

**BANK MANAGEMENT RESPONSE TO
REQUEST FOR INSPECTION PANEL REVIEW OF THE
ISLAMIC REPUBLIC OF PAKISTAN TAX ADMINISTRATION REFORM
PROJECT (IBRD Loan No. 72640-PAK; IDA Credit No. 4007-PAK)**

Management has reviewed the Request for Inspection of the Islamic Republic of Pakistan Tax Administration Reform Project (IBRD Loan No. 72640-PAK; IDA Credit No. 4007-PAK), received by the Inspection Panel on December 22, 2009 and registered on January 19, 2010 (RQ10/02). Management has prepared the following response.

February 19, 2010

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ABBREVIATIONS AND ACRONYMS

Currency Unit = Pakistan Rupee (PKRs)
US\$1 = PKRs 85

GOVERNMENT'S FISCAL YEAR:
(January 1 – December 31)

WEIGHTS AND MEASURES:
Metric System

CBR	Central Board of Revenue
CSS	Central Superior Services
DfID	Department for International Development (United Kingdom)
FBR	Federal Board of Revenue
GDP	Gross Domestic Product
HR	Human Resources
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
IRS	Inland Revenue Service
IT	Information Technology
LTU	Large Taxpayer Unit
MTU	Medium Taxpayer Unit
OCEGA	Officers of Customs and Excise Group Association
PAD	Project Appraisal Document
PID	Project Information Document
PRESO	Poverty Reduction and Economic Support Operation
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper
RTO	Regional Tax Offices
SBA	Stand-By Arrangement
TA	Technical Assistance
TARP	Tax Administration Reform Project
VAT	Value Added Tax

EXECUTIVE SUMMARY

1. **Weak revenue mobilization has been Pakistan's core development challenge for many years.** The country's low yielding revenue system is a result of an inefficient and ineffective tax administration, a narrow tax base, a skewed tax structure, a complex and non-transparent tax system, corruption, and tax evasion. At about 10 percent, Pakistan's tax to GDP ratio is among the lowest in the world. Its tax system is considered as deeply inequitable, with only 3 percent of income earners paying tax and only 80,000 businesses filing sales tax returns, and inefficient, tax administration employing over 24,000 people, which is far in excess of comparative benchmarks.

2. **The impact of Pakistan's weak revenue performance cannot be overestimated.** Resources to finance necessary investments in education, health care and infrastructure remain limited, increasing Pakistan's dependence on external aid. Moreover, the structural weaknesses of the tax system have heightened Pakistan's vulnerability to economic shocks.

3. **In 2003, the Government of Pakistan approved a comprehensive strategy for tax administration reform over the long term.** The strategy set out a clear objective—to shift from a “type-of-tax” organizational structure to a functionally integrated tax administration. In a type-of-tax structure, each tax—sales tax, income tax, excise tax, and customs duties—has its own administration. Taxpayers face a confusing array of different rules, processes and procedures to obtain tax registration, file returns, make payments, manage audits, and file appeals. This creates an unnecessary duplication of services that should be common across all tax types. More importantly, by increasing the number of points of contact between tax collectors and taxpayers and multiplying rules across different taxes, a type-of-tax structure opens greater opportunities for discretion in the application of tax laws, and hence, corruption.

4. **A tax administration based on functional lines entails the development and application of standard and unified business processes across all tax types** including audit, enforcement, collection, and registration. Taxpayers have a single point of contact with the tax authorities. This reduces overlap, enhances economies of scale and enforcement, and ensures a fair application of tax legislation.

5. **At the request of the Government of Pakistan, the World Bank approved the Tax Administration Reform Project on December 12, 2004 to assist the Federal Board of Revenue (FBR) in implementing its own reform strategy.** The total cost of the project is \$149 million, financed by a blend of IBRD (\$24.4 million) and IDA (\$78.5 million) resources, DfID (\$23 million) and the Government of Pakistan (\$23 million).

6. **The project's development objective is to fundamentally reform the FBR into a more efficient and effective revenue administration system.** The specific project objectives are:

- Improving organizational efficiency and effectiveness of revenue administration;

- Promoting compliance through strengthened audit and enforcement capacity and high quality tax services;
- Improving trade facilitation through modern and internationally acceptable customs procedures;
- Improving integrity and fairness of tax administration.

7. **With the support of the project, the Government of Pakistan has achieved some notable changes in tax administration.** The form of interface between taxpayers and tax collectors has changed with the introduction of a new system of self-assessment for paying income tax, the development of a new set of user-friendly tax forms, guides, a modern web site, and the construction of 21 Taxpayer Facilitation Centers. The organization of tax administration across the country has been consolidated through the establishment of a network of 13 Regional Tax Offices (RTOs), 3 specially designed Large Taxpayer Units (LTUs), and 6 Model Customs Collectorates. New IT systems have been developed to improve efficiency, including a data warehouse, e-portal, payments and refunds system, and taxpayer accounts, along with the implementation of a single Tax Identification Number for all taxpayers for effective functioning of these systems. With the support of the project, the FBR has also developed, for the first time, an integrity strategy, including a taxpayer charter and a code of conduct and ethics.

8. **Though beneficial, these *outputs* have not yet translated into the critically important *outcome* of demonstrably higher tax revenues.** The new processes and systems have only recently been supported by institutional reforms to create a functionally integrated tax administration that are necessary to change behaviors in the way that taxpayers and tax collectors interact. The Government's commitment to major tax administration reforms has wavered over time, especially during the boom years when higher economic growth generated modest revenue gains regardless of the inefficiencies of tax administration. The project itself suffered from slow disbursements, weak management, and inconsistent commitment to the Government's own reform agenda.

9. **As Pakistan faced a mounting economic crisis in 2008, the need to increase tax revenues became the single most urgent priority of the Government.** There was a broad recognition that the failure to improve revenue generation had left Pakistan increasingly vulnerable to shocks, and it jeopardized the country's development efforts by limiting the resources necessary for planned investments. A new, reform-minded Minister of Finance pushed to reinvigorate the Government's commitment to reforming the tax administration and sought enhanced World Bank technical assistance (TA) and support from the IMF to work with the FBR management to achieve demonstrable progress. This renewed commitment to reform was incorporated in the Government's Second Poverty Reduction Strategy Paper (PRSP-II) of 2008 as well as Government's Stabilization Program supported by the IMF's Stand-By Arrangement (SBA).

10. **Starting in January 2009, the Government took a series of administrative measures to reorganize the FBR along functional lines**—a reform that had been part of the Government's strategy since 2003. This meant merging the administration of sales, income and excise taxes and integrating common functions for collection, enforcement,

audit and IT systems across all these taxes. These initial measures were reversed in May 2009 in the face of legal challenges to the administrative methods employed through the reforms.

11. **However, a new FBR management worked closely with the Establishment Division and the Law Division in May-June 2009 and agreed on a revised administrative plan to re-organize the FBR through the establishment of a new occupational group—the Inland Revenue Service (IRS).** Tax administration officers were previously separated into two distinct occupational groups—the Customs and Excise Group and the Income Tax Group—with separate civil service career streams. With the creation of the IRS, officers from both groups were given the option to transfer to the new service or remain in their existing groups. The Government’s plan to introduce a broad-based value added tax (VAT) in July 2010 and the need to ensure that this new tax would be effectively administered gave added importance and urgency to the reorganization.

12. **Recognizing the critical importance of tax administration reform, the World Bank has been supporting the Government’s reform efforts through a range of instruments** including the TARP, a specially commissioned team of internationally recognized tax administration experts, and the Poverty Reduction and Economic Support Operation. Given the slow progress in achieving higher tax revenue, the Bank was planning to close the TARP at the end of its scheduled term in December 2009 (later temporarily extended until March 31, 2010). However, in light of the Government’s renewed commitment to tax administration reform and the enhanced urgency of increasing tax revenues due to the economic crisis, the Bank agreed to consider a restructuring and a two-year extension of the project if the FBR implemented its proposed institutional reorganization. Given the TARP’s unsatisfactory outcomes in the past, the Bank believed that this reform would be critical to achieving the project’s intended development objectives.

