, Pakistan's past experience and the experience of many other countries is that the consumer demand for variety will be met by local production of new models, either from the establishment of new auto assembly plants by multinational auto firms not yet represented in Pakistan, and/or from the introduction of new models on existing assembly lines. The domestic demand for many of these models is likely to be small, and at low production scales they are likely to have high production costs, especially if they are obliged to meet the same or similar deletion targets as higher volume models. This creates a situation in which, behind the tariffs needed to protect the high cost low volume plants and models and their component suppliers, firms producing cars with larger volumes can earn high profits and/or "easy life" economic rents. Such a system involves high economic costs for the economy, and if and when in the future it is decided to reduce tariffs and allow import competition, both the high-cost producers and the high-volume more profitable producers are likely to constitute a strong lobby against reform.
- If the domestic market continues to be closed to imports by prohibitively high tariffs and the ban on imports of second hand cars, it is probable that tariff jumping lumpy investments will continue to create periods of substantial and wasteful excess capacity. This was the case for a long period during the 1990s and has happened again following new investments after 2004. At present (2010 data) the industry's capacity utilisation rate is 43%, with capacity at 284,000 and demand around 122,000. Even if demand eventually catches up with capacity, as long as present policies continue, periods of excess capacity followed by periods of inadequate capacity and shortages, are likely to reoccur in the future, since prohibitive tariffs would continue to prevent imports from playing their normal equilibrating role.
- Small scale assemblers similar to the assemblers of Chinese components in the motor cycle industry have a valuable potential role but are excluded by present policies
- The administrative apparatus associated with the de facto deletion programs still being operated will continue to be strongly anti-competitive, by setting up barriers to the entry of new competitors, discouraging aggressive competition between assemblers, creating and reinforcing the market power of established component producers, and weakening the competitive power of small producers. According to knowledgeable people interviewed, at present the three major auto firms in Pakistan effectively monopolise their specialised market segments: Suzuki the low priced small car segment, Honda the medium price medium size segment, and Toyota the larger size, higher price segment.
- The system will continue produce large and economically inefficient variations in effective protection levels as between different car models, processes and components. We discuss this point below.
- Substantial government and private resources that could be used more productively, will continue to be expended in negotiating and administering the deletion programs, with a motive in some cases to prevent changes that would negatively impact profitability, and in others to promote or support changes which will generate additional profits and economic rents.

Prices and protection. Car prices in Pakistan are higher than they would be in the absence of the present protection system, but the extent to which domestic prices exceed world prices varies between models and over time. Table 10 updates some 2004 price comparisons to 2011 by comparing the ex-factory prices of two Pakistan models with the closest approximations we could find of Indian models with similar specifications. The 2004 comparisons made rough allowance for the then premia in the secondary market for cars, which was associated with consumer prepayments and long waiting times for delivery. We understand that prepayments are also required in 2011, but have not attempted to allow for this in the comparisons. According to knowledgeable people interviewed both in 2004 and 2011, the quality of the Pakistan models is below international standards -for example they do not meet European exhaust emission standards whereas the Indian models do. Quality deficiencies seems plausible in view of the generally very low production volumes, especially of some of the parts suppliers, but we have no way of verifying let alone quantifying these claims. We chose Indian models as comparators as price, specification and tax data is easily available, the Indian domestic market is highly competitive, and India is exporting large numbers of cars at similar prices to domestic prices

After adjusting for sales taxes and importer and dealer margins, our preliminary findings are that domestic ex-factory prices of the inexpensive car (the 796 cc Suzuki Mehran) exceeded Indian prices by about 30% in 2004 and by about the same margin (32%) in 2011. In 2004 the Pakistan price of the more expensive model (the Honda City) exceeded the Indian price by about the same proportion (27%) but in 2011 the price difference seemed to be about zero. We can only speculate on the reasons for this change: it may have something to do with Honda Atlas's low capacity utilisation (about 25%) and financial problems in 2010.

It is apparent from Table 10 that implicit nominal protection rates are well below the protection available from tariffs, which for the Suzuki Mehran were 75% in 2004 and 50% in 2011, and for the Honda City 100% in 2004 and 60% in 2011. Even allowing for current financing premia and possible quality differences, this suggests that the current tariffs could be cut substantially without having much effect on imports of cars.

Why don't assemblers price up to the full extent of the protection available from tariffs? It is likely that profit maximizing prices have been lower than this, especially during the 1990s and again since 2007 to the present in the presence of considerable excess capacity, but also during 2004 when demand was running ahead of demand. Another likely reason is that the international auto companies operating in Pakistan prefer stable, moderate- to- low prices over high prices in order to encourage long term growth of demand. Finally, "moral suasion" by the government to keep car prices down also appears to be important.

The cost of producing cars is affected by the 32.5% tariff on imported non-localised parts and the prices paid for locally procured components and accessories, and these need to be allowed for in assessing the international competitiveness of the industry. A useful way of getting some feel for this would be to estimate the protection to value added in car production for a representative sample of car models, distinguishing effective protection rates which are available from the present tariffs, from implicit effective protection rates based on the differences between domestic prices and estimated international prices of the same or similar cars. In doing this it would also be relevant to distinguish effective protection for assembly, effective protection for vendors which are supplying parts to the assemblers, and finally to estimate effective protection for car production considered as a single integrated process combining the activities of the vendors, "in-house" parts production by the assemblers, and assembly. Unfortunately because of the complexity of Pakistan's car policy system, doing this rigorously would involve a major and expensive empirical study which among other things would require the collection of detailed domestic and world price and input-output information from the assemblers and the vendor firms. *We strongly recommend against attempting such a study*, which is likely to come up with results that will in any case be outdated by changing conditions and policies and will provide a reason for delaying reforms the need for which seem to us to be obvious.

Protection rates: some illustrative simulations. Nevertheless, we think it is worthwhile to work through some likely effective protection rates for the main auto industry segments based on alternative assumptions about relevant parameters. This has been attempted in Table 11 which uses assumptions about input-output ratios (listed in the Table) expressed in world prices derived from A.R. Kemal's 2004 study. Using these input-output parameters, col (1) first shows the current 50% tariff for finished cars below 800 cc (we have in mind the Suzuki Mehran model), the 32.5% tariff on "non-localised" parts (i.e. the ckd pack minus deletions), and the 50% tariff which we understand protects most "localised" parts .The last tariff in the column is a guesstimate based on a few interviews in 2004 and December 2010 of the average concessional tariff applied to imports of raw materials and subcomponents used by the "vendor" firms.

With this tariff structure the effective protection available comes out at 120% for assembly, 95% for vendor production, and 104% for the entire integrated process starting with the inputs used by the vendors and finishing with the assembly of the car. We stress that these are the potentially available protection rates assuming that all the tariffs are binding i.e. that the actual differences between domestic and world prices at the various production stages are the same as the tariffs. For assembly this means that the CBU factory price is raised 50% above world prices, while paying prices respectively 32.5% and 50% above world prices for the imported pack and for manufactured parts. Vendors (and also in-house parts manufacture by the assemblers) are protected by a 50% tariff on their finished products but face protection of only 5% on their raw material and sub-component inputs. On the assumption that valued in world prices the inputs cost half the world price of the finished components, this gives effective protection to their processing margins of 95%. Finally, the integrated process including the operations of both the vendors and assemblers, is protected by the 50% CBU tariff, and its material input costs are raised by the 32.5% tariff on non-localised parts and the 5% tariff on vendor raw materials and subcomponents, providing effective protection to value added in the total process of 104%.

Columns (2) to (5) provide EPRs on alternative assumptions about *realised* (or implicit) nominal protection rates based on actual price differences rather than the price differences that are available from tariffs. Considering first the total-process EPRs (row (7)), in Col (2) this EPR is 48%. This is the outcome, firstly of implicit CBU protection of 32%, which is our estimate of the excess of the actual domestic price of the Suzuki Mehran in 2011 over its world price, as indicated by the comparison with the price of the Indian Maruti-Suzuki model discussed previously. Secondly, it assumes that the 32.5% tariff on the imported pack is binding and represents the actual excess cost of that pack over its value at world prices. Thirdly, it assumes that actual implicit protection rate of the materials and subcomponent inputs used by vendors is the same as the (guesstimated) 5% tariff. As there is some escalation in this tariff structure, the estimated EPR for the total process at 48% is higher than the 32% protection rate for the finished car, but very considerably below the 104% EPR that would result if the Suzuki Mehran had been fully priced up to the protection available from the 50% tariff. Note that the realised total-process EPRs are the same (also 48%) in the simulations reported in cols (3) to (5) as in col (2) since the protection rates relevant for calculating these EPRs do not change.

The incentives for assembly on the one hand and for vendor parts production on the other, are obviously both very much affected by the prices that the vendors receive for their finished parts from the assemblers. If all the vendors were able to fully price their products up to the 50% tariff protecting their production against imports, this would reduce the assemblers' processing margins, (unless the assemblers were able as a result to increase their CBU selling prices) and would result in very high vendor processing margins since the protection rate on their own inputs is guesstimated to be only 5%. This case is illustrated in Col (2), in which the assembly EPR comes out at minus 30% and the vendor EPR is plus 95%. This says that the protection for the entire process of 48% is strongly biased in favour of the vendors, who can operate with processing costs (that is labour costs, non-traded input costs, interest,

depreciation and pre-tax profits) exceeding world standards by 95%. This compares with the assembler processing margins which are squeezed below world standards by about 30%.

But it is highly questionable whether the local Pakistani vendors are able in practice to price their finished parts up to the protective tariffs. During 2004 interviews with some local enterprises supplying parts and other inputs, most said that their bargaining power viz a viz the assemblers was extremely limited and that in practice the prices they were actually receiving were far below the prices theoretically available from tariffs. This is plausible for a number of reasons including the following (a) the technical specifications, quantities and delivery times are typically solely determined by the assembler (b) the assembler often provides the production technology including the equipment needed to produce the parts (c) the assembler is the sole buyer of the parts (d) the assembler frequently has the capacity to produce the parts in-house if not satisfied with the general performance including the quality and prices of the parts supplier (e) very few parts suppliers have alternative markets for their products and rely almost entirely on one or at most three of the major local Japanese assembly operations for sales (f) the production scales of most parts suppliers are far below the levels required to make exports profitable, and in any case exports would generally have to start with supplies to the multi-national operations of the same companies being supplied in Pakistan.

To quantify these observations would require a major empirical survey which we believe would in any case have highly problematic results in view of the reluctance of both the assemblers and the vendor suppliers to provide what they consider to be detailed confidential information, especially confidential information on world prices, which is highly sensitive owing to the transfer pricing issue. Instead in cols (2)-(5) we have run the EPR calculations for assemblers on arbitrary alternative assumptions about the average actual (implicit) nominal protection rate for the vendors, starting with the assumption in col (2) that the average implicit vendor protection rate is 50% (the same as the tariff) and then assuming implicit protection rates of 25%, 10% and zero. None of these simulations affect the total-process EPR, but make a great difference to how this protective margin is split between the assemblers and the vendors. As can be seen from the Table the vendor EPR starts at 95 % and goes down to minus 5% at the other extreme when it assumed that they are obliged to sell to the assemblers at world prices. Conversely assembler EPRs start in negative territory if they were to pay full tariff inclusive prices for the parts supplied by the vendors, but increase steeply at lower part prices and reach 137 % if they were able on average to keep the prices of their vendors down to world prices.

