The Pakistan Business Council

FOSTERING ECONOMIC GROWTH

(A Company set up under Section 42 of the Companies Ordinance 1984)

A Framework to Control Illicit Trade

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The Pakistan Business Council
Overview

The Pakistan Business Council (PBC) is a research-based business advocacy platform established in 2005. It is now supported by over 100 private sector local and multinational businesses with significant investment in and long-term commitment to sustainable growth of the country. They come from 14 countries, have leading roles in 17 major sectors of the formal economy, generate 40% of annual exports, contribute a third of Pakistan's total tax revenues and employ three million people. Their combined sales represent every 9th Rupee of Pakistan's GDP.

PBC's major objectives are to advocate polices that lead to creation of jobs, value-added exports and reduction in import reliance through improved competitiveness of manufacturing, services and the agriculture sectors. It also promotes formalization of the economy.

PBC's over-arching theme, ***"Make-in-Pakistan"*** consists of three pillars: ***"Grow More/Grow Better"***, ***"Make More/Make Better"*** and ***"Serve More/Serve Better."*** Its evidence-based advocacy is backed by over two hundred studies to date through its full-time research team, supplemented by collaborative research with renowned industry experts and economists. Through its Centre of Excellence in Responsible Business (CERB), PBC works to build capacity and capability of businesses beyond its membership, to adopt high environmental, social and governance standards. PBC holds conferences, seminars and webinars to facilitate the flow of relevant information to all stakeholders in order to help create an informed view on the major issues faced by Pakistan. Through its presence in Islamabad and Karachi, it works closely with relevant government departments, ministries, regulators and institutions, as well as other stakeholders including professional bodies, to develop consensus on major issues impacting the economy.

PBC is a pan-sectoral, not-for-profit, Section 42 entity. It is not a trade body; therefore, it does not advocate for any specific business sector. Rather, its key advocacy thrust is on easing barriers that thwart competitiveness of businesses and investment in Pakistan. Further information on the PBC is available on: www.pbc.org.pk.

A Framework to Control Illicit Trade

Executive Summary

Pakistan suffers from one of the highest levels of illicit trade in Asia. The combined value of smuggling, under-invoicing, mis-declaration of imports, counterfeiting and adulteration is estimated at US$ 68 Bn or 20% of the formal economy. Informal economy is estimated at about the same size as the formal economy, therefore illicit trade represents 10% of the total economy. The estimated annual tax loss from illicit trade is Rs. 8 trillion, amounting to 85% of the tax revenue target for FY 24. There can be other estimates of the size of illicit trade. Suffice to say that it is large and needs to be addressed. Besides loss of tax revenue, illicit trade undermines the formal sector's growth, exploits labour, operates in environmentally detrimental ways, produces and sells substandard, unsafe and sometimes life-threatening products. Smuggling and under-invoicing also feeds off Hawala, affecting the country's official remittances and reserves, as well as the value of the Rupee. The eco-system of illicit trade is supported by and funds crime.

The combination of high taxes and ineffective enforcement are primary reasons for illicit trade. Poor political will and vested interests' thwart efforts to stem it. A poorly documented, cash-based economy sustains it. Pakistan's recurring economic crises and IMF imposed short term, front-loaded tax targets have not allowed time for fundamental and holistic changes in talent, technology or structures, nor addressed the fragmentation in jurisdictions that could, over a period, deliver concrete results. Instead, knee-jerk, revenue-seeking measures to meet high and increasing government expenditure, losses of state-owned enterprises, growing energy circular debt and the cost of servicing government debt have resulted in higher taxes, which in turn grow the incentive to evade. Reliance on import levies to fund a large part of tax revenue does not help. Caught in a vicious cycle, the various stop-start measures to quell illicit trade yield unsustainable results. Enduring, fundamental reforms require a system-wide change which only strong political will and a 'whole-of-government' approach can deliver. This will take time, patience and determined implementation to yield results. Piecemeal changes can only bring temporary relief.