The Request

13. **On December 22, 2009, a Request for Inspection was submitted by members of the Officers of Customs and Excise Group Association, which was registered by the World Bank on January 19, 2010, alleging:**

- that the World Bank, through the TARP, unduly pressured the Government of Pakistan to merge the Customs and Excise Tax and Income Tax Groups into a new IRS in contravention of Pakistan law;
- that this administrative merger caused undue harm to Customs and Excise officers by limiting their operational latitude, promotion and mobility prospects;
- that the disruptions caused by the merger have weakened the whole taxation system;
- that the World Bank did not consult with members of the Customs and Excise group in the preparation and supervision of the TARP, violating OP 10.0 and OP/BP 13.05, and that a series of e-mails in late 2009 raising their concerns to World Bank staff were ignored;

- that the World Bank recommended to the Government of Pakistan to bypass Parliament and promulgate a Presidential Ordinance to implement some of the related legislative changes thus disrespecting the sovereignty of Parliament.

Management Response

14. **Management recognizes that the Requesters share a common vision with the FBR on tax reforms** with the “objectives of making the tax system more transparent, vibrant and taxpayer friendly.” The Requesters also explicitly agree that merging the functions of all domestic taxes under one hierarchy is one way to achieve these objectives.

15. **The Requesters raise concerns about the merger of occupational groups¹, not the merger of domestic taxes.** This refers to the administrative *means* to reach the *end* of a tax administration organized along functional lines and not the *end* itself. As a result, the concerns of the Requesters relate more to civil service issues around the handling of the merger of occupational groups than to the substantive issues of tax administration reform. On the basis of international experience, there are many different potential administrative paths to merging domestic taxes and reorganizing tax administration along functional lines. The path chosen needs to conform to the country’s own laws, administrative procedures, and institutional culture. The Requesters have raised important issues that have been the focus of substantial attention from the FBR, Establishment Division, and the Law Division and have been reviewed by Pakistan’s High Court. The World Bank recognizes the complexity of these issues and has supported efforts by the FBR to ensure fair and equitable treatment of all staff as a result of the reorganization.

16. Management’s response to these concerns is focused around the following four points:

17. **First, the FBR designed and implemented its own plan for the merger of occupational groups; the World Bank has supported the implementation of that plan.** The World Bank’s entire engagement on tax administration in Pakistan has been based on the FBR’s own 2003 comprehensive reform strategy which explicitly calls for the merger of all domestic taxes and the integration of tax administration along functional lines. Support for this goal has been incorporated into a number of World Bank lending and TA instruments and has been a consistent feature of the World Bank’s policy dialogue in Pakistan. The specific reorganization plan to merge existing occupational groups into a newly established IRS was designed and initiated by the FBR in consultation with the Establishment Division and the Law Division as the most appropriate means to achieve the reorganization of tax administration along functional lines in the context of Pakistan

¹ This response refers to the *merger of occupational groups*, even though in practice the merger was only *partial*. In addition to creating the IRS, the Government retained the Customs and Income Tax Groups in order to accommodate staff concerns and give them choice and flexibility. Each officer was given a choice to join the IRS and stay in the existing group; that is, joining the IRS was voluntary.

law and civil service guidelines. Management emphasizes that this was the Government's plan, which the World Bank supported through its appropriate instruments.

18. **Second, while the TARP continually stressed the importance of merging all domestic taxes, the project did not initially envision merging existing occupational groups.** Following the FBR's 2003 strategy, the TARP supported a gradual approach to the reorganization of tax administration, which envisioned a 5-7 year time frame for the eventual merger of all domestic taxes. After several years of implementation, neither the FBR nor the World Bank was fully satisfied with the results of the TARP. As pressures on revenue generation mounted in the face of economic crisis, the Ministry of Finance decided to pursue a more robust plan of organizational reform to fully integrate income, sales, and excise taxes through the establishment of the IRS and the voluntary merging of existing occupational groups. The World Bank believed that this new plan had increased the likelihood of meeting the project development objectives of the TARP and explicitly linked the further restructuring and extension of the TARP beyond its initial closing date of December 31, 2009 to the plan's successful implementation. Management believes that the creation of the IRS was not a deviation from the original design of the TARP, but will enhance the project's potential success in achieving its desired outcomes.

19. **Third, the FBR and the Establishment Division designed the merging of occupational groups to ensure fair and equitable treatment to all its officers** within the framework of Pakistan law and civil service procedures. While all civil service reorganizations inevitably entail disruptions to existing status, practices, and routines, Management believes that significant efforts were made by the FBR and Establishment Division to minimize harm to any specific group and the associated risks to the functioning of the taxation system. Management emphasizes the following features of the reorganization:

- Each officer has the option, but not the obligation, to join the new service and, as a result, the integration of the services is strictly voluntary;
- Neither the Customs and Excise Group nor the Income Tax Group have been abolished as a viable career path for officials who choose to remain in those groups and not join the IRS;
- All officers joining the new IRS or remaining in their existing groups retain the seniority as determined by the dates of joining their respective groups;
- The terms and conditions of employment, compensation, appraisal, mobility, and promotion of all officers—both IRS and Customs—are covered by the same civil service rules as enshrined in the Civil Service Act of 1972, which continue to apply;
- A special committee has been established to settle any service disputes in conjunction with the creation of the IRS and transfers from the existing service groups;
- Horizontal mobility across the administration is not blocked as the FBR management can assign staff to other functions at their request.

20. Management notes that all but one of the legal challenges in Pakistan's courts on behalf of individual Customs and Excise officers have already been dismissed. In its January 27, 2010 judgment, the Lahore High Court ruled that **“the merger of Sales Tax, Federal Excise or the Income Tax into one group, i.e. IRS, does not in any way reflect anything contrary to the fundamental rights of the petitioners [Customs and Excise officers] or derogatory to the settled principles in that respect. The only visible impression behind such exercise appears to bring different organs of tax collecting agencies into one, which exercise apparently would benefit the taxpayers and would ultimately result in widening the tax net.”**

21. **Fourth, the FBR and the World Bank team engaged in extensive consultations in the preparation and supervision of the TARP and the associated tax administration reforms.** The development of the TARP was based on a three year process led by the FBR of preparing a strategic vision for tax administration reform supported initially by a \$0.5 million Institutional Development Fund Grant and then, as the TARP project came into the operational pipeline, a \$2.9 million Project Preparation Facility in 2002. The resulting strategy was eventually approved by the President and integrated into Pakistan's PRSP-II. That process incorporated consultations with a broad range of stakeholders. Regular supervision missions were held, including visits to RTOs, LTUs and customs facilities. The World Bank Task Team Leaders of the TARP were based in the Islamabad office, ensuring frequent communication with the clients and other stakeholders. In addition to the TARP team, a specially commissioned group of tax administration experts conducted 6 missions to Islamabad within an 18 month period, which included field visits as well as regular meetings with FBR Members representing all of the occupational groups.

22. **The FBR led the specific consultations on the creation of the IRS and merger of the occupational groups as this was an internal administrative matter not directly supported through the TARP.** Though the first round of administrative decisions to reorganize tax administration in January 2009 may not have involved adequate consultation of the stakeholders and were eventually reversed, the newly appointed FBR management in May 2009 took a far more consultative approach and held several workshops and discussions with affected officers and their collective representatives as inputs into the proposal to establish the IRS. World Bank staff participated in some of these consultations as invited guests and were asked to assist the FBR in considering various reform options based on international experience. Though the issues discussed in these meetings were clearly contentious among certain groups of officers, the FBR and the Establishment Division sought to incorporate their concerns about the allocation of management positions, the retention of seniority, and promotion and mobility prospects into the final design of the reorganization. The World Bank emphasized in its recommendations to the FBR that effective change management efforts would be essential to the successful implementation of the reorganization.