Recommendations on tariff policies. What do these EPR estimates imply for auto industry tariff policies? We suggest the following:

- The current tariff structure makes available vastly excessive effective protection rates –in the region of 100% or more–for assembly, vendors and for car production considered as a single integrated process. It is hard to justify these very high protection rates for the auto industry when both nominal and effective protection rates are much lower in other industries–for example in the textile and clothing industries, over most of agriculture, and for exports generally. Modernisation, new investment, FDI and innovation in these other sectors and activities are just as–and possibly more– important as they are for the auto sector, but are held back if resources are pulled into import substitution in auto production by very high protection.
- Fortunately the actual realised protection rates in the auto sector are considerably lower than the protection available from the present tariff structure, mainly due to the reluctance and probably the long run self interest of the assemblers to price their built-up cars up to the levels available from the tariffs. This suggests that there is still a lot of “water” in the present auto tariffs, and that they could be substantially reduced without much effect on auto and auto parts production.

- A scenario in which tariffs would be brought down to about the levels shown in Col (3) of Table 11 would about halve the currently available EPRs from tariffs, and produce a more efficient reasonably uniform structure of EPRs as between assembly, vendor production, and car production considered as an integrated process. However according to these estimates the resulting EPRs would still be very high-in the region of 50%. We therefore reiterate the suggestion made in the 2004 reports to aim for a lower uniform tariff of say 25% which would be the same for CBUs, imported packs, and other components.
- Such a reform would dismantle the present de facto local content programmes at present being operated by EDB, in the process removing the very considerable negotiation and transaction costs that these programs involve both for the government (notably for EDB and FBR) and for the private sector, including the various private sector organisations such as PAAPAM.
- The 2004 reports suggested that the proposed unification and reduction of auto tariffs could be pre-announced and carried out in small 5% tariff reductions over for example 5 or 7 years. Except for some early reductions –in particular the reduction of the small car tariff to 50%-this never occurred, and CBU tariffs were never unified. In the light of this unpromising history, the government might want to consider a more drastic direct reduction to a lower target level such as 25%.

Regarding the concessionary tariffs for the inputs of auto-vendor firms, so as to remove the present de-facto import licensing system managed by EDB, we think that these tariffs should be made generally available to all importers, including especially trader importers. This is the same recommendation we have made as regards the concessionary tariff regime for non-auto products.

A note on the motor cycle industry: contrasting performance, different policies?

Before concluding this section, it is pertinent to note the dramatically superior performance of the motor cycle industry (Figure 9). In contrast to car production which has increased at rates far below earlier predictions, since 2002 motor cycle production has increased more than 11 times, from 121,000 in 2001/02 to almost 1.4 million in 2009/10. During the same period both the retail and ex-factory prices of a major model (the Honda CD70) came down in real (inflation adjusted) terms by about 56%. This occurred despite prohibitive tariffs (90% in 2002, 65% in 2010/11) that kept out legal imports of built up bikes, and low parts tariffs (15% in 2010). This combination made available very high effective protection rates for domestic assemblers if they had been willing and able to price their finished bicycles up to the levels of the tariffs. But this did not happen for three key reasons. First, in contrast to the auto industry, small scale assembly operations using parts and components imported mainly from China were permitted and proliferated. Secondly, according to knowledgeable people there is large scale under-invoicing and smuggling of motor cycle components, including especially engines. Third, probably in part due to the smuggling and under-invoicing, there was no effective attempt by EDB to enforce indigenisation guidelines and rules.

There are a number of beneficiaries of this situation, above all Pakistan consumers –especially lower income consumers-who can choose between a wide variety of motor cycle models selling at prices that are probably not far above world prices. This very fast expansion of production will also have benefited the small and medium enterprises involved and will have rapidly expanded employment in assembly and marketing, and also in repair and maintenance activities. We have not had time to check, but we imagine that the local enterprises producing the more expensive models such as Honda have also seen their demand growing at very fast rates and have been able to lower their costs due to larger production volumes.

However it seems clear that these highly desirable outcomes are not the result of carefully planned and meticulously enforced “deletion” program for the motor cycle industry which is now showing up as a successful “infant industry” initiative. The dynamic changes in this industry came from the opening of the Pakistan market to assemblers of imported (mostly Chinese) components, not from the careful nurturing and protection of the original investments in Pakistan by the major Japanese multinationals. A strong case can be made that there would likely be further large benefits by reducing the current 65% tariff on built up motor cycles. Current domestic prices are certainly far below the level in theory permitted by this tariff -perhaps 15% or 20% above cif prices? Tariff cuts to about these levels and eventually lower would tie in benefits to consumers, probably substitute some imports of assembled cycles for imports of parts, reduce the incentives for under invoicing and smuggling, and contribute to government revenue.

10. Trade policies in the textile and clothing (T&C) sector

Background. Pakistan's T&C sector is very large, both in absolute terms and as measured by its share of GDP (about 9%) and share of merchandise exports (usually about 50% to 60%). In the past the cotton based section of the industry was subsidized by export taxes and export controls over cotton, which depressed the domestic price paid for cotton well below world prices. This major distortion has long been removed and cotton is exported without restrictions or taxes and is now available to the industry at world prices. About three quarters of the industry's output is exported, and as the industry is highly competitive with large numbers of competing producers, domestic prices in most segments are about equal to export prices. This is one of the principal themes of a 2006 study which analysed the likely outcome of free trade between Pakistan and India in T&C products. This study found that except for synthetics the import share of total production of intermediate products was very small despite duty free access under Pakistan's duty exemption and duty drawback provisions. For example roughly 75% of fabric production was exported either directly or indirectly, but the import share in this market was only about 1%. The domestic section of the fabric market (about a quarter of total production) was protected by a 25% tariff but fabric imports over this tariff were only equivalent to about 1% of the market, suggesting that the tariff was redundant for most types of fabric. This was confirmed by the observation that prices were similar to export prices and that domestic sales were reported to be less profitable than export sales.

Clear tariff redundancy was also found in the markets for final products, which are also very export oriented. The percentages of exports to household sales +exports were 54%, 83%, and 93% respectively for knitted garments, woven garments and made-ups and miscellaneous products. Imports of these products over the 25% tariff were negligible, suggesting that the tariff was prohibitive. This was supported by a discussion of the prospects for Indian exports of final textile products to Pakistan under hypothetical free trade, which noted that “Indian exporters ...would be competing with Pakistani T&C producers which are exporting most of their output and for which most of the domestic markets are residual markets, in which gross margins are likely to be about equal to or lower than gross margins in export markets” (p.50).

Tariffs. Table 12 shows the CDs for most T&C products and for comparison also the CDs of the same products in India. We have the following comments:

- Overall, T&C tariffs are lower than tariffs in some other manufacturing sectors, especially engineering products such as cars
- Tariff escalation in some products is considerable however e.g. between cotton yarn (5% or zero under SRO 567) and cotton fabrics (25%). Depending on the yarn input share in fabric production and the shares and tariffs on non-yarn inputs, this probably provides quite high effective protection to cotton fabric production...possibly of the order of 60% to 80%.

- But the escalation varies considerably between different T&C products, and in some cases there is none : for example between cotton (zero CD) and cotton yarn (zero CD with the SRO exemption), giving effective protection in cotton yarn production of zero. Similarly cotton fabrics (25%) and cotton woven garments (also 25%) giving an EPR to cotton garment production of about 25%
- Another example: synthetic yarns (10% or 9% under the SRO exemption) and synthetic fabrics 15%, without allowing for other inputs probably equivalent to effective protection of about 27%.
- Overall, this structure of tariffs provides a very wide range of effective protection rates to different activities in the sector from about zero to probably as high as 100%. We can see no good economic rationale for this pattern.
- Why this pattern? It seems to be the outcome of the widely held belief in “the principle of cascading” and the provision of “adequate protection” to local industry as stated for example in the Ministry of Textile’s policy document and in various other places including the Ministry of Commerce’s Strategic Trade Policy Framework document. Under this approach failure to cascade or to cascade sufficiently =an “anomaly” which is sometimes but not always corrected by CD exemptions and/or increases which are announced in various SROs.
- We don’t know but speculate that the correction of such an “anomaly” is behind some of the CD reductions given in Table 12, in particular the exemptions for staple fibre tariffs which create a cascading structure which goes from 6.5% (fibres) to 9% (yarns) to 15% (fabrics). As discussed previously, there is no good economic rationale for the so called “principle of cascading”. The main practical rationale seems to be to provide an apparent basis of principle to which firms/industries wanting tariff adjustments can appeal.
- Whatever their rationale, the effective protection rates resulting from tariffs represent what the tariffs make available. In practice actual prices of many products-both inputs and outputs-seem to be well below world prices plus the tariffs. As discussed in the previous section, in the case of the T&C sector, most domestic T&C prices –including yarns, fabrics and garments-are probably equal to or in some cases even below world prices. Consequently realised effective protection rates are certainly on average much lower –probably close to zero -and less dispersed than the EPRs available from tariffs.
- This raises the question: why keep a structure of tariffs most of which are redundant and not determining actual prices, and which would create a very inefficient protective structure if for some reason they ever were to affect actual prices? This leads to the following recommendations on T&C tariffs.

Recommendations on T&C tariffs

- The principal potential for high to very high effective protection within the sector are the 15% tariffs on cotton/synthetic blended fabrics, and filament and staple fibre fabrics, and the 25% tariffs on cotton sewing thread, cotton fabrics and garments and made-ups. We think that all of these should be brought down to somewhere within a range of zero to 10%. If they were all set 10%, there would still be some tariff escalation but the potential for high effective protection would be greatly reduced
- For tariffs within the zero-10% band, policies should emphasise uniformity and the “principle of cascading” should be abandoned. Ideally all tariffs might be set for example at the same rate: say 5% or 10%. A possible exception is cotton, where protection rates in the rest of the agricultural sector need to be considered, even though there is also a case for equalising the cotton and synthetic fibre (especially PSF) tariffs.