This framework outlines key measures that can in combination help control illicit trade:

- Develop a strong political consensus to fight informality in the economy
- Starve the flow of foreign currency that funds smuggling and under-invoicing
- Create transparency of transactions by limiting the use of cash
- Broaden the tax base to include all points of sale through which illicit goods are sold
- Reduce incentives to evade through lower taxes and levies;
- Raise the cost of evasion through tighter enforcement;
- Provincial government co-operation to prevent sale of illicit items in their jurisdictions;
- Use technology and labelling measures to make it difficult to evade;
- Minimize misuse of Afghan transit trade;
- Refocus provincial Food Authorities on items that are more vulnerable to adulteration;
- Enable effective prosecution and penalize the guilty in the extended chain of evasion.

Illicit Trade: What & how significant is it?

Illicit trade for the purpose of this framework is defined as smuggling (including of contraband items), under-invoicing and misdeclaration of imports, diversion of goods imported for transit to Afghanistan, counterfeiting/brand infringement and adulteration. It also extends to contravention of SRO 237 regulating remainder shelf-life and labelling of food products.

The primary objective of illicit trade is to evade duties and taxes. A secondary objective in some cases, is to cheat customers and brand owners by passing off spurious and about to expire goods. Whilst some safeguards are common, others need to be tailored to address specific challenges.

The exact size of illicit trade is difficult to determine. However, extrapolating from the size of the informal economy at about equal to the formal sector i.e. US$ 340 Bn pa, and assuming 20% of this is accounted for by the host of illicit trade activities listed above, the size of illicit trade is estimated at $68 Bn pa. Assuming further, a direct and indirect evasion of duties and taxes at 40%, the loss of tax revenue is estimated at $27 Bn or nearly Rs. 8 trillion. This loss is 85% of the FY24 tax collection target. Smuggling alone was estimated in 2018 by a Harvard Alumni unpublished study to then contribute approximately $7 Bn loss of tax revenue. A comparison by the Pakistan Business Council of exports reported by China, UK, Germany and Singapore and import values declared in Pakistan from these countries in 2022 showed a likely potential loss of revenue due to under-invoicing of up to Rs 1 trillion. **Companies in the FMCG sector estimate a loss of 5% of their turnover to smuggling and counterfeiting/brand infringement. Estimates can vary but it is clear that the size of illicit trade is large and it has significant impact on tax revenues.**

Besides substantial loss of tax revenue, an unlevel playing field thwarts the growth of the formal sector and allows unsafe practices in the informal sector to continue. These include exploitation of labour, non-compliance with environmental requirements, production and sale of harmful and sometimes, life threatening goods. Illicit trade is supported by and funds crime.

This framework provides a general direction to thwart illicit trade in the most vulnerable items – tea, cosmetics & toiletries, food items, auto-parts, domestic appliances, cloth, cigarettes, medicines, tires, petroleum products, betel leaves etc.

Key Measures to thwart illicit trade

The key measures, which in combination can be effective to thwart illicit trade are listed below. None of these are possible without a strong political will and consensus between the key stakeholders – politicians, establishment, bureaucracy including police, judiciary. Secondly, a whole-of-government approach is required to systematically address the issues. Piecemeal approaches will only provide temporary relief.

- Develop a strong political consensus to fight informality in the economy
- Starve the flow of foreign currency that funds smuggling and under-invoicing
- Create transparency of transactions by limiting the use of cash
- Broaden the tax base to include all points of sale through which illicit goods are sold
- Reduce incentives to evade through lower taxes and levies;
- Raise the cost of evasion through tighter enforcement;

- Provincial government co-operation to prevent sale of illicit items in their jurisdictions;
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- Minimize misuse of Afghan transit trade;
- Refocus provincial Food Authorities on items that are more vulnerable to adulteration;
- Enable effective prosecution and penalize the guilty in the extended chain of evasion.