23. **Management recognizes that a series of e-mails sent to World Bank staff representing concerns by Customs and Excise officers were not properly acknowl-**

edged. Management is informed that World Bank staff did not respond to these messages for the following reasons:

- As the matters raised in the e-mails were under jurisdiction in the Pakistan courts, the World Bank staff did not believe it would be appropriate to respond on the substance of the matter as this could be seen as interference in an ongoing domestic legal process;
- As the World Bank had been in communication with the Association of the Customs and Excise Officers, staff did not believe that the e-mails were representative of the officers as a group as claimed by the senders;
- Some e-mails contained unprofessional remarks about specific FBR officials leading staff to believe that the e-mails represented intra-organization or personal rivalries that would be inappropriate for the World Bank to comment on.

24. **Management recognizes that the World Bank staff made an error in not acknowledging receipt of the e-mails as the responses could have been handled in an appropriate manner respecting the ongoing legal process.** Management regrets this error and has provided appropriate instruction to the relevant teams on proper guidelines for responding to such external requests. However, Management notes that World Bank staff did meet with representatives of the Association of Customs and Excise Officers as part of the FBR's consultations on the establishment of the IRS and subsequently incorporated concerns raised by the Customs Officers in the World Bank's communications with the FBR.

25. **Management also acknowledges that the mission report of October 19, 2009, prepared by a team of World Bank-funded tax administration consultants, contained a regrettable reference recommending the use of an executive ordinance instead of the legislative process to achieve reforms.** Management recognizes that this was a failure of oversight by the World Bank not to adequately vet the document prepared by the consultants. Alerted to the issue by press reports of the document, Management unequivocally recognized the error and communicated this to the Government of Pakistan in a letter dated November 5, 2009, by the Country Director Yusupha Crookes. Following this error, stricter management review and clearance of subsequent mission reports of the tax administration TA team were put into place.

26. **While Management recognizes that World Bank staff and consultants did make some misjudgments in communication, Management does believe that the World Bank has properly applied its policies and procedures and pursued concretely its mission statement in the context of the project.** In Management's view, the World Bank has followed the guidelines, policies and procedures applicable to the matters raised by the Request. As a result, Management believes that the Requesters' rights or interests have not been, nor will they be, directly and adversely affected by a failure of the World Bank to implement its policies and procedures.

I. INTRODUCTION

1. On January 19, 2010, the Inspection Panel registered a Request for Inspection, IPN Request RQ10/02 (hereafter referred to as “the Request”), concerning the Islamic Republic of Pakistan Tax Administration Reform Project (TARP) financed by the International Bank for Reconstruction and Development and the International Development Association (the World Bank).

2. *Structure of the Text.* The document contains the following sections: Section II presents the Request. Section III provides background information on the Country Context and on the Project. Section IV provides the Management’s Response. Annex 1 presents the Requesters’ claims, together with Management’s detailed responses, in table format. Additional information is included in the following annexes:

Annex 1.	Claims and Responses
Annex 2.	Terms of References for the Technical Assistance Work
Annex 3.	Tax Administration Reform: Amended Summary of Agreements Reached – July 10, 2009
Annex 4.	Lahore High Court Judgment Sheet of January 7, 2010; Lahore High Court Judgment Sheet of January 27, 2010
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Annex 10.	Letters of the World Bank Country Director to Ministry of Finance

II. THE REQUEST

3. The Request for Inspection was submitted by members of the Officers of Customs and Excise Group Association (OCEGA) hereafter referred to as the “Requesters.” The Requesters have asked that their identities be kept confidential.

4. Attached to the Request are seven annexes in support of the Request.

5. Management understands that the Requesters have made the following claims:

- That the World Bank, through the TARP, unduly pressured the Government of Pakistan to merge the Customs and Excise Tax Group and Income Tax Group into a new Inland Revenue Service (IRS) in contravention of Pakistan law;
- That this administrative merger caused undue harm to Customs and Excise officers by limiting their operational latitude, promotion and mobility prospects;

- That the disruptions caused by the merger have weakened the whole taxation system in Pakistan causing harm to the national economy;
- That the World Bank did not sufficiently consult with members of the Customs and Excise Group in the preparation and supervision of the TARP, violating OP10.0 and OP/BP 13.05 and that a series of e-mails in late 2009 raising their concerns to World Bank staff were ignored; and
- That the World Bank recommended to the Government of Pakistan to bypass Parliament and promulgate a Presidential Ordinance to implement some of the related legislative changes thus disrespecting the sovereignty of Parliament.

6. The Request contains claims that the Panel has indicated may constitute violations by the World Bank of various provisions of its policies and procedures, including the following:

OP/BP 13.05	Project Supervision
OP/BP 10.00	Investment Lending
OMS 2.20	Project Appraisal

III. COUNTRY CONTEXT AND PROJECT BACKGROUND

A. Pakistan's Weak Revenue Performance

7. **Weak revenue mobilization has been Pakistan's core development challenge for many years.** Revenue mobilization has suffered from an inefficient and ineffective tax administration, a narrow tax base, a skewed tax structure, a complex and non-transparent tax system, and corruption and tax evasion. As a result, Pakistan has a revenue system that is low yielding by international and regional standards and has been declining over time despite several years of robust economic growth. The federal tax-to-GDP ratio, which at the start of the decade stood at 9.1 percent, declined to 8.8 percent of GDP in 2008/09 (see Table 1).² In addition, the system is inequitable (with only 3 percent of income earners paying tax and only 80,000 businesses filing sales tax returns) and inefficient (tax administration employing over 24,000 people, far in excess of comparative benchmarks).

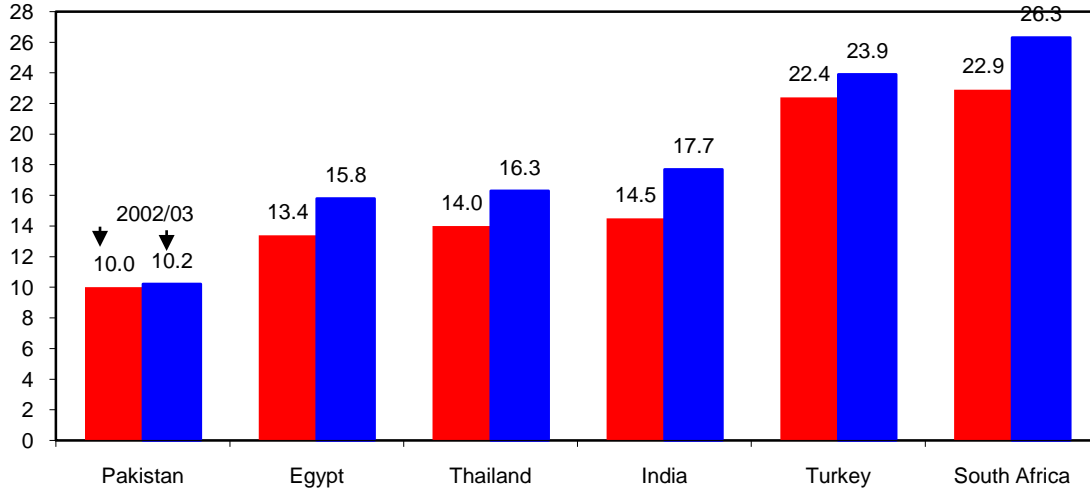
		2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Revenue receipts	<i>Rs billions</i>	553	624.1	720.8	793.7	900.014	1076.6	1297.957	1499.381	1851
	<i>% growth</i>		12.9%	15.5%	10.1%	13.4%	19.6%	20.6%	15.5%	23.5%
Tax revenues	<i>Rs billions</i>	441.6	478.1	555.8	611	659.41	803.7	889.685	1086	1331
	<i>% growth</i>		8.3%	16.3%	9.9%	7.9%	21.9%	10.7%	22.1%	22.6%
of which FBR	<i>Rs billions</i>	392.3	403.9	460.6	518.8	588.4	713.4	847.2	1007	1157
	<i>% growth</i>		3.0%	14.0%	12.6%	13.4%	21.2%	18.8%	18.9%	14.9%
as percent of GDP										
<i>Revenue receipts</i>		13.1	14.0	14.8	14.1	13.8	14.1	15.0	14.6	14.1
<i>Tax revenues</i>		10.5	10.7	11.4	10.8	10.1	10.5	10.3	10.6	10.2
<i>of which FBR</i>		9.3	9.1	9.4	9.2	9.1	9.4	9.8	9.8	8.8

Source: Economic Survey of Pakistan

² Owing to GDP rebasing in 1998/99, data prior to 2000 is not comparable to data from 2000 onwards.