- These recommended changes pertain to MFN tariffs, but for some products preferential tariffs are already below MFN tariffs. For example, the CDs on cotton fabrics under the FTA with China range between 12.8% and 21%, so an MFN tariff cut from 25% to say 10% would not be as great as it seems in view of the already lower tariffs on potential Chinese cotton fabric imports. Likewise, the China FTA tariffs for garments and made-ups (21%) are already somewhat lower than the 25% MFN tariffs. However we note that there are no or few China FTA tariffs on synthetic products including fabrics, suggesting that China is perceived to be an especially competitive supplier of these products.
- Bringing down T&C tariffs to a maximum of say 10% would replicate similar reforms in India that were undertaken in pre-announced steps between 2002/03 and 2007/08. Currently most Indian ad valorem T&C tariffs are 10% and all are 10% or lower (Table 12). There is still some escalation in the Indian structure (e.g. filament and synthetic yarns 5% and synthetic fabrics 10%) but the resulting EPRs are quite low since the general T&C tariff level is also low.
- However the Indian reforms are not a good model to follow in other respects, since at an early stage (in 2000) the local T&C producers with the support of the Ministry of Textiles successfully lobbied the government to introduce large numbers of “alternative” specific duties (i.e.. duties that are either a specific amount or the ad valorem rate, whichever is higher) on many fabrics, garments and made-ups. The presence of these alternative-specific duties among a number of the products listed in Table 12 is indicated with an asterisk. India's T&C producers have also been active and successful users of anti-dumping to keep out import competition, especially competition for Indian large scale manufacturers of synthetic fibres and yarns.
- Having noted this, it is also relevant to note that in India despite high to very high ad valorem equivalent specific tariffs on many potential low price/low quality imports, domestic ex-factory prices in most segments of the Indian T&C market approximate export prices. The Indian specific T&C tariffs were imposed just before general import licensing was finally lifted from T&C products in 2001, and have since been politically difficult to remove even though most are clearly redundant. This underlines the undesirability of Pakistan following the Indian example on specific tariffs in the T&C sector. Anti-dumping along Indian lines for T&C products should also be resisted for similar reasons.
- Because of marked tariff redundancy in Pakistan's T&C industries, we don't expect that these proposed tariff cuts would have much if any effect on T&C imports and therefore on the exchange rate. Such effects would need to come from tariff cuts in other much more highly protected industries such as a range of engineering industries including the auto sector. Increased imports of these products will tend to equilibrate the real exchange rate at a lower devalued level, directly as a result of the increased imports of these products, and indirectly by improving the government's fiscal position and reducing domestic inflationary pressures. In turn the lower real exchange rate will boost T&C exports, thus increasing the profitability of T&C producers and their interest and willingness to invest in new equipment. An expansionary and profitable environment for the T&C sector such as this would increase the interest and responsiveness of the sector to some of the initiatives set out in the Ministry of Textiles policy statement, especially its proposal to provide technical support and training for the power loom sector, which is responsible for something like 85% of fabric production²⁵.

Export subsidies.²⁶ The government deploys a number of export subsidies and has used many different schemes in the past. We understand that the largest of these at present are provided by way of the export financing scheme (EFS) under which exporters receive export related working capital at subsidized interest rates. During 2008/09 the textile sector received more than half (63%) of the total subsidised credit disbursed under this scheme. According to our very rough estimates the resulting subsidy was equivalent to approximately 2.2% of the total fob value of T&C exports in that year. In addition the T&C sector also benefited from subsidised long term credit under the LTFF (Long Term Financing Facility) scheme, but the value of this during 2008/09 was equivalent to only about 0.4% of total T&C exports. The total of these subsidies (equivalent to about 2.6% of exports) would have slightly offset anti-export bias in the T&C incentive regime resulting from whatever protection the industry receives in the domestic market.

However, as noted above, the realised (as distinct from theoretically available) effective protection of the T&C sector in domestic markets is probably quite low and may be zero for many products, so there is probably not much protection-related anti-export bias to offset. In addition export subsidies, and this one in particular, have a number of costs and disadvantages. Firstly they involve non-negligible administrative and transaction costs for both the government institutions involved (notably SBP) and for exporting firms because of the need to ensure that only genuine exporters receive the subsidised finances, and to ensure ex-post that the financing is actually used for exports. Secondly, the banks are understandably cautious about providing subsidised financing to new exporters and exporters of new products. These must use Part 1 of the system and will only be admitted to Part 2 which is more automatic and less demanding, after they have built up a track record. As a result the credit subsidy system favours existing established exporters and in this way discriminates against new exporters and the diversification of Pakistan's export portfolio, including diversification of exported T&C products but also more general export diversification. Thirdly, the subsidised export credit adds to the central government's fiscal deficit unless offsetting expenditure reductions are imposed or taxes raised. Finally, since the export loans are guaranteed and subsidised by the government the banks give preference to them over their normal commercial lending activities, thus reducing the supply and tightening the terms for these normal credit sources. Among others this would hurt exporters not participating in the EFS and also indirect exporters i.e. domestic suppliers of intermediate inputs to exporters which as far as we know are not eligible for credit under the EFS scheme.

All this suggests the need for a general review of the EFS and LTFF schemes and also of other export subsidy and promotion schemes, in the light especially of exchange rate changes as alternative, impartial and cleaner ways of managing the current account balance.

11. Summary of recommendations

This section summarises our recommendations under three broad headings. Under the first heading we outline a suggested general policy statement on the principles and objectives of trade policies. Under the second heading we list a set of suggested changes to specific policies. The third heading summarises suggestions to remove information gaps and improve transparency. More detail and the reasons behind these recommendations are in various places in the report.

General policy statement

- Non-tariff measures including import licensing will not be used to control import and exports
- Specific duties will not be used
- Import tariffs should be low and uniform
- The government will aim to bring all tariffs down to a maximum ad valorem rate of 10%
- Uniformity means that tariffs on individual products should be the same for all importers, including trader- importers.

Recommendations on specific policies

- Abolish the present Regulatory duties
- “Tops down” tariff cuts back to the 2002/03 general maximum level of 25%
- Pre-announce further “tops down” tariff cuts to a general maximum of 10%
- Require that as a general principle, all concessionary tariffs should be available to all importers, including especially trader-importers
- Remove the discrimination of the sales tax (ST) and the income withholding tax (WHT) on imports, which at present favour manufacturer-importers against other importers, especially trader-importers
- As a consequence of the general availability of input tariff concessions, abolition of the *de facto* system of import licensing at present being administered by EDB and by various line ministries
- Immediate cuts to a maximum and uniform rate of 25 % in all motor car, motor car component and motor car component tariffs, and pre-announcement of further tariff cuts and other basic changes to auto sector policies
- Immediate cuts in all tariffs on motor cycles and motor cycle parts to a maximum of 20%, to be followed by further cuts to a maximum of 10%
- Immediate cuts in all textile and clothing tariffs to a maximum of 10%
- Explicit abandonment of the present “cost plus” and “principle of cascading” approaches to tariff setting
- A review of the economic justification for the present export subsidies
- A review of the economic justification for the use of export taxes
- A review of the economic justification for the present bans and restrictions on the import of second hand products
- Inclusion of a consumer/buyer interest clause in the anti-dumping law

Recommendations on information gaps and transparency

- A review of the current situation in which many tariff changes are being made without reference to NTC
- Establishment of some systematic process for the economic evaluation of tariff changes that at present are made outside the annual budget cycle and which are published in SROs
- Public availability of these evaluations
- Publication by NTC of its past tariff enquiry reports
- Publication by NTC of all future tariff enquiry reports before they are passed on to MOC

- MOC to provide publicly available reasons for adopting or not adopting the recommendations of NTC tariff enquiry reports
- Publication and easy access to information on appeals against anti-dumping decisions
- Publication on the FBR website of a computable version of the detailed Customs tariff schedule which includes for each tariff line Customs duties, sales and other domestic taxes, preferential tariffs, changes due to SROs and whether or not imports from India are banned
- Substantial improvements to, and greater user-friendliness of, the computable version of the detailed trade database on the FBR website

Table 1 – Pakistan's tariff structure: 2002/03 versus 2009/10

	2002/03	2009/10
Unweighted average protection rates %		
"Agriculture" HS 01-24	19.6	21.1
"Industry" HS 25-97	16.9	15.1
All tariff lines	17.3	15.8
All tariff lines: standard deviation	11.9*	15.1
All tariff lines: Coefficient of variation	0.71*	0.96
Normal maximum rate	25	50
Normal minimum rate	5	0
Number of normal rates ("slabs")	4	9

* For 2004/05: 2002/03 not available

Table 2 – Products subject to regulatory duties August 2008

HS	Frequency	Product types affected
04	13	Dairy products
08	51	Fresh fruits
16	28	Meat preps
17	3	Chewing gum etc
18	6	Processed cocoa prods
19	21	Processed grains (pasta etc)
20	53	Processed vegetables, fruit drinks etc
21	15	Sauces, soups etc
22	6	Soft drinks
23	1	Dog & cat food
24	7	Tobacco products
33	30	Toilet preps -shampoos, toothpaste etc
34	4	Toilet soaps etc
68	7	Granite, marble etc
69	24	Ceramic & porcelain household products
73	4	Cooking household appliances
83	1	Pad locks
84	25	Machines -mainly household...refrigerators, fans etc
85	29	Elec machines-mainly household-toasters, TVs etc
87	4	Cars & jeeps >1801 cc
93	19	Weapons (revolvers etc)
94	19	Household furniture
96	4	Miscl
Total	374	

Table 3 – Illustration of effective protection rates resulting from different combinations of output and input tariffs

Input Tariffs		Output Tariffs	→									
			0	5	10	15	20	25	30	35	40	45
↓	0	0.0	12.5	25.0	37.5	50.0	62.5	75.0	87.5	100.0	112.5	125.0
	5	-7.5	5.0	17.5	30.0	42.5	55.0	67.5	80.0	92.5	105.0	117.5
	10	-15.0	-2.5	10.0	22.5	35.0	47.5	60.0	72.5	85.0	97.5	110.0
	15	-22.5	-10.0	2.5	15.0	27.5	40.0	52.5	65.0	77.5	90.0	102.5
	20	-30.0	-17.5	-5.0	7.5	20.0	32.5	45.0	57.5	70.0	82.5	95.0
	25	-37.5	-25.0	-12.5	0.0	12.5	25.0	37.5	50.0	62.5	75.0	87.5
	30	-45.0	-32.5	-20.0	-7.5	5.0	17.5	30.0	42.5	55.0	67.5	80.0
	35	-52.5	-40.0	-27.5	-15.0	-2.5	10.0	22.5	35.0	47.5	60.0	72.5
	40	-60.0	-47.5	-35.0	-22.5	-10.0	2.5	15.0	27.5	40.0	52.5	65.0
	45	-67.5	-55.0	-42.5	-30.0	-17.5	-5.0	7.5	20.0	32.5	45.0	57.5
50	-75.0	-62.5	-50.0	-37.5	-25.0	-12.5	0.0	12.5	25.0	37.5	50.0	

NOTES: For this example it is assumed that the value of inputs at world prices =60% of value of finished product at world prices. Tariffs and effective protection rates are shown as percent differences of domestic protected prices with respect to world (border) prices. So for example if the output tariff is 25% and the average of the input tariffs is 10%, the processing margin available for domestic producers is raised 40% above the processing margin with no tariffs on either the output or the inputs i.e. the effective protection rate (EPR) is 40%. The variation of EPRs with different combinations of output and input tariffs differs according to the input/output ratios. The smaller the percent processing margin at world prices the bigger the variation of EPRs with differences between average output and average input protection rates

Table 4 – List of some of the products produced in Pakistan subject to ‘Made to Measure’ protection under SRO 565(I)/ 2006