Develop a strong political consensus to fight informality in the economy	Examples of recent success of consensus include the war on terror, the BISP/Ehsaas Programme, expansion in power generation, managing the fallout from the Covid pandemic and moving Pakistan out of the FATF grey list. A consensus has perversely existed by default between successive governments and political parties on retaining the status quo on key areas for reforms: taxation, energy, state owned enterprises, (de)industrialization, agriculture productivity, a bloated bureaucracy, over-regulation, state capture of economic activities and recurring external and fiscal account balances. In the context of illicit trade, the largest vested interest that politicians shy of disturbing is the vote bank of wholesalers and retailers through which illicit goods are sold. This needs to be addressed with urgency and determination.
Starve the flow of foreign currency that funds smuggling and under-invoicing	Smuggled, under-invoiced and mis-declared goods require foreign currency to fund their business. Hawala is the traditional source of this. Recent success in limiting hawala through administrative measures needs to be sustained. Additionally, overseas Pakistanis need to be incentivized to use banking channels for remittances. Much of the effort to date has been on incentivizing banks to grow remittances. A gap analysis on ease and speed of remittances with the informal sector together with incentives, such as prize draws for remitters will help sustain official flows and starve the funding of smugglers etc.
Create transparency of transactions by limiting the use of cash	Cash is the most untransparent method of transactions and one that is widely used to hide turnover and profit of operators in the extended illicit supply chain. At least for high value transactions such as for domestic appliances, use of bank transfers, credit/debit cards and pay orders/cheques should be encouraged. Only through a system-wide transparency can illicit trade be discouraged.
Broaden the tax base to include all points of sale through which illicit goods are sold	Illicit goods are sold through shops. A large number of wholesale and retail outlets are outside the tax base. It is estimated that 40% of goods sold through such outlets are illicit, mainly smuggled, but also counterfeited and adulterated. Whilst a sector that represents 20% of GDP and contributes just 1% of direct taxes needs in any case to be brought into the tax net, documentation would also help in stemming unchecked sale of illicit goods.
Reduce incentive to evade through	High import duties (including additional and regulatory duties), GST at 18% on duty paid value, Advance Income Tax, Federal Excise Duty on some items, all combine to create significant incentive for evasion. Coupled with weak and ineffective enforcement and substantially lower

lower taxes and levies	cost of evasion, it is not surprising that illicit trade is large and growing in the country. Paucity of foreign exchange and import crunch has accelerated the pace of this growth. Any gains from stemming smuggling through administrative controls are unlikely to be sustained without a drastic reduction in duties and taxes. Tax cuts would have an immediate negative revenue impact but will in time be offset by growth of the formal sector. Reduction in illicit trade will also lead to safer working conditions for labour and better quality of products for consumers. ***Disincentivizing illicit trade through reduction in duties and taxes is beyond doubt, the most effective way to stem illicit trade. Efforts in the past to lower duties and taxes have been thwarted by vested interests that benefit from illicit trade. A leap of faith is required to start reducing levies that incentivize evasion. Fiscal deficit commitments to the IMF should factor the time required to address fundamental flaws in the current systems and structures. It is unrealistic to expect immediate benefits.*** Weak enforcement along with high tax rates forms a perfect recipe for evasion. Also, enforcement cannot be sustained without political will which has been lacking. Tax-free zones such as FATA/PATA exacerbate leakage of revenue, rendering industry uncompetitive in the rest of the country. High import duties lead to under-invoicing and misdeclaration. GST at 18% in a poorly documented economy is an invitation to evasion and a way to breed informality. Import restrictions, such as on gold keeps the entire jewelry trade in the informal sector. There is poor correlation between the rate of FED and the quantum of revenue raised. High levies lead to further evasion and erode the sales of the formal sector which produces all the tax revenue.
Raise the cost of evasion through tighter enforcement	Coupled with lowering the incentive to evade by reducing taxes, enforcement has to be tightened. The key control points to check the entry of smuggled, under-invoiced or mis-declared goods are land borders, ports/airports, coastal areas and dry ports. Border controls should be strengthened through continuing, as opposed to 'stop-start' cooperation of military institutions with Customs and civil administration. The recent success in stemming inflow of diesel from Iran demonstrates the value of such joint action. It needs to be sustained. Controls at these primary points of entry should be supplemented by spot checks on inland transportation, warehousing, wholesale and retail trade. The enforcement capability is one of the big challenges for the Federal Board of Revenue. Its field formations including Directorate of Customs Intelligence and Investigation lack the capability to execute and bring matters to closure. A ***"Whole-of-Government"*** approach would address coordination between different law enforcement agencies, resolve jurisdictional disputes, develop reward sharing mechanisms and find more effective ways to dispose confiscated goods.