8. **Pakistan’s tax-to-GDP ratio lags considerably behind most other countries in the world** at a similar income level and even comparators in South Asia with similar tax policies and administration, such as Bangladesh, India, Nepal and Sri Lanka (see Figure 1). This gap has increased over the last decade. While other fast-growing developing countries—such as Egypt, India, Thailand, Turkey, and South Africa—have enjoyed rapidly rising tax ratios in this decade, Pakistan’s economic boom years did not generate concomitant increases in tax collection.

Figure 1: Comparison of Tax Collection in Pakistan with Select Other Countries



9. A large volume of evidence demonstrates that **Pakistan’s poor performance in revenue mobilization reflects weaknesses both in tax policy and tax administration.**³ The tax base is narrow as Government taxes only a limited number of sectors, businesses and people. Agriculture contributes about one fifth of GDP, yet gives no more than one percent in federal tax revenue. The services sector makes up almost half of economic value added, but contributes only one quarter of federal taxes due to low tax receipts from the wholesale, retail and transport sub-sectors. Industry carries the brunt of the tax burden; its tax share is three times as high as its share of GDP. Tax evasion is rampant and there is a vast network of special treatments and exemptions backed up by powerful vested interests. Tax enforcement measures are also extremely weak. The estimated federal tax gap for 2007/08 was an extraordinary 79 percent of actual tax receipts.⁴

³ See, for example, Pakistan Tax Policy Report, Tapping Tax Bases for Development, Report no. 50078-PK, World Bank, 2009.

⁴ The tax gap measures the extent of tax evasion in a country. Tax evasion, or non-compliance with the tax law, refers to the non-payment of lawful tax liabilities and is illegal. It is different from tax avoidance which refers to the use of the tax law to minimize tax liabilities and is legal. The tax gap does not arise from tax avoidance, but rather from evasion, whatever the underlying motivation.

10. **The impact of Pakistan’s weak revenue performance cannot be overestimated.** Resources to finance necessary investments in education, health care and infrastructure have remained limited, increasing Pakistan’s dependence on external aid. The structural fiscal gap equivalent to cover development needs for social services and public infrastructure has been estimated at about five percent of GDP.⁵ Moreover, the structural weaknesses of the tax system have heightened Pakistan’s vulnerability to economic shocks.

11. **During the 1990s, the Government made many attempts to reform tax policy, but most had only limited impact** as exemptions proved difficult to eliminate and administration of tax reforms was weak.⁶ It has long been recognized that far-reaching reforms are necessary in both tax policy and tax administration.

B. Government’s Strategy for Tax Administration Reform

12. **The Government of Pakistan initiated a new round of tax administration reform in June 2000** with the appointment of a high profile 11 member Task Force, supported by a \$0.5 million Institutional Development Grant, whose mandate was to recommend measures to increase the efficiency and integrity of Pakistan’s tax system. The Task Force recognized the urgency of its mandate. “If the tax-to-GDP ratio does not increase significantly, Pakistan cannot be governed effectively, essential public services cannot be delivered and high inflation is inevitable,” said its main report. “Reform of tax administration is the single most important economic task for the government.” The Task Force carried out detailed analyses and surveys and consulted tax officials, trade associations, and members of the then Central Board of Revenue (CBR), which was in July 2007 renamed the Federal Board of Revenue (FBR), in preparing its reports.⁷ The final report called for “radical reform of recruitment, training, compensation, and performance management.” It recommended major changes in the interface between tax officials and taxpayers by moving towards a “system of self-assessment and selective audit” and a “reduction of discretion and direct contact between tax collector and taxpayer” through upgraded IT systems.

13. Based on the Task Force report, **FBR management, with additional inputs from international tax administration consultants, developed a strategy for tax administration reform** that was approved by the President in November 2001 and thereafter further developed into a *Comprehensive Medium and Long Term Strategy* in May 2003. The strategy set out a clear objective—to shift over the long term from a type-of-tax organizational structure to a functionally integrated tax administration. Tax administration reforms over the last 30 years have demonstrated the benefits both in terms of ef-

⁵ Pakistan Tax Policy Report, Tapping Tax Bases for Development, Report no. 50078-PK, World Bank, 2009.

⁶ Evaluation of the Prolonged Use of Fund Resources, IMF Independent Evaluation Office, IEO Publications, IMF, 2002.

⁷ For convenience, hereafter in this document the Board of Revenue is referred to as the Federal Board of Revenue (FBR) regardless of the year.

efficiency and integrity, of the shift towards a functionally integrated model. In a type-of-tax structure, each tax—sales tax, income tax, excise tax, and customs duties—has its own rules, procedures, and administration in such areas as delegation of powers, taxpayer obligations, establishment of penalties, criminal procedures and procedures for appeals, increasing opportunities for discretion by tax officials. It also entails unnecessary duplication of cross-cutting services such as audit, collection, enforcement, and IT. More importantly, by increasing the number of points of contact between tax collectors and taxpayers and increasing the complexity of rules and procedures across different taxes, a type-of-tax structure opens greater opportunities for discretion in the application of tax laws, and hence, corruption.

14. **A tax administration based on functional lines entails the development and application of standard and unified business processes across all tax types** including audit, enforcement, collection, and registration. Taxpayers have a single point of contact with the tax authorities on all forms of domestic taxes. This reduces overlap, enhances economies of scale and enforcement, and ensures a fair application of tax legislation. International experience has demonstrated that this significantly increases the efficiency and transparency of tax administration, improving the level of service to the taxpayer, reducing the risks of corruption, and increasing revenue collection for the state.

15. **The FBR’s strategy** called specifically for: (i) integrating income, sales and excise taxes; (ii) re-engineering and automating business processes and workflows; (iii) establishing databases for reporting and audit purposes; (iv) introducing a self-assessment system for filing of tax returns; (v) improving services for taxpayers; and (vi) strengthening the human resource base.

16. Given the critical importance of this issue for Pakistan’s overall development, **the World Bank has been supporting the implementation of Government’s strategy of tax administration reform since 2004 through a combination of instruments**, including investment lending, development policy lending, and non-lending technical assistance (TA). Of these, the TARP has been the main vehicle for investment support.

C. Tax Administration Reform Project (TARP)

17. **At the request of the FBR, the World Bank prepared the TARP in 2003/04 to assist the Government and the FBR in implementing its comprehensive tax administration reform strategy.** The Board approved it on December 12, 2004. The project design follows the Government’s proposed road-map for achieving the vision, mission, values, goals and strategy of the future FBR. The total cost of the project is \$149 million, financed by a blend of IBRD (\$24.4 million) and IDA (\$78.5 million) resources, DfID (\$23 million) and the Government of Pakistan (\$23 million).

18. **The project development objective is “to fundamentally reform the Federal Board of Revenue for a more efficient and effective revenue administration system.”** The overriding objective is to raise revenues through improved compliance with tax laws and broadening the tax base, improving the effectiveness, responsiveness and efficiency

of tax administration through institutional and procedural reforms, improving collection through transparent and high quality tax services, and strengthening audit and enforcement procedures.