S. No	Product/industry as described in the SRO	Probable HS classification	Final product tariff %				
			MFN	Preferential from China	Raw materials	Sub-components and components	
2	Air conditioners	8415.10	50	37.5	5	10,0	Final product tariff CD 35%+RD15%
3	Deep freezers/chest coolers	8418.30/40/50	50	37.5/21/37.5	5	10,0	Final product tariff CD 35%+RD15%
4	Refrigerators/Visicoolers	8418.1000	50	37.5	5	10,0	Final product tariff CD 35%+RD15%
5	Washing machines	8450	50	21	5	10	Final product tariff CD 35%+RD15%
6	Car air conditioners	8415.2000	65	50	5	10,15	Final product tariff CD 35%+RD15%+AD15%
8	Chrysotile cement pipes, sheets and fittings (for vehicles)	6813.2010	65	50	5		Final product tariff CD 35%+RD15%+AD15%
10	Industrial refrigeration plants	8418.5000	50	37.5	5	10	Final product tariff CD 35%+RD15%
11	Alkyd resins	3907.5000	20	None	10		
12	Aluminium pre-sensitized printing plates	3701.3030	15	None	0		
13	Articles of stationery : Example ball point pens	9608.1000	25	21	5	10	
	Articles of stationery : Example pencils	9609.0000	20	16.8	5	10	
14	Artificial leather industry: example suit-cases	4202.1120	25	21	10		

S. No	Product/industry as described in the SRO	Probable HS classification	Final product tariff %				
			MFN	Preferential from China	Raw materials	Sub-components and components	
15	Audio/video cassettes	8523.2940/90	20	16.8	10		
17	Boilers	8402.0000	20	16.8	5		
18	Bearings	8482.0000	10	5.83	0		
19	Bolts,nuts, screws etc Example of steel	7318.0000	25	21	5		
20	Cables and conductors: Example most types	8544.0000	25	21	5		
	Cables and conductors: Example vehicle wiring	8544.3011/ 12/21/22	60/70	None	5		Final product tariff CD 35%+AD 25% or 35%
22	Ceramics	6907 to 6914	50	21	0		Final product tariff CD 35%+RD15%. Also anti- dumping duties
23	Circuit breakers	8535	10/20	5.83/16.8	5		
24	CNG dispensers manufacturing industry	7311.0010	0	16.8		0	
26	Composite doors and windows	3925.2000	25	21	5	15	
29	Cranes and derricks	8426	5/10/15	0/5.8/12.6	5	10	
31	Diapers and sanitary napkins : Example diapers		25		5		
32	Diesel generating sets	8502	20	16.8	5	5	
35	Dry battery cells	8506	10	5.83	0		
37	Electric bulbs	8539	20	16.8	0		
38	Tube lights	8539.31	20	16.8	5		
40	Electric meters	9028.3000	25	21	5	10	
41	Electrical capacitors	8532	10/25	5.75/21	5	10	
42	Electrical switchgear & high voltage switches	8535	20	16.8	5	10	
46	Footwear	64	25	21	5		
60	Paper and paper board	60	20/25	16.8/21	5		
71	Toilet soap industry	3401.1100	50	17.85	10		Final product tariff CD 35%+RD15%
74(14)	Textile machinery : Example looms	8446	5/15/20	0/0/0	0		
	Textile machinery : Example spinning machines	8445	0	0	0		
	Textile machinery : Example knitting machines	8447	5	0	0		Input tariff exemption controlled by EDB
80	Tyres and tubes: example for motor cars	4011.1000	25	25	0		
83	Under EEPAS: example microwave ovens	8516.5000	50	21	10		EEPAS="Emerging Electronics Products Assembly Scheme" controlled by EDB
	Under EEPAS: example pocket size cassette player	8527.1200	50	16.8	10		Final product tariff CD 30%+RD 20%
84	Mobile phones	8517.1210	Rs.250/ set	0	0/5		
85	Viscose staple fibre	5502.0010	5	5	0		
86	Water and waste water treatment plants etc	8421.2100	25	21.75/21	0		
88	Welded Steel Pipes	7306.1100	15	None	5	5	

S. No	Product/industry as described in the SRO	Probable HS classification	Final product tariff %					
			MFN	Preferential from China	Raw materials	Sub-components and components		
89	Wire rope, High carbon and pre-stressed concrete wire etc	5607	17	21.75/21	5	0		
91	Example: cold rolled, stainless steel	7304.4100	5	4.5/0	0			
92	Milk Chillers	8418.6910	10	6.67/5.83		0		
93	Pthalic Anhydride	2917.3500	15	None	0			
95	Arms and Ammunition	93	15/25/50	11.67/8.33/6.67	0	5	Final product tariff CD 35%+AD 15% or CD 30%+AD 20%, CN_FTA 11.67 applicable in cases where MFN = 25/50	
96	Polester or Synthetic Fibre	5503	5/10	5/10	0			
98	Fans	8414.5	50	21/21.75/37.5	10/0		Final product tariff CD 35%+RD15%	
99	Recordable Discs, example: CD	8523.4050	20	16.80/17.40	0			
	Recordable Discs, example: DVD	8523.4060	20	0	0			
100	Air Screw Compressor	8414.802	15	13.05/12.60		5		
101	Instant Gas Heater	8419.1100	25	21.75/21		10		
102	Electric Socket and Switch, Example: 16pins or above	8536.6910	5	0		10		
103	Vehicle Tracking System	8525.6060	5	None		5		
104	Electronic Meters	9028.3000	25	21/21.75		10		
108	Motorcycle/Bicycle chain	7315.1120	35	21/21.75		0		
109	Integrated circuits, solar cells	8541.4000	5	0		0		
110	Spark Plugs	8511.1000	10	4.5		0		
113	Scratch or Magnetic Strip Cards	8523.2100	5	0	10			
114	Acrylic/Pigment thickner	3906.9040	0	None	0			
118	CNG Compressors	8414.8030	15	13.05/12.6	0			
119	Digital Radio systems/ VHF radio systems, Example: radio broadcast trasmitter	8525.5010	15	None		0		
120	DOP	2917.3200	20	17.40/16.80	0			
122	Metalized BOPP Film	3920.2030	20	None		10		
123	Gum base	3824.9010	10	5.72/6.43/9.3	0			
124	Locomotive Parts	8607	5/10	0/4.5/5.83/6.67		0		
125	Un-interrupted power supply (UPS)	8504.4010	20	16.8/17.4		5		
126	Private Automatic Branch Exchanges, Automatic Call distribution systems, etc	8517.6970	0	0		0		
128	Polyethylene Foamed & Bridged	3901	5	5	0			
129	Polyestyrenes	3903	5/15	0	5			
130	Shoe Adhesive	3506.9110	15	8.4/8.7				
132	Energy Saving Lamps	8539.3910	0	0/9.3		0		
134	Laminated Board	4412.9400	20	none	10			

S. No	Product/industry as described in the SRO	Probable HS classification	Final product tariff %				
			MFN	Preferential from China	Raw materials	Sub-components and components	
136	Central heating gas boiler	8403.1000	20	16.8/17.4/20		10	
138	Gas Stoves/ cooking ranges with over	7321.1110	50	21/21.75		10	Final product tariff CD 35%+RD15%
139	Aluminium Alloys	7601.2000	0	0	0		
140	Electric Iron	8516.4000	50	16.8/17.4		10	Final product tariff CD 30%+RD20%
142	Vacuum cleaner	8508.6010	5	0		10	
144	Nickel Rotary Printing Screens	7508.9010	10	None	0		
145	Sheets of Stainless Steel	7219	5	0/5.83/6.67	0		
146	Benzene Sulphuric Acid	2904.1010	10	0	0		
151	Cylinders for CNG	7311.0010	0	16.8/17.4		0	
152	Silicon Sealant	3214.9010	10	None	0		

Table 5 – Example of ‘Made to Measure’ protection for specific industries

The air conditioner industry under “Survey based” input exemptions (SRO 565(I)/ 2006)				
FINISHED PRODUCT TARIFF				
8415.8200	Air conditioners			
		CD	RD	Total
	2003/04	25	0	25
	2007/08	25	0	25
	June-July 08	35	0	35
	Aug 08-June 09	35	15	50
	2009/10	35	15	50
	2010/11	35	15	50
INPUT TARIFFS				
(1) Until Dec 2003 under the indigenization (TRIMS) program				
		CD		
	Raw materials#	5		
	Sub-components#	10		
	Components#	10		
(2) In August 2010 under SRO 565(I)/2006		Customs duty if imported by:		
Raw materials		Approved AC producer	Other importer , MFN rate	Other importer, pref rate from China
3212.1000	(1)Hot stamping foil.	5	20	16.8
7208.3690	(2)Hot Rolled Steel Sheets	5	10	5.83
7209.1690	(3)Cold Rolled Steel Sheets	5	10	5.83
7209.1790	(4) Cold rolled steel sheets >0.5mm	5	10	5.83
7209.1890	(5)Cold rolled steel coils – < 0.5mm	5	10	5.83
7210.3090	(6)Electro galvanized steel sheet in coils.	5	10	5.83
7411.1090	(7)Copper tube in coils	5	15	15
7608.2000	(8) Aluminium tube in coils	5	10	5.83
Sub components and components				
8415.9099	Terminal block.	10	20	19
8415.9099	Remote control.	10	20	19
8481.8090	Service valve 2 way & 3 way	10	15	12.6
8501.4090	Single phase AC motor upto 320 watts.	10	20	16.8
8414.5190	Axial fan.	10	50*	50*
8415.9099	Plasma filter assembly.	10	20	19
8414.5190	Cross flow fan - indoor unit	10	50*	50*
8481.8090	4 Way reverse cycle valves	10	15	12.6
8414.301	Compressor for use with non-CFC and HFC gases	0	5	0

#Only if input “not manufactured locally “

Table 6 – Example of industry-specific effects of SRO tariff exemptions

INPUT EXEMPTIONS FOR THE POULTRY MEAT SECTOR UNDER SRO 567(I)/2006				
TARIFF ON FINISHED PRODUCT				
0207	Poultry meat	25%	LK=0, MY=20	Banned from India
TARIFFS ON INPUTS				
		Customs duty % when imported by/for		
	Some examples from list of 33 inputs for the poultry sector which exempt from Customs duties under SRO 567(I)/2006	Poultry sector by importers authorized by MINFAL*	All other importers, MFN rate	All other importers, preferential rate#
1005.9000	Maize grain	0%	10	6.2
2304.0000	Soyabean meal	0%	10	6.2
2309.9090	Vitamin B12 (feed grade)	0%	20	16.8
2309.9090	Vitamin H2 (Biotin) (feed grade)	0%	20	16.8
2309.9090	Fish Feed	0%	20	16.8
2309.9090	Poultry feed preparation (coccidiostats)	0%	20	16.8
2309.9020	Growth promoter premix	0%	20	16.8
2309.9020	Vitamin premix	0%	20	16.8
2309.9020	Choline Chloride	0%	20	16.8
2309.9020	Mineral premix	0%	20	16.8
VERY APPROXIMATE ESTIMATES OF EFFECTIVE PROTECTION RATES OF POULTRY MEAT PRODUCTION				
	Example 1: without SRO input exemptions	At world (border) prices	Protection rate	At domestic (protected) prices
	Value of output	100	25	125
	Cost of material inputs	60	15	69
	Value added (processing margin)	40	40	56
	Example 2: with SRO input exemptions			
	Value of output	100	25	125
	Cost of material inputs	60	0	60
	Value added (processing margin)	40	62.5	65

*Exemption to poultry sector only available if an officer of MINFAL "shall determine annual requirement of the importers of poultry inputs"

Maize preferential duty of 6.2% is for SAFTA NLDCs, but if imported from India subject to a regulatory duty of 25%: so total duty from India would be 31.2%. .Soya meal preferential tariff of 6.2% is SAFTA NLDC rate and imports from India are allowed. The other preferential tariffs are the 2010/11 preferential tariff on imports from China. Imports of all these products from India are banned.