	Transporting and dealing in illicit goods should be treated as a crime. This will not be possible without local police support.
Provincial government co-operation to prevent sale of illicit items in their jurisdictions	The remit of federal authorities to limit illicit trade is weak in the provinces where the evaded goods are often openly stored and sold. Resultantly, shops and markets known to deal in them go unchecked. Since most of the evaded taxes are federal, the provinces have little monetary incentive to help enforce checks. A Federal/Provincial fine-sharing mechanism needs to be developed to motivate provinces to cooperate in thwarting the sale of such items. Measures taken in the Finance Act to punish retailers for dealing in smuggled goods was a good start. However, it needs to be enforced and extended to cover counterfeit, adulterated, about to expire food and medicine and products that are not labelled according to requirements of SRO 237 (see below).
Use technology and labelling measures to make it difficult to evade	A successful example of the use of technology to stem smuggling is the requirement for cell phones to be registered with the Pakistan Telecommunications Authority. Only registered and duty paid cell phones can be used on the mobile networks. Another, non-technical, administrative measure that worked to limit import (and sale of smuggled) food items was the requirement under SRO 237 of a minimum 66% unexpired shelf-life, with primary labelling in English and Urdu of ingredients, Halal certification with a clearly visible logo of an accredited authority. Since smuggled food items are usually small stock lots, suppliers are not able to justify customized primary labelling in Urdu. This proved initially to be an effective step to quell import/smuggling and sale of products that did not meet the requirements of SRO 237. However, following import crunch, such products now have a visible and unchecked presence in retail. Gamma Scanners at ports can check the contents of containers. That would help control misdeclaration. Videorecording of inspection/examination by Customs can augment this. If Custom duties and associated levies are to be maintained at the current high rates, Customs officers need to develop specialized skills to value imports of items that are most prone to manipulation. Often unscrupulous importers mis-describe items and attribute valuation differences from the norm to quality or other attributes. Without appropriate inspection capability and deep, specialized knowledge, Custom officers are unable to determine proper value. Public sharing of import values, post the clearance of consignments is a step in the right direction. However, the level of detail is often missing for it to be challenged. For a limited number of under-invoicing prone items, Customs should share the declared value allowing others to bid at a prescribed premium, with proceeds going to the government. Auto parts are often declared at 15% of the true value. A check with OEM's price list would show the anomalies. Similarly, the declared values of branded items imported by traders should be verified by brand owners, if they are present in the country.