19. The TARP includes seven components:

- (i) *Management and Institutional Development (US\$9.29 million):* This includes strengthening of organization and policy, corporate planning, human resource development, internal audit, internal affairs and vigilance, and change management. The component addresses key institutional, organizational, and legal constraints to a more efficient tax and customs administration, through the gradual implementation of a functional structure of tax administration. It aims at reorganizing the FBR to facilitate more efficient planning, execution, and supervision of core administrative functions.
- (ii) *Improving Revenue Operations (US\$93.17 million):* This component supports transformation of the FBR's three revenue streams—direct tax, sales tax and central excise, and customs—through the introduction of risk-based self-assessment systems based on voluntary compliance of taxpayers. It includes the establishment of a network of Regional Tax Offices (RTOs) and Large Taxpayer Units (LTUs) for integration of all domestic taxes and the introduction of new business processes and IT systems to support a functionally-based organization.
- (iii) *Strengthening Revenue Services (US\$6.62 million):* This includes reforms in audit, voluntary and enforced collection, appeals and dispute resolution, national intelligence and risk management, and customs and tax fraud. The main thrust of the component is to establish and implement a tax audit function as a separate functional stream at a national level.
- (iv) *Creating a Tax Compliant Culture (US\$6.27 million):* This involves strengthening taxpayer education and facilitation. The project supports the full transition to a unique taxpayer identification and registration system.
- (v) *Adopting Responsive IT Systems (US\$3.65 million):* This supports development and implementation of a comprehensive IT modernization strategy across the FBR to improve management controls, increase transparency of tax administration, reduce interaction with taxpayers in day-to-day operations, manage information for broadening the tax net, increasing revenues, and facilitating trade, and allowing for multi-directional communication.
- (vi) *Infrastructure Improvements (US\$24 million):* This involves the preparation and implementation of a comprehensive modernization plan to accommodate the FBR's re-organization. It supports major renovations for modernizing the FBR's office infrastructure.
- (vii) *Project Management and Implementation (US\$3.06 million).*

20. The TARP became effective in April 2005 and was initially scheduled to close on December 31, 2009. **To date, the TARP has achieved a number of important results, including:**⁸

- Introduction of a Universal Self-Assessment System for income tax;
- The establishment of a network of 3 LTUs and 13 RTOs, including merger of 6 Medium Taxpayers Units (MTUs), as well as 6 Model Customs Collectories;
- Construction of 21 Taxpayer Facilitation Centers, a Passenger and Trade Facilitation Center, upgrading Directorates of Training, and 13 Transit Accommodations;
- Development and introduction of a new set of user-friendly tax forms, guides and a modern web site to improve taxpayer facilitation;
- Development of IT systems to support core functions (data warehouse, e-portal, payments and refunds, taxpayer account, traffic management supervision);
- Implementation of a single Tax Identification Number for all taxpayers for an efficient functioning of information systems;
- Development of an integrity strategy, including a taxpayer charter and a code of conduct and ethics;
- Training in many areas, including change management.

21. **In a Quality Enhancement Review (QER) at the mid-term of the project** (May 2008), the final report stated: “[A]ll signs are that the project has been well conceived, pertinent to the country’s needs and activities and its costs reflect good practice for the reform of revenue administrations. **Still, results on the ground as well as disbursements are weak...**”⁹ Though the project had achieved by mid-term a number of *outputs*, these were not being translated into effective *outcomes* in terms of the initial development objectives. The problems related to the inconsistent commitment to the institutional reforms necessary to achieve those broader outcomes and to persistent weaknesses in the project implementation management. The QER made a number of recommendations that were incorporated into the project, including the provision of enhanced support to the FBR in implementing its own reorganization strategy.

22. **Many of the project’s key investments depended on the outcomes of a sequence of reforms.** Thus, the project envisioned the development of cross-cutting functions across all domestic taxes, development of new and improved business procedures to accompany the functional reorganization, and related automation support systems to carry out these new procedures. Any break in the chain of reforms had consequences for the investments envisioned by the project. Without the creation of common functions—such as collection, enforcement, and audit—the redefinition of business processes could not

⁸ “Pakistan: A Tax Administration Review,” World Bank, September 2008. The Bank supported the implementation of some of the measures in TARP also through the series of Poverty Reduction Support Credits (PRSC1-2) during 2005-2007.

⁹ Quality Enhancement Review, May 2008, para.14.

continue. Without the implementation of new business processes, related IT investments were halted or insufficiently incorporated into business routines. Without the new IT systems, training and change management investments were delayed. As will be discussed in later sections of this Response, the shift from co-location of tax streams to actual integration of functions across all domestic taxes—along with the concomitant changes in business processes, IT systems and HR reforms—did not have consistent commitment from within the FBR. Due to high growth rates and the resulting tax buoyancy effects, tax revenues were increasing, albeit slowly, even without reform efforts thus reducing the sense of urgency to tackle the more difficult elements of reform.

23. **Prolonged delays in the development of IT software and applications, the largest category of TARP investments,¹⁰ were further compounded by indecision and shifts in the FBR’s IT strategy during the course of the project.** The decision to outsource customs automation as a public-private partnership activity instead of the investment planned under the project took some \$28 million of intended disbursements out of the project. In addition, FBR management and its own internal IT group disagreed about the replacement of existing systems for Integrated Tax Management with an off-the-shelf integrated solution vs. new systems developed in-house. Initially the TARP team recommended the off-the-shelf system, but a more thorough review of the proposed in-house solutions by the TA team eventually supported the FBR management’s decision to opt for the in-house approach. This led to about \$7.5 million in savings in project costs that have been reflected in the proposed TARP restructuring. However, the prolonged discussions and indecision regarding this issue seriously delayed the IT procurement plan, which ultimately became the major cause for the low disbursement rate of the project.

24. **There were also persistent weaknesses in project management.** Personnel turnover in the Project Management Unit was high. There were delays in hiring the necessary complement of procurement experts and financial management specialists.

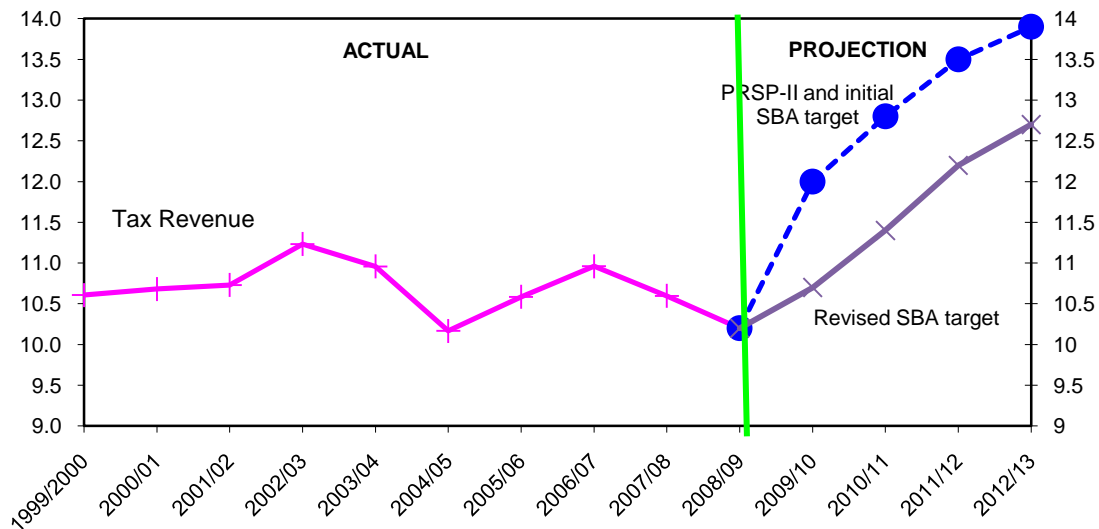
25. As a result of these problems, **the World Bank in its own internal supervision reviews rated project implementation as “moderately unsatisfactory”** and overall progress towards achieving the project’s development objectives as “moderately satisfactory” beginning in December 2006. Owing to its weak performance, the World Bank considered closing the TARP prior to its scheduled completion date in December 2009. However, the economic crisis in 2008 refocused the Government’s efforts and renewed its commitment to tax reform leading the World Bank to consider a restructuring and possible extension of the project.