So the input exemptions raise the effective protection of poultry meat production from 40% to 62.5%. Note that this is the protection available from the tariff structure. The Implicit protection may be higher or lower than the available effective protection if the excess of domestic prices over border prices is less than the tariffs.

Table 7 – Some examples of discriminatory tariffs: Pharmaceutical/medical products under SRO 567(I)2006

S No	HS Code	Description	Customs duty % if imported by :		
			Approved local manufacturer	Importer, MFN rate	Importer, from China
(1)	(2)	(3)	(4)		
A. ACTIVE PHARMACEUTICAL INGREDIENTS					
1	2916.3990	Flurbiprofen	5%	10	5.75
2	2918.2210	Aspirin	5%	25	21
3	2933.3920	Pyrazinamide	5%	20	16.8
4	2933.3990	Amlodipine	5%	10	5.83
5	2933.3990	Deferiprone	5%	10	5.83
6	2933.3990	Lamivudine	5%	10	5.83
7	2933.3990	Loratadine	5%	10	5.83
8	2933.3990	Pantoprazole Sodium (Injec Grade)	5%	10	5.83
9	2933.3990	Risedronate Sodium	5%	10	5.83
10	2933.4990	Moxifloxacin	5%	5	0
10A	2933.5990	Protacine (Proglumet, Dimaleate)	5%	10	5.83
11	2933.9990	Atorvastatin	5%	10	5.58
12	2935.0060	Sulphanilamide	5%	25	21
13	2935.0090	Gliclazide	5%	10	5.83
17	2941.5000	Clarithromycin Powder	5%	10	5.83
18	2941.9090	Azithromycin	5%	10	5.83
19	2941.9090	Fusidic Acid	5%	10	5.83
20	2941.9090	Gentamycin	5%	10	5.83
21	2941.9090	Rifampicin	5%	10	5.83
B. EXCEPIENTS/CHEMICALS					
10	1515.3000	Castor oil (Pharmaceutical grade)	5%	Rs 9050/MT	
12	1701.9910	Sugar (pharmaceutical grade)	5%	25	8.4
21	2801.2000	Iodine (Pharmaceutical grade)	5%	10	5.83
C. DRUGS					
1	1702.3000	Dextrose (injectable grade and pharma grade)	10%	20	21
2	2501.0090	Sodium chloride (injectable grade) (Pharmaceutical grade).	5%	20	0
3	2922.4990	Oseltamivir	0%	5	4.5
4	2924.2990	Zanamivir	0%	5	0
5	3002.2090	All types of vaccines for Hepatitis, Interferon and other medicines for hepatitis, and etc.	0%	10	5.83
6	3002.2090	All vaccines and antisera	0%	10	5.83
7	3002.2090	Antihemophilic factor ix (Human)	0%	10	5.83
8	3002.2090	Blood fraction & immunological products (biological products) including rabies immunological (150 IU per ml) (Human)	0%	10	5.83
9	3002.2090	Factor viii & plasma derived fibrin sealant. (Human)	0%	10	5.83
10	3002.2090	Hepatitis B immunoglobuline (Human)	0%	10	5.83
11	3002.2090	Human albumin (Human)	0%	10	5.83
12	3002.2090	Intravenous immunoglobuline (Human)	0%	10	5.83

S No	HS Code	Description	Customs duty % if imported by :		
			Approved local manufacturer	Importer, MFN rate	Importer, from China
(1)	(2)	(3)	(4)		
10	3002.2090	Intramuscular immunoglobuline (Human)	0%	10	5.83
14	3002.2090	Tatanus immunoglobuline (250 IU/ml) (Human)	0%	10	5.83
15	3002.9010	Injection Anti-Dimmunoglobulin (human) 300mcg/vial	0%	5	0
16	3004.9050	Medicinal eye Drops	10%	20	16.8
17	3004.9060	Ointments, medicinal	10%	20	16.8
18	3004.9099	Alfacalcidole Injection	0%	10	5.83
19	3004.9099	All medicines of cancer.	0%	10	5.83
21	3004.9099	All medicines for HIV/AIDS.	0%	10	5.83
D. PACKING MATERIALS / RAW MATERIALS FOR PACKING					
2	3005.1010	Surgical tape in jumbo rolls	5%	20	16.8
3	3005.9090	Cetylpyridinium chloride pad	5%	25	14.75
4	3906.9090	Polyacrylate (Acrylic Copolymers)	5%	10	10
5	3917.2390	PVC non-toxic tubing (Pharmaceutical grade)	5%	20	20
6	3917.3100	PVC lay flat tube material grade (Pharmaceutical grade)	5%	20	20
7	3917.3910	Pre-printed polypropylene tubes with tamper proof closures (with or without dessicant) indicating particulars of registered drug and manufacturer (Pharmaceutical grade)	5%	5	5
8	3919.1090	Other self-adhesive plates, sheets, film, foils, strip and other flat shapes of plastic (Pharmaceutical grade)	5%	20	16.8
9	3920.4910	Rigid PVC Film (Pharmaceutical grade)	10%	20	21
E. DIAGNOSTIC KITS/EQUIPMENTS					
1	3822.0000	4C Es Trionyx	5%	20	16.8
2	3822.0000	5C Cell control Lnormal	5%	20	16.8
3	3822.0000	Albumin bcg	5%	20	16.8
4	3822.0000	Alkaline phosphatase (Alb)	5%	20	16.8
5	3822.0000	Ammonia Modular	5%	20	16.8
6	3822.0000	Aslo tin	5%	20	16.8
7	3822.0000	Bilirubin kit	5%	20	16.8
8	3822.0000	Blood cancer kit	5%	20	16.8
9	3822.0000	Blood glucose test strips	5%	20	16.8
10	3822.0000	Bovine precision multi sera	5%	20	16.8

26[TABLE III : From SRO 567(I) /2006. Cols E & F from 2010-2011 Customs Tariff

Note: The China FTA CD is either the "Early Harvest" rate or the 2010/11 rate

If there is not a preferential CD for China under the FTA, the China CD is the same as the MFN CD
PHARAMACEUTICAL RAW MATERIALS, CHEMICALS, FINISHED PRODUCTS IF APPROVED BY THE MINISTRY OF HEALTH.
PHARMACEUTICAL RAW MATERIALS, CHEMICALS AND PACKING MATERIALS SHALL ONLY BE ALLOWED CONCESSIONS IF IMPORTED FOR IN-HOUSE USE IN THE MANUFACTURE OF SPECIFIED PHARAMACEUTICAL SUBSTANCES

Table 8 – Customs General Order 11/2007: List of locally produced products generally not eligible for Customs Duty concessions

HS Chapters	CGO S.nos	Number of producers per product							Total
		1	2	3	4	5	6	>6	
01-05		0	0	0	0	0	0	0	0
06-14		0	0	0	0	0	0	0	0
15	1	1	0	0	0	0	0	0	1
16-24		0	0	0	0	0	0	0	0
25-27	2-9	8	0	0	0	0	0	0	8
28-38	10-72	41	9	7	2	0	2	2	63
39-40	73-131	42	11	4	1	1	0	0	59
41-43	132	1	0	0	0	0	0	0	1
44-49	133-137	5	0	0	0	0	0	0	5
50-63	138-147	10	0	0	0	0	0	0	10
64-67		0	0	0	0	0	0	0	0
68-70	148-172	23	1	1	0	0	0	0	25
71		0	0	0	0	0	0	0	0
72-83	173-403	215	10	4	2	0	0	0	231
84-85	404-858	433	10	8	3	1	0	0	455
86-89	859-867	9	0	0	0	0	0	0	9
90-92	868-883	16	0	0	0	0	0	0	16
93	884-896	13	0	0	0	0	0	0	13
94-96	897-906	10	0	0	0	0	0	0	10
97-99		0	0	0	0	0	0	0	0
TOTAL	1-906	827	41	24	8	2	2	2	906
% of total		91.3	4.5 0	2.6	0.9 0	0.2	0.2	0.2	

Table 9 – Products subject to regulatory duties if imported. Imports and Customs duties collected

	Imports	Customs duties collected				Percent change	
		CD	RD	CD+RD	CD+RD collection	Imports	CD+RD
		Rs billion	Rs billion	Rs billion	Rs billion	rate %	
2007/08	92.5	11.4	nil	11.4	12.3		
2008/09	49.6	9.6	3.1	12.7	25.6	-46.4	11.9
July 08-Feb 09	33.2	6.9	2.0	8.8	26.5		
July 09-Feb 10	23.9	5.0	2.2	7.3	30.4	-28.0	-17.5

Source, FBR. Regulatory duties at different rates were imposed in August 2008. Note that the normal maximum CD was increased from 25% to 35% from July 2008, and that this increase affected a number of the products in this group that were subsequently subject to RDs. The increase in the average (CD+RD) collection rate between 2007/08 and 2008/09 was the result of both these changes.

Table 10

PROTECTION ESTIMATES FOR PAK-SUZUKI MODELS 2004 AND 2011					
		Protection rates in 2004 %		Protection rates in 2011 %	
	% of world price	Available from tariffs	Implicit (actual price differences)	Available from tariffs	Implicit (actual price differences)
Ex-factory price	100	75	30	50	32
Imported pack (CKD less deleted parts)	48	35	35	32.5	32.5
Locally produced parts (vendors and in-house)	40	25	?	50	?
Value added (gross margin)	12				

Notes: "Implicit" protection means actual price differences as distinct from the protection made available by tariffs. The shares of inputs in the price valued at world prices are rough estimates based on information in Dr A.R. Kemal's 2005 report. "Value added (gross margin)" means the difference between the world price of the CBU car and the world price of the complete CKD pack for the same car i.e. the margin available for assembly under free trade conditions. The 2004 price comparisons for the finished cars (CBUs) are from the estimated ex-factory prices of Pakistan's Suzuki Mehran compared with the ex-factory prices of the Indian Maruti Suzuki with about the same specifications. The 2011 comparisons are of the Pakistan Suzuki Mehran 796 cc VX model with the ex-factory price of the Indian Maruti 800 standard model. In both of these years Maruti was exporting similar but better equipped models from India at about the same fob prices as the estimated domestic ex-factory prices.