	Scrap imports are often used to smuggle auto parts and other items, and these should receive added attention. Track and Trace systems will assist in limiting evasion of the most vulnerable items. Satellite trackers on transit containers can ensure that containers leave Pakistan. However, they should also be used to monitor the movement of empty containers back from the border to Karachi. Electronic Data Interchange (EDI) with key trading partners will help Customs obtain authentic import value information to stem under-invoicing. EDI with China should cover items in and beyond the FTA. PBC has identified significant differences between export and import data reported by Pakistan and its trading partners on the International Trade Centre portal. The risk of under-invoicing will grow after the signing of the free trade agreement with GCC. Stricter enforcement of anti-money laundering laws and checks on hawala dealers dries up the source of funding payments abroad for under-invoiced and smuggled goods.
Minimize misuse of the Afghan Transit Trade	Many items imported for ostensible use in Afghanistan exceed the country's requirement or its industrial capacity and are not the preferred choice of Afghan consumers. They are diverted for sale in Pakistan. Payment for these imports is generally made from third countries such as the UAE and often outside the official banking channels. Whilst the government has recently moved to prevent imports of certain misuse-prone items through Pakistan, the following controls are suggested for when the import ban is lifted and the transit treaty is renegotiated: ***Qualitative and quantitative controls*:** allow only those items that are used in Afghanistan and in quantities that bear a reasonable justification of demand and industrial capacity in Afghanistan. Pakistan should continue to resist the inclusion of auto-parts and cigarettes in the list of items admissible for transit. ***Duties, GST and Advance Income Tax*:** GoP should charge import duty, GST and income tax at rates applicable to imports for Pakistan at the point of entry and refund these to the Afghan government upon reliable confirmation of exit at the border with Afghanistan. This would also augment the tax revenue of the Afghan government. It may be noted that many misusers of the transit arrangements are traders in Pakistan who would be severely penalized by this measure. ***Payments for Imports:*** In the interest of transparency and compliance with FATF and Anti-Money Laundering laws, do not allow payments to be made from third countries.

	Tracking: Continue satellite tracking of containers up to the Afghan border, strengthen deviation monitoring enroute, share actions taken to provide deterrent and heighten checks on returning containers to ensure that goods do not re-enter Pakistan. ***Diversion from Chabahar, Iran:*** Iran is an alternative route for transit trade into Afghanistan. Border controls should be strengthened to prevent diversion of items into Pakistan through this route. This is even more important if the aforementioned limits apply to what can transit through Pakistan.
Refocus Provincial Authorities on items vulnerable to adulteration	Presently, provincial food authorities focus much of their attention on branded and packed products, whereas most of the adulteration takes place in open/ loose items, such as milk, spices, tea, etc. Refocusing their attention on places where the latter are sold would protect consumers, create a level playing field for the formal sector and raise government revenue. Also, penal action should be harsher for repeat offenders. Brand-owners should regularly conduct public awareness campaigns highlighting the harmful effects of adulteration. The campaign by the packaged milk industry is a good example.
Enable effective prosecution and penalize the guilty in the extended chain of evasion	Counterfeiting cases are presently prosecuted by public prosecutors who generally lack motivation and commitment. Allowing brand owners to join the prosecution and by transferring such cases to consumer courts with better understanding of consumer interest, would make the trials more effective. Sale of counterfeit and adulterated products by wholesale and retail trade should attract penalties at par with those on smuggled goods under the powers available in the Finance Act. Counterfeiters rely on import of pre-printed packaging material carrying brands and trademarks of intellectual property owners. Such imports should be confiscated and handed over to the brand owners for destruction. The Directorate General of IPR Enforcement established by Pakistan Customs has not proved to be effective in curbing import of counterfeit products. It needs to be reorganized. Given the ineffective government support, brand owners should strengthen their sales networks and inspection teams in the far-flung areas where counterfeit/grey products are mainly sold. They should also minimize the risk of leakage of packaging material from their suppliers. Joint monitoring of trade and co-operation between brand owners and their brand protection agencies will deter outlets from dealing in counterfeits. Use of QR Codes and other infringement impediments would further assist. In most large cities there are well established and long-standing markets where counterfeit/grey and smuggled products are sold brazenly. Shah Alam Market in Lahore and Jodhia Bazar in Karachi are notorious. Authorities are well aware of these, yet no meaningful action

	is taken to deter sale. Customs, Inland Revenue and local administration should be held responsible and accountable for this.

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