¹⁰ In addition to the specific IT component of the project (Adopting Responsive IT systems), the component on Improving Revenue Operations entailed significant IT investments. The total budget allocated to IT related investments (soft and hardware) amounted to about \$89 million.

D. Economic Crisis and Government's Renewed Commitment to Tax Reform

26. As Pakistan faced a mounting economic crisis in 2008, the need to increase tax revenues became the single most urgent priority of the Government. In November 2008, to avoid a default on foreign debt payments, the Government of Pakistan developed a stabilization program, which was supported by the IMF through a Stand-By Arrangement (SBA). The cornerstone of the Government's program was a significant increase in total tax revenues—from 10.2 percent of GDP in 2008/09 to 13.9 percent of GDP by 2012/13. This was also reflected in the Government's Second Poverty Reduction Strategy Paper (PRSP-II),¹¹ which was completed in Fall 2008 (see Figure 2).

Figure 2: Turning Around the Tax-to-GDP Ratio



27. There was recognition that failure to improve revenue generation had left Pakistan increasingly vulnerable to shocks and jeopardized the country's development efforts by limiting the resources necessary for planned investments. Pakistan's high economic growth in the earlier part of this decade was driven in part by external financing and an expansionary fiscal stance, while revenues and savings stagnated. This reliance on external financing left the economy vulnerable to external shocks, which came in 2007/08 and, in the absence of corrective measures, brought economic crisis. To reduce the economy's vulnerability to shocks and avoid repetition of the crisis, stepping up domestic revenue mobilization was recognized as critical.

28. To meet the ambitious revenue target, the Ministry of Finance returned to many of the comprehensive reforms of both tax policy and administration initially envisioned in the FBR's 2003 strategy document. But the crisis also precipitated con-

¹¹ Pakistan Joint IDA-IMF Staff Advisory Note on the Second Poverty Reduction Strategy Paper (PRSP-II), Report No. 47352-PK includes the Government's PRSP-II.

sideration of more accelerated tax policy actions such as the quick implementation of a broad-based value-added tax (VAT) on goods and services, which the Government committed to roll out by July 2010. The VAT was seen as the key tax policy measure to expand tax revenues. At the same time, there was recognition that tax policy measures alone would not be sufficient, but would need to be complemented with more robust tax administration reforms.

29. **Government's intention to introduce VAT made the reform of the FBR along functional lines particularly urgent** to make sure the new tax would be effectively administered. Facing these pressures, a new, reform-minded Minister of Finance pushed to reinvigorate the reorganization of tax administration and sought enhanced TA and support from the World Bank, IMF and other development partners to work with the FBR management to achieve demonstrable progress. In September 2008, the Minister of Finance requested the World Bank to support a TA team of international tax administration experts outside the framework of the TARP to work directly with the senior FBR management to support tax administration reforms. The team carried out an assessment of Pakistan's tax administration and recommended a set of options for consideration by the FBR management. In mid-September 2008, as the assessment was being carried out, the Ministry of Finance stated in a working draft of its Stabilization Program that, "The Government plans to use the ongoing review of the FBR, with World Bank assistance, to modernize the tax administration and bring it to high international standards."

30. In late October 2008, the Government committed, in the context of the IMF-supported SBA, to integrating both the income and sales tax administration and reorganizing the FBR along functional lines. In January 2009, to fulfill the SBA structural benchmark, the FBR prepared a brief action plan for tax administration and policy reform in which it indicated its intention to complete the administrative integration by end 2009. This intent was reflected in later IMF Staff Reports.

31. The Government's efforts to increase revenue mobilization through more robust tax administration reform were **also included in the prior actions of the single-tranche Development Policy Credit, Pakistan Poverty Reduction and Economic Support Operation (PRESO)** (Report No. 46685-PK, March 2, 2009). The operation supported the implementation of the subset of PRSP-II focusing specifically on structural reforms to regain macroeconomic stability. The prior action on tax administration reflected the Government's decision to introduce a new organizational chart for the FBR in which new functional areas were established across all domestic taxes and corresponding changes in the FBR's top management were made to create a new Member Inland Revenue to replace the two positions of Member Sales Tax and Member Direct Taxes. Though this changed management responsibilities to ensure a single reporting line through the RTOs and LTUs, the action itself did not entail the merging of the existing occupational groups, which had not been discussed with the World Bank during the preparation of PRESO.

32. **After the PRESO had already been approved and the funds released, the FBR, consistent with its January 2009 action plan, accelerated the move towards a new functionally-based structure.** On April 30, 2009 the FBR issued vide C.No. 3(12)ST-LNP/09 announcing an administrative merger of sales, income and excise taxes

in the Lahore LTU. The FBR planned to issue notifications for integration of functions in the Karachi and Islamabad LTUs and all RTOs later in the year.

33. On May 13, 2009, in response to a legal challenge in the Islamabad High Court to the administrative methods for merging income, sales, and excise taxes in the Lahore LTU, **the FBR reversed its decisions regarding the reorganization.** This included also the January 2009 appointment of Member Inland Revenue and the abolition of the positions of Member Sales Tax and Member Direct Taxes, thus reversing part of the PRESO prior action.

34. On May 18, 2009, a new Chairman of the FBR was appointed. The following day, the Secretary, Finance Division of the Ministry of Finance was also appointed as Secretary, Revenue Division, expanding his existing responsibilities. **The new team emphasized that the Government was committed to restarting the reorganization of the FBR along functional lines, but recognized that further consultation was needed** with FBR staff as well as with the Establishment Division and Law Division to ensure that the administrative aspects of this reorganization were implemented in accordance with Pakistan's laws and administrative procedures and provided fair and equitable treatment to all FBR staff. The Minister of Finance and the FBR Chairman immediately held discussions on May 21, 2009 with a Delegation of the Association of Customs and Excise Officers.

35. In June 2009, the **FBR Chairman invited representatives of the Association of Customs and Excise Officers and the Association of Income Tax Officers to a full day of consultations on the proposed institutional reforms.** Members of both the TARP team and the TA team of tax experts were also invited to participate by the FBR and the Ministry of Finance; they were asked to present various reform options based on international experience. At that meeting, the new FBR management reiterated its intention to merge all domestic taxes and presented a plan to establish a new occupational group to support this merger. The consultations lasted from early morning until late into the night and were clearly quite contentious, as might be expected from any proposal to change established civil service positions, status, and routines. Staff especially raised concerns about career paths and mobility. In addition, discussion focused on the number of management positions that would be allocated to Customs and Excise officers and Income Tax officers as a result of reorganization. Based on the feedback received, the FBR revised its proposed new organizational chart to accommodate both groups.

36. On the basis of these consultations and in collaboration with the Establishment Division and Law Division, **the FBR formulated a new plan in June 2009 for the merger of the existing occupational groups within the FBR through the creation of an IRS.** This was the first time that the creation of a new occupational group had been proposed by the FBR as the most appropriate administrative means according to Pakistan law and civil service guidelines for implementing the integration of sales, income and excise taxes. The new plan and a timetable for implementation were presented to the World Bank during consultations in June 2009. As the proposed reorganization had important implications for the TARP, PRESO and the IMF SBA—all of which supported the broader objective of reorganizing tax administration along functional lines—the out-

lines of the plan were documented in a memorandum. Further discussions with representatives of the World Bank and the IMF were held on July 10, 2009 in the context of the second review of the IMF-supported SBA in Istanbul and the reform timeline adjusted. The FBR's new reorganization plan was again documented in a memorandum, to ensure a shared understanding of the Government's plan for the way forward, and was formally included in the IMF Staff Report.