PROTECTION ESTIMATES FOR HONDA CITY MODELS 2004 AND 2011					
		Protection rates in 2004 %		Protection rates in 2011 %	
	% of world price	Available from tariffs	Implicit (actual price differences)	Available from tariffs	Implicit (actual price differences)
Ex-factory price	100	100	27	60	0
Imported pack (CKD less deleted parts)	48	35	35	32.5	32.5
Locally produced parts (vendors and in-house)	39	25	?	50	?
Value added (gross margin)	13				

The 2004 price comparisons for the finished cars (CBUs) are from the estimated ex-factory prices of Pakistan's Honda City 1300 cc iDSi model, compared with the ex-factory prices of the Indian Honda City Lxi 1343 cc model. Both models are manual with air conditioning and with about the same other specifications. The 2011 comparisons are of Pakistan's Honda City 1300 cc (manual with a/c and power steering) the Indian Honda City 1497 cc model (manual). Ex-factory prices are estimated by deducting indirect taxes and dealer margins from advertised dealer prices. In 2011 Pakistan's sale tax was 17% and in India the combined central excise tax and state sales tax was 26%. Dealer margins in both countries were assumed to be 3% of showroom prices before indirect taxes. In 2004 the Pakistan prices were adjusted to allow for the substantial interest cost to buyers which was shared between dealers and manufacturers resulting from prepayments and long waiting times for delivery. Prepayments were also required in Pakistan in 2011 but we did not have the data needed to quantify this cost. The price comparisons were in US dollars after conversion of Rupee prices by the following exchange rates. Pakistan 2004 Rs 57/\$US, 2011 Rs 85/\$US. India Rs 45/\$US in both 2004 and 2011.

Table 11 – Effective protection rates (EPRs) for assembly, vendors, and car production as an integrated process, at various nominal protection rates for outputs and inputs

		Protection rates %						
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
(1)	Finished cars (CBUs)	50	32	32	32	32	20	10
(2)	Imported pack	32.5	32.5	32.5	32.5	32.5	20	10
(3)	Vendor manufactured parts	50	50	25	10	0	20	10
(4)	Vendor inputs	5	5	5	5	5	5	5
(5)	EPR for assembly	120	-30	53	103	137	20	10
(6)	EPR for vendors	95	95	45	15	-5	35	15
(7)	EPR total process	104	48	48	48	48	29	13
	Assumptions on input-output ratios at world prices							
	Assembly							
	Finished cars (CBUs)	100						
	Imported pack	48						
	Vendor manufactured parts	40						
	Value added (gross processing margin)	12						
	Integrated process							
	Finished cars (CBUs)	100						
	Imported pack	48						
	Vendor inputs	20						
	Value added (gross processing margin)	32						
	Vendor production							
	Vendor finished products	40						
	Vendor purchased inputs	20						
	Value added (gross processing margin)	20						

Table 12 – Pakistan and Indian T&C tariffs (MFN) 2010/11

	Pakistan CDs 2010-11			Indian CDs 2010-11
	Statutory	Exemptions SRO 567(I)/2006		
HS 52 COTTON				
Cotton	0			0
Cotton carded or combed	5			0
Cotton sewing thread	25			10
Cotton yarn	5	0		10
Cotton yarns retail sale	10			10
Cotton fabrics	25			10*
Cotton/synthetic blended fabrics	15			10*
HS 54 FILAMENTS				
Filament yarns	10	9		5
Fabrics	15			10*
HS 55 STAPLE FIBRES				
Tow	10	6.5		5
Fibres (e.g. PSF)	10	6.5		5
Yarns (e.g. PFY)	10	9		5
Fabrics	15			10*
HS 57 CARPETS ETC	25			10*
HS 58 SPECIAL FABRICS	25			10*
HS 59 IMPREGNATED FABRICS	25			10
HS 60 KNITTED FABRICS	25			10*
HS 61 KNITTED GARMENTS	25			10*
HS 62 WOVEN GARMENTS	25			10*
HS 63 MADE UPS	25			10*

* indicates that some of the Indian tariffs are "alternative" tariffs i.e. the higher of 10% or a specific amount per unit of the product

**Table 13 – National Tariff Commission
Protection cases studied during the last 10years**

Sr. No.	Name of applicant	Subject/ Product	Case Finalized
1	Lever Brothers Pakistan Ltd	Toilet Soap 3401.11	29.02.2002
2	Ramna Fitting (Pvt) Ltd	Malleable pipe fitting 7307.199 7307.19	15.08.2002
3	Chemi Viscose fibre (Pvt) Ltd	Viscose Staple Fibre	24.01.2003
4	Cera-e-Noor (Pvt) Ltd	Porcelain Tableware 6911	17.02.2003
5	CTI Industries	Multiplexer Transmission Apparatus 8517.803 8525.1 8527.1 8529.1	02.04.2003
6	Apex/Grapex Styainless Steel Pipe Ind.	Tubes, pipes & hollow profiles of Stainless Steel 7304.41 7304.49	28.04.2003
7	Pakistan Jute Mills Association	Jute bags 6305.1	30.04.2003
8	Evian Fats and Oils (Pvt) Ltd	RBD Palm Oil 1511.902	13.10.2003
9	Nimir Industrial Chemicals Ltd	Oleo Chemicals	19.01.2004
10	Delta Industries (Pvt) Ltd	Alkyd Resin 3907.509	11.03.2004
11	Colgate Oalmoilve (Pvt.) Ltd	Detergant Powder	13.09.2004
12	Olympia Chmicals (Pvt.) Ltd	Soda Ash 2836.2	
13	Pakistan Papersack Corporation Limited	Sack Kraft Paper 4804.21 4804.29	20.09.2004
14	Speed (Pvt) Limited	Sport wears 4202,6103 to 6105, 6109, 6110, 6112, 6114, 6115, 6201 to 6203, 6211,6402 to 6405, 6505	20.09.2004
15	Servis Industries (Pvt) Ltd	Footwear (6401.0000 to 6405.0000)	14.02.2005
16	Huffaz Seamless Pipe Industries (Pvt) Ltd.	Seamless pipes -7304	14.02.2005
17	Pakistan Vanaspatti Manufacturers Association (PVMA)	Edible Oils 1511.902 1515.19 1507.9 1512.19 1514.19	12.04.2005
18	Cadbury Pakistan Limited.	Chocolate 1806.2 1806.209 1806.31	30/03/2005
19	Pakistan Soap Manufacturers Association	Soap	06.07.2005
20	Syngenta Pakistan Ltd.	Shellsole A100 (2707.5000)	14.07.2005
21	Raffisons (Pvt) Ltd.	Photopolymer Plates	27.08.2005
22	Pharmagen Limited	Cefixime -2941.909	14.09.2005
23	Poplon Company (Pvt) Ltd.	Chrome Pigments (3206.2010)	22.09.2005
24	Harris Silicones	Silicone Sealants -3214.9	12.12.2005
25	Pharmagen Limited	Cefixime -2941.909	17.04.2006

Sr. No.	Name of applicant	Subject/ Product	Case Finalized
26	Tradimpex (Pvt) Ltd	PVC Flex Printable Media	03.05.2006
27	Medipak Ltd.	Removal of tariff anomaly regarding infusion giving sets	28.06.2007
28	Clyde Chemicals	Review of tariff protection to the indigenous industry manufacturing shoe adhesives.	24.07.2007
29	M/s Unitech International (Pct) Ltd.	Review of tariff protection to the indigenous industry manufacturing Farm Milk Chillers	04.10.2007
30	Descon Chemicals (Pvt) Ltd.	Removal of tariff anomaly relating to inputs and outputs of Fortified Rosin and ISO Propyl Alcohol	02.04.2008
31	Pakistan PTA Limited	Tariff protection to Pakistan PTA Limited	15.05.2008
32	Pakistan Electronics Manufacturers Association	Reduction of duty on import of LCD/ PLASMA TVs and parts/ components thereof	22.01.2009
33	M/s. Chemiworld (Pvt) Ltd.	Protection to indigenous industry manufacturing Ferrous Fumarate	17/03/2009
34	M/s Abbas Steel Industries (Pvt) Ltd.	Tariff Protection to the indigenous industry manufacturing Low Carbon Steel Wire Rods (HS Code 7213.1090 & 7213.9190)	18/04/2009
35	M/s Himont Pharmaceuticals (Pvt) Ltd.	Review of tariff structure of the indigenous industry pertaining to Iron Protein Succinylate	25/05/2009
36	Polyester Staple Fibre Manufacturers Group	Review of tariff structure of indigenous industry manufacturing Polyester Staple Fibre (PSF)	21/11/2009
37	Pakistan Steel	Imposition of regulatory duty on Hot Rolled, Cold Rolled & Galvanized Sheets	26/11/2009
38	Siddiqsons Tinplate Ltd.	Removal of Tariff Anomaly by Rationalization of Customs Duty on Tin Mill Black Plate	27/03/2010
39	M/o Textile Industry	Monetization of PTA	07-04-2010
40	AHN Steel Industries Limited	Budget anomaly and industrial protection as manufacturer of Cold Rolled Stainless Steel Coil (PCT NO. 72.19 and 72.20)	06/05/2010
41	ECC of the Cabinet	Impact of Deemed Duty Draw back on textile value chain.	Under process
42	M/o Textile Industry	Tariff Rationalization for Textile Value Chain. Reference received from Ministry of Textile.	Under process
43	Copy of the Summary for the made by FBR. (Received through) M/o Commerce	Restoration of Regulatory Duty on export of Waste & Scrap of Aluminum and Cooper	Under process
44	Ministry of Commerce on the request of All Pakistan Sugar Mills Association (APSMA)	Imposition of Countervailing duty on import of Sugar	Under process
45	M/S Pak Precise Engineering regarding under invoicing of imported Alloy Wheel Rims	Imposition of custom duty to stop under invoicing.	Under process
46	Surfactant Chemicals Company Karachi.	Tariff protection to the Indigenous Industry Manufacturing Agricultural Surfactants)	Under process
47	Reference received from Ministry of Textile.	Study of Waste and Scrap of PET Crush/Flakes	Under process
48	Imposition of Custom duty on import of jute yarn and twine.	Imposition of import duty.	Under process
49	Suo Moto	Protection of Local industry of leather and leather products.	Under process
50	Suo Moto	Tariff Rationalization of the plastic resins.	Under process
51	Suo Moto	Tariff Rationalization of electric cables.	Under process
52	Suo Moto	Tariff Rationalization on the energy saving lamps.	Under process
53	Suo Moto	Protection of Local industry of Plastic Plasticizers by reduction of duty on the inputs of Plasticizers.	Under process

Sr. No.	Name of applicant	Subject/ Product	Case Finalized
54	Suo Moto	Reduction of the duty on the inputs if viscose staple fibre	Under process
55	Suo Moto	Rationalization of duty on bicycles and parts thereof.	Under process
56	Pakistan Card Clothing Company (Pvt.) Limited	Review of Tariff structure of duty on raw materials imported for local manufacturing of card clothing	Under process
57	Lucky Cement	Review of the tariff structure of the domestic industry manufacturing cement	Under process
58	Falcon Abrasives (Pvt.) Limited	Review of the Tariff Structure of the domestic industry manufacturing Abrasive Products	Under process
59	Shaigan Electric & Engineering Co. Ltd.	Imposition of Custom duty on import of spark plug.	Case Closed
60	Sino- Pak Electro Chemical Industries Pvt. Ltd.	Protection of indigenous industry of Calcium Carbide and Ferro Alloys	Case Closed
61	Reference received from FBR	Imposition of duty on import of Rahu Fish Carp fish from Myanmar	Case Closed
62	Ayub Bearing Industry	Exemption of Sales tax on local sale of Ball & Taper & Roller Bearings	Case Closed