37. By July 2009, **World Bank management was already beginning preparations for the closure of the TARP** as the scheduled end-date was December 31, 2009. Though the FBR had requested a two-year extension of the TARP on June 22, 2009, the World Bank, through a visit by the responsible Sector Manager to Islamabad in April 2009, had expressed concerns that an extension would not necessarily ensure that the project could meet its development objectives. The FBR had taken actions to address some of the World Bank's concerns with regards to the slow disbursement and weaknesses of project management, yet the World Bank team had made clear that slow progress on moving towards actual integration of functions across all domestic taxes was undermining progress in the implementation of new business processes and IT systems that were necessary to meet the overall objectives of increasing efficiency, reducing discretion and enhancing tax revenues. The FBR's proposal, presented in the June and July consultations, to integrate all domestic taxes through a merger of occupational groups represented a strong commitment to the long-delayed institutional reform agenda. As a result, the World Bank team recommended that an extension of the TARP might be warranted as the reorganization held out the promise that the development objectives initially agreed in the project could be met in an extended timeframe. World Bank management thus agreed that a restructuring and extension of the TARP would be considered if the FBR followed through on the reorganization plan outlined in the July 10, 2009 agreement. This was conveyed to the FBR management through a letter from the Pakistan Country Director on July 27, 2009.

38. The proposed restructuring would involve the following changes to improve the TARP's performance: (i) a reduction in the overall size of the project reflecting, among other things, the FBR's decision to develop IT systems in house; (ii) refocusing the project on the core reform measures, such as audit, enforcement, human resource management, adjustment of business processes; (iii) strengthening of project management; and (iv) enhancement of the monitoring framework with a set of performance indicators focused on project outcomes. The project's development objectives were also revisited to make them consistent with any modifications.

39. In summary, **many past attempts to increase tax revenues through tax policy reform have failed in Pakistan owing to the weakness of tax administration.** In response, the Government developed a comprehensive strategy for reform of the FBR during 2000-2003 through an extensive consultative process. The core building block of the strategy was to move the FBR from a type-of-tax to a functionally-based structure to enhance efficiency and transparency of tax administration, following best international practice. However, not much was done for years to realize this vision until the 2008/09 economic crisis, which made revenue generation urgent. The Government renewed its commitment to tax reform, including reorganization of the FBR, and this renewed drive

was reflected also in Government's PRSP-II and stabilization program. The Ministry of Finance sought the support of both the World Bank and the IMF for the tax reform. Since 2004, at the request of the Government, the World Bank has been supporting the implementation of Government's strategy for tax administration through various instruments, including the TARP.

IV. MANAGEMENT'S RESPONSE

40. **The Requesters' claims, accompanied by Management's detailed responses, are provided in Annex 1.**

41. **Management appreciates that the Requesters share a common vision with the FBR on tax reforms** with the "objectives of making the tax system more transparent, vibrant and taxpayer friendly." These have been the basic goals of the World Bank's engagement with the Government of Pakistan on tax policy and tax administration for over a decade.

42. **Management recognizes that the Requesters also appear to be in agreement with the basic approach of the FBR's institutional reform supported by the World Bank** to transform tax administration into a modern organization based on functional—as opposed to "type-of-tax"—lines, as stated in their Request for Inspection: "If these objectives can be achieved by merging the functions of all domestic taxes under one hierarchy, as was the original plan, we have always been ready for that...."

43. **The Requesters raise concerns about the merger of occupational groups,¹² not the merger of domestic taxes.** This refers to the administrative *means* to reach the *end* of a tax administration organized along functional lines and not the *end* itself. The Requesters claim that the administrative action of merging the occupational groups caused specific harm to the Customs and Excise officers as a group and to the economy as a whole, and was not based on consultation of those officers affected. As a result, the concerns of the Requesters relate more to civil service issues around the handling of the merger of occupational groups, than to the substantive issues of tax administration reform. On the basis of international experience, there are many different potential administrative paths to merging domestic taxes and reorganizing tax administration along functional lines. The path chosen needs to conform to the country's own laws, administrative procedures, and institutional culture. The Requesters have raised important issues that have been the focus of substantial attention from the FBR, Establishment Division, and the Law Division and have been reviewed by Pakistan's High Court. The World Bank recognizes the complexity of these issues and has supported efforts by the FBR to ensure fair and equitable treatment to all of its staff as a result of the reorganization.

¹² This response refers to the *merger of occupational groups*, even though in practice the merger was only *partial*. In addition to creating the IRS, the Government retained the Customs and Income Tax Groups in order to accommodate staff concerns and give them choice and flexibility. Each officer was given a choice to join the IRS and stay in the existing group; that is, joining the IRS was voluntary.

44. Management's response to these concerns is focused around the following four points:

45. **First, the FBR designed and implemented its own plan for the merger of occupational groups; the World Bank has supported the implementation of that plan.** The World Bank's entire engagement on tax administration in Pakistan has been based on the FBR's own 2003 comprehensive reform strategy which explicitly calls for the merger of all domestic taxes and the integration of tax administration along functional lines. Support for this goal has been incorporated into a number of World Bank lending and TA instruments and has been a consistent feature of the World Bank's policy dialogue in Pakistan. The specific reorganization plan to merge existing occupational groups into a newly established IRS was designed and initiated by the FBR in consultation with the Establishment Division and the Law Division as the most appropriate means to achieve the reorganization of tax administration along functional lines in the context of Pakistan law and civil service guidelines. Management emphasizes that this was the Government's plan, which the World Bank supported through its appropriate instruments.

46. **Second, while the World Bank continually stressed the importance of the merger of all domestic taxes, the TARP did not initially envision a merger of existing occupational groups.** Following the FBR's 2003 strategy, the TARP supported a gradual approach to the reorganization of tax administration, which envisioned a 5-7 year time frame for the eventual merger of all domestic taxes. After several years of implementation, neither the FBR nor the World Bank was fully satisfied with the results of the TARP. As pressures on revenue generation mounted in the face of economic crisis, the Ministry of Finance decided to pursue a more robust plan of organizational reform to fully integrate income, sales, and excise taxes through the establishment of the IRS and the voluntary merging of existing occupational groups. The World Bank believed that this new plan had increased the likelihood of meeting the project development objectives of the TARP and explicitly linked the further restructuring and extension of the TARP beyond its initial closing date of December 31, 2009 to the plan's successful implementation. Management believes that the creation of the IRS is not a deviation from the original design of the TARP, but will enhance the project's potential success in achieving its desired outcomes.

47. **Third, the FBR and the Establishment Division designed the merging of occupational groups to ensure fair and equitable treatment to all its officers** within the framework of Pakistan law and civil service procedures. While all civil service reorganizations inevitably entail disruptions to existing status, practices, and routines, Management believes that significant efforts were made by the FBR and Establishment Division to minimize harm to any specific group and the associated risks to the functioning of the taxation system.

48. **Fourth, the FBR and the World Bank team engaged in extensive consultations in the preparation and supervision of the TARP and the associated tax administration reforms.** The preparation of the TARP was based on a three year process, led by the FBR, of developing a strategic vision for tax administration reform, eventually ap-

proved by the President and integrated into Pakistan's PSRP-II, which incorporated consultations with a broad range of stakeholders. Regular supervision missions were held, including visits to RTOs, LTUs and customs facilities. The Task Team Leaders of the TARP were based in the Islamabad office ensuring frequent communication with the clients and other stakeholders. In addition to the TARP team, a specially commissioned group of tax administration experts conducted 6 missions to Islamabad within an 18 month period that included field visits as well as regular meetings with FBR Members representing all of the occupational groups. **The FBR led the specific consultations on the creation of the IRS and merger of the occupational groups as this was an internal administrative matter not directly supported through the TARP.**

A. The FBR's Reform Strategy

49. **Management welcomes the broad consensus in Pakistan on the need for fundamental tax reform to provide a sustainable foundation for development and independence from external aid.** Reorganization of tax administration along functional lines has been a key feature of the FBR's own strategy of reform since 2000. The roots of this strategy can be traced back to a specially commissioned *Task Force on Tax Administration* that began its consultations in 2000. That contributed to a *Strategic Framework Paper* in November 2001. Additional strategy documents were prepared by the Customs Wing and the Policy and Tax Reform Wing, along with a specially commissioned report by the consultancy Maxwell Stamp. All of these contributions fed into the FBR's *Pakistan Tax Administration Reform: Comprehensive Medium and Long Term Strategy* of May 2003. This comprehensive strategy provided the foundation for the design and development of the TARP.