Fig 1 – Agriculture including food processing: % frequency of tariff rates 2002/03

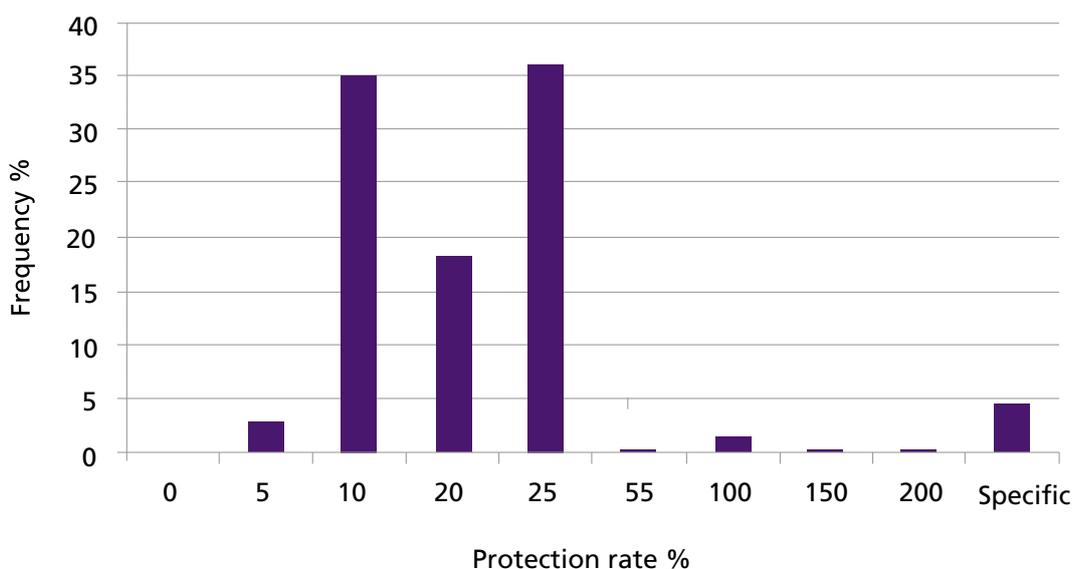


Fig 2 – Agriculture including food processing: % frequency of tariff rates plus regulatory duties, 2009-10

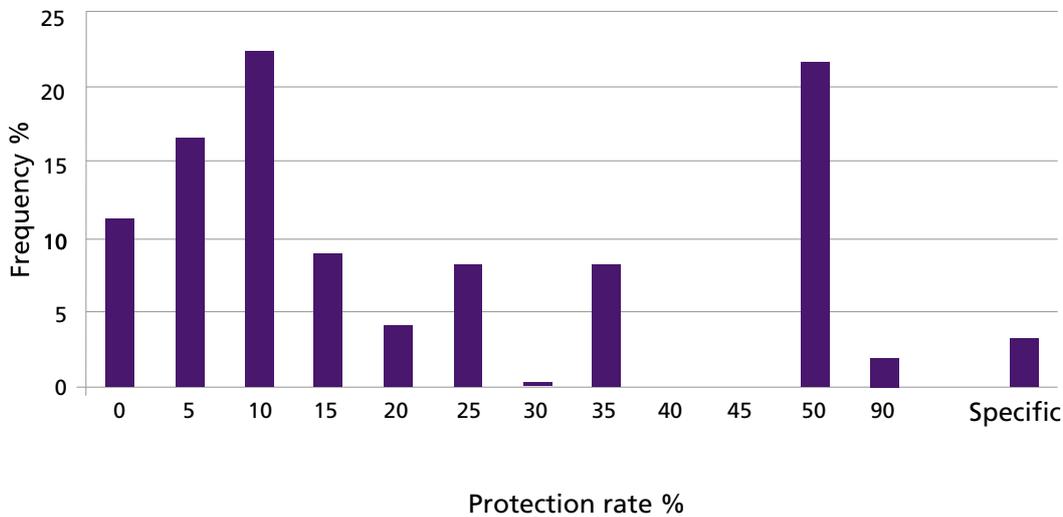


Fig 3 – Industry and all other: % frequency of tariff rates, 2002/03

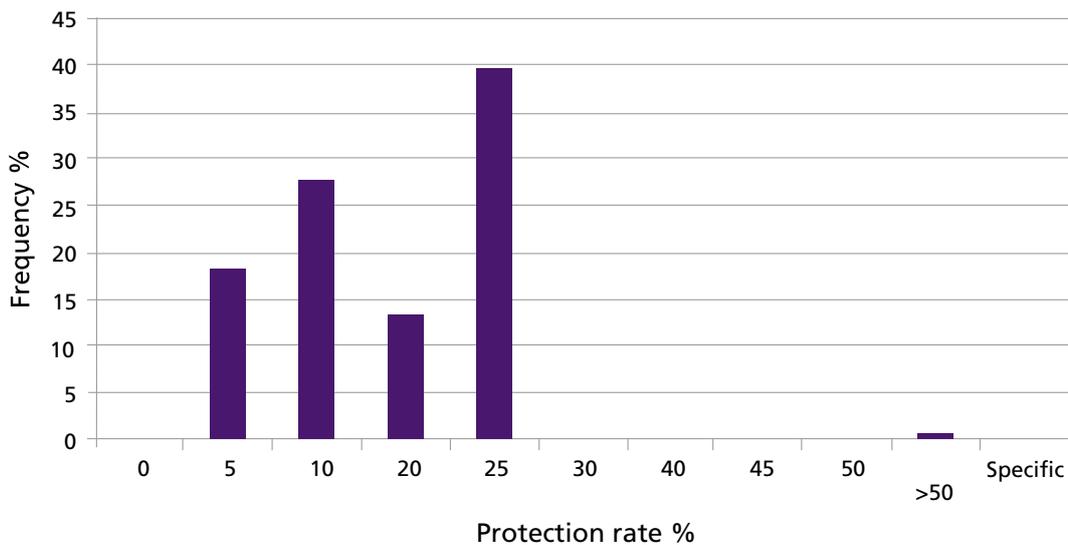


Fig 4 – Industry and all other: % frequency of tariff rates plus regulatory duties, 2009-10

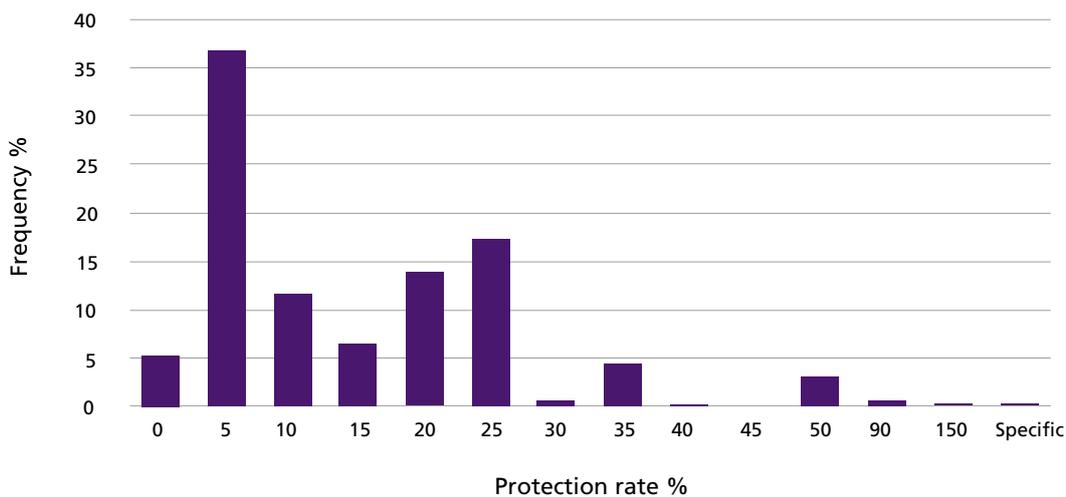


Fig 5 – All tariff lines: % frequency of tariff rates 2002/03

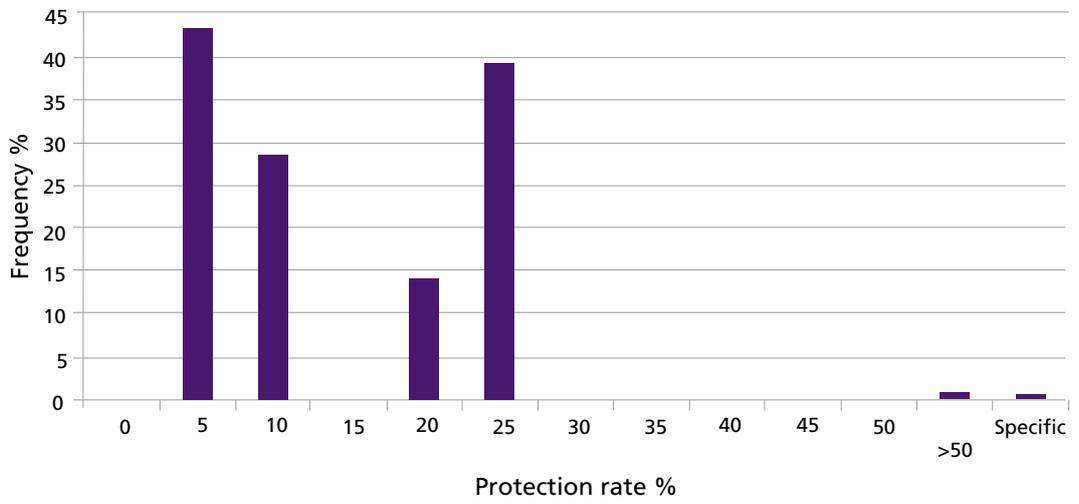


Fig 6 – All tariff lines: % frequency of tariff rates plus regulatory duties 2009-10

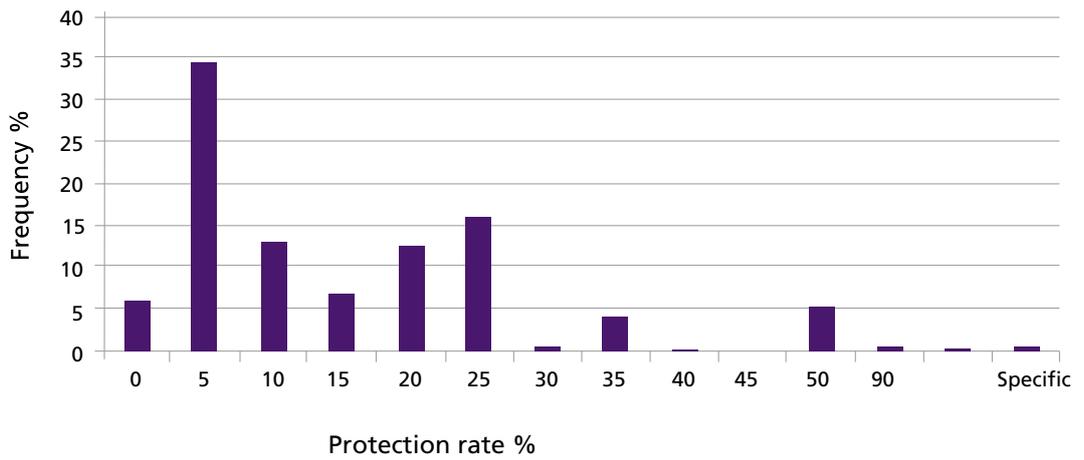


Fig 7 – Pakistan tariffs 1996/97 - 2009/10 (includes regulatory duties in 2009/10)

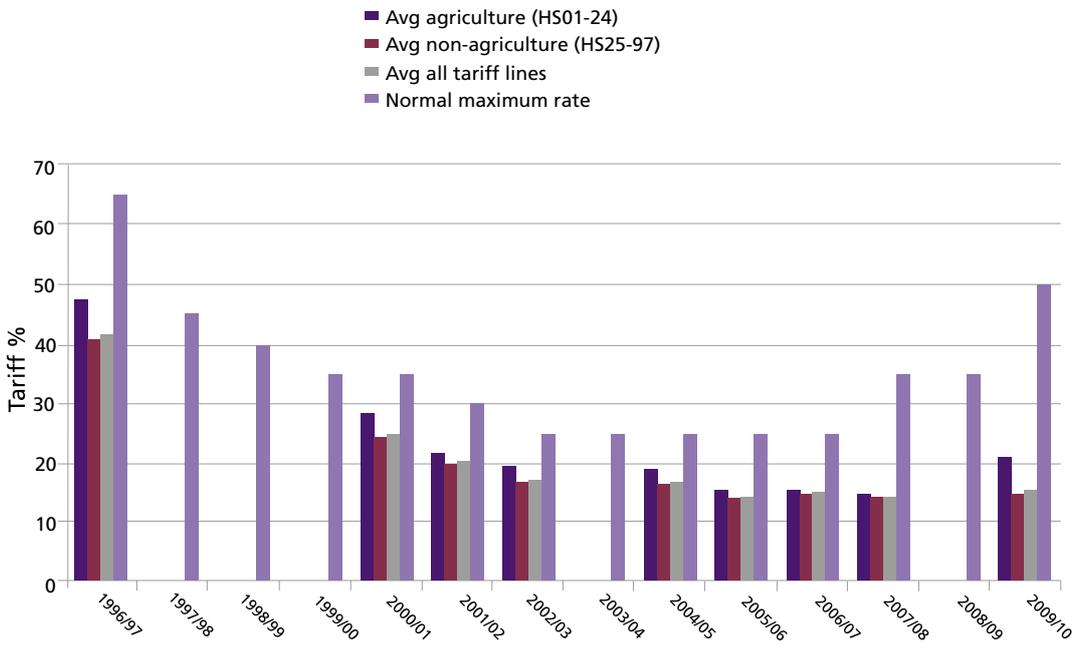


Fig 8 – Frequency distribution of regulatory duties August 2008 (average 17.4%)

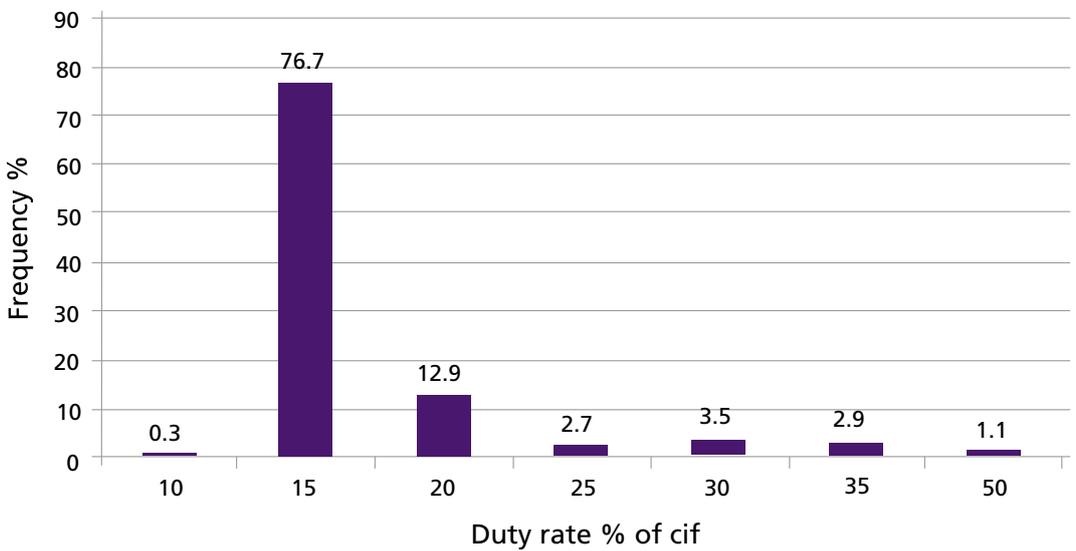
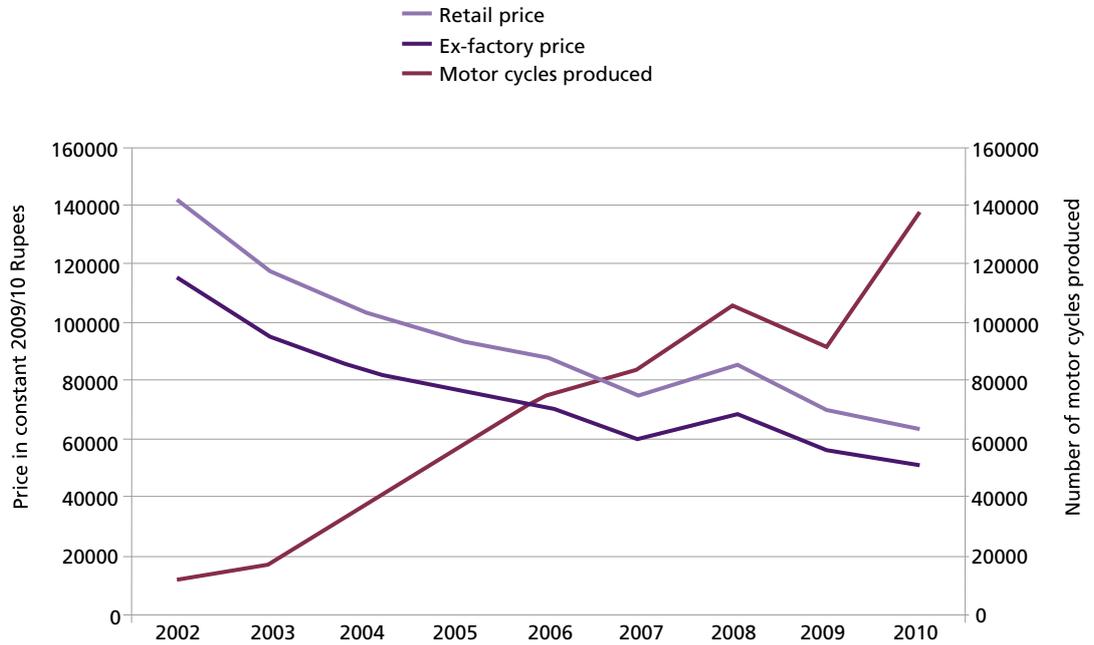
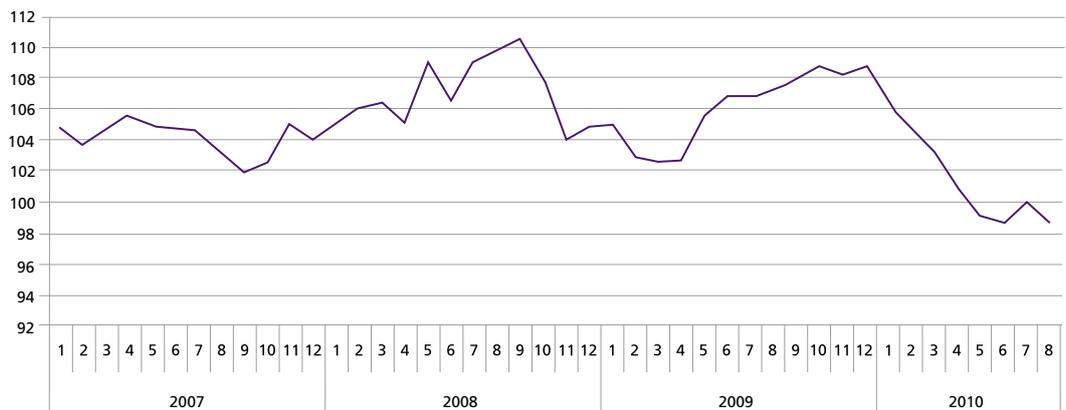


Fig 9 – Honda CD70 prices 2001/02 to 2009/10 and total motor cycle production



Approximate retail prices and dealer margins supplied by Engineering Development Board (EDB). Ex-factory prices estimated by deducting dealer margin and sales tax from retail price. All prices in constant 2009-10 Rupees per motor cycle (deflator CPI general index). Using the WPI or the GDP deflator doesn't change the price trends very much. Total motor cycle production supplied by EDB. Does not include imported fully built up motor cycles, but these were a very minor share of total sales. The big expansion in production and sales was mainly from imports of components of inexpensive Chinese motor cycles which are assembled in Pakistan. The price decline of the more expensive Honda 70 cc model illustrated here was due to the competitive pressure from the cheaper Chinese models. For most of the period motor cycle parts could be imported over a relatively low tariff: 15% in 2009/10. This contrasted with prohibitively high tariffs on imported built up motor cycles: 90% in 2001/02, 65% in 2009/10. There are reports of both large scale smuggling and under-invoicing of motor cycle parts, especially of engines.

Fig 10 – Pakistan REER index: monthly averages Jan 2007 - August 2010. 2000=100, increase=devaluation



Annex

INITIAL TERMS OF REFERENCE FROM PLANNING COMMISSION (NOV 2010)

Study on Tariff Rationalization and Trade Deregulation

The study will look into the following areas in about four months.

- 1.** Review the Tariff Structure to recommend simplification; by (a) reducing slabs and (b) accommodating WTO and FTA obligations.
- 2.** Review protection policy to clearly articulate the goals of protection as defined under clause 12 of BNTC Act 1990 and propose new strategy of protection;
- 3.** Review non-Tariff barriers (Procedures, technical, regulatory duties etc.) and recommend their simplifications.
- 4.** Review the institutional arrangements for trade regulation and assess their impact,
- 5.** Review the incentive structure including the preferred financing arrangements with a view to understanding their impact and efficiency.
- 6.** Revisit the exemptions and based on cost of exemption give recommendation for their possible withdrawal and retention.
- 7.** Examine the loss/gain of revenue due to reforms i) reduction of slabs and gradual move to optimal Tariff/EPR rate and ii) revenue gain from reduction in exemption and concessions.
- 8.** Recommend Tariff policy that promotes competitiveness and investment by rationalizing Tariff structure and determining optimal Tariffs/Effective Rate of Protection.

This TOR was later supplemented by a request to pay particular attention to the trade policies affecting the auto and textile and clothing sectors

About the International Growth Centre

The IGC offers independent advice on economic growth to governments of developing countries. Based at the London School of Economics and in partnership with Oxford University, the IGC is initiated and funded by the UK Department for International Development (DFID).

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