50. **The 2003 strategy document set out a clear objective: "Restructuring the FBR into a modern functionally-based and integrated Revenue Authority"** (p. 11). As part of the FBR's new mission statement, the document states, "At the end of the reform process, the FBR will be a functionally structured organization with staff organized in functional groupings" (p. 13). The strategy recognizes that the existing "type-of-tax" organizational structure was undermining efficiency as a result of the duplication of cross-cutting services such as audit, collection, enforcement, and IT. The integration of different types of taxes was seen as significantly enhancing taxpayer services by providing a single point of access and simplified procedures, as well as reducing the points of contact between tax collectors and taxpayers to minimize the risks of discretion in the application of tax laws and procedures.

51. **From the very start, the FBR recognized the risks inherent in the process of institutional reform and advocated a gradual approach to implementation.** As clearly stated in its strategy document, "[R]ecognizing the challenges of the change process during the transitional period, the FBR will maintain the separation of function by tax type in the initial reform period with the aim of gradually reducing this through time" (p.19). In outlining the future structure of the organization, the FBR strategy makes clear that the three basic revenue streams (income, sales and excise taxes) will eventually report to the Chairman through a single Revenue Operations Member. The long term goal

is that the streams “will integrate fully into one stream organized by type of taxpayer” (p. 27). The 2003 strategy defines the “long term” as a 5-7 year period. It envisions the introduction of a new FBR functional structure in place by end 2007 along with approved staff reduction and staff rotation programs (p. 35). In its reform timeline, the FBR plans for the “merging of taxes” and “complete implementation of functional operation” by 2009 (p. 36).

52. *Management emphasizes that the design of the TARP closely followed the objectives, approach and timeframe of the FBR’s own comprehensive strategy, recognizing both the complexities and the risks of the proposed institutional reforms in the Pakistan context.*

53. **Following the FBR’s own strategy, the TARP Project Appraisal Document (PAD) envisions a phasing of the institutional reforms:** “The strategy is to restructure FBR along functional lines and have an integrated tax administration over the long term.... Merging of direct and sales tax will be phased over a realistic period considering legal, political, geographical, taxpayer type, and revenue implications” (p. 10).

54. **The TARP was designed to support three key components of the FBR’s institutional reform agenda:** (i) to redesign organization structures to promote co-location through consolidation of the fragmented office network for income tax and sales tax administration into RTOs and LTUs; (ii) to integrate as many business processes and support services as possible across all revenue administrations, and; (iii) to streamline the management structure at FBR headquarters to foster integration along functional lines.

55. **The TARP recognized that the “type-of-tax” organization needed to be maintained in the short term, while other institutional reforms were put into place.** However, it did recommend that *after 2007*, the separate management structures for administering income tax and sales tax should be abolished and “the separate functions of a Member Income Tax and Member Sales Tax would be merged into a ‘Taxation’ or ‘Revenue Functions’ function.”¹³ The TARP did not make any recommendations on *whether or how* to reorganize the civil service groups according to which the existing officers were organized, nor did it propose the creation of a new IRS. This reflects the fact that the merger of sales, income and excise taxes as well as the establishment of cross-cutting functions for all of these taxes did not necessarily require a merging of the existing occupational groups. Several other options were feasible. Individual officers could have been re-assigned different functions while retaining their existing affiliations in separate occupational groups. Alternatively, newly hired officers could have been recruited into a new merged service, while existing officers retained their original occupational groups. The most appropriate mechanism for handling the configuration of occupational groups under a new, functionally integrated tax administration was a civil service issue rather than a tax administration issue. As such, the TARP recognized from the start that the pace and

¹³ Pakistan Tax Administration Reform Project (TARP), Appraisal Mission, Aide Memoire, World Bank, May 2004.

ultimate shape of such reforms would be set by the Government's consideration of what was feasible in light of Pakistan's civil service guidelines and procedures.

56. **The gradual approach set out in the Government's own strategy and in the TARP was based on a clear recognition of the inherent risks and complexities of institutional reform in the Pakistan context.** The TARP PAD was very explicit about those risks: "The project is classified as 'substantial risk'. Reforming FBR involves challenging various vested interests which have existed for decades and have a strong hold in the political and bureaucratic circles. However, if FBR is able to capitalize on the government's commitment to reform as well as the momentum generated through its own short term measures, it can quickly move forward with the broader reforms before any vested interests creep in to slow down the process."¹⁴

57. *Management emphasizes that reform of tax administration in Pakistan has been based on a clearly articulated strategy by the FBR to gradually shift towards a modern, integrated and functionally-based institution. The TARP was explicitly designed to support that strategy and closely followed the FBR's overall approach to the reform and its stated timeframe. The key risks to the reform process were recognized and the gradual approach was recommended to mitigate those risks.*

B. A New Urgency for Tax Reform: The Establishment of the IRS

58. By 2008, the continued weaknesses in Pakistan's revenue collection performance coupled with the mounting fiscal pressures resulting from the domestic economic and global financial crisis led **the Ministry of Finance to assign greater urgency to tax administration reform.** By that time, though the TARP had achieved some notable successes, neither the FBR nor World Bank management were satisfied with the progress of the TARP in achieving its stated development objectives as emphasized in the regular TARP supervision reports and associated Aide Memoires to the Government of Pakistan. The Ministry of Finance and in particular a new, reform-minded Minister of Finance sought a more robust approach to implementation of the tax administration reform.

59. **The Minister of Finance requested the services of a team of internationally recognized tax administration experts to work directly with the senior FBR management** on the implementation of necessary reforms (see Annex 2 for the Terms of Reference for the TA work). In September 2008, the TA team carried out an assessment of Pakistan's tax administration reforms to date. Among other things, the assessment highlighted that while the "general move towards a functional organization structure" had begun, "the more difficult elements like full organizational integration of sales and income taxes ... are yet to be started."¹⁵ The assessment suggested that co-location had not yet led to a genuine integration along functional lines preventing the FBR from achieving

¹⁴ Project Appraisal Document for the Tax Administration Reform Project, World Bank, November 5, 2004, p.34.

¹⁵ "Pakistan: A Tax Administration Review," World Bank, September 2008.

the efficiency gains that were promised from integrated business processes and systems, in particular newly installed IT systems in RTOs and LTUs. The TA team recommended the “full merger” of sales and income tax consistent with what had originally been envisioned in the 2003 FBR strategy document.

60. **The recommendations of the TA team were consistent with the earlier observations of the TARP team.** In its September 2007 supervision mission, the team noted that although sales tax and income tax officials were working under one Director General in each RTO or an LTU, in practice there were some operational issues between the two services, which would only get resolved once the two services were fully integrated. The project team recommended that serious efforts be made to integrate sales tax and income tax functions at the LTUs and RTOs through changes at the top management level, namely by creating a single Member of the FBR Board responsible for supervising all domestic taxes and overseeing the LTUs and RTOs.

61. Though the World Bank consistently emphasized the importance of achieving progress in merging sales, income and excise taxes and introducing new management structures to cover cross-cutting functions, it was **the FBR that proposed the merging of existing occupational groups and the creation of the IRS as the most appropriate administrative means of achieving these objectives** in accordance with Pakistan law and civil service procedures. Spurred by the renewed momentum to achieve demonstrable progress in tax revenue collection, the FBR launched a series of administrative actions from January through September 2009 that ultimately resulted in the establishment of the IRS. The World Bank fully supported these actions, integrated them into the ongoing lending (TARP and PRESO) and TA instruments, and reflected these actions in its agreements with the FBR and the Ministry of Finance.

62. **In January 2009, the FBR launched the first organizational change towards a shift to an integrated functionally-based organization.** The top management of the FBR headquarters was restructured, creating a new position of Member Inland Revenue to replace the two positions of Member Sales Tax and Member Direct Taxes. This, in effect, created one management structure at FBR headquarters for supervising all domestic taxes through RTOs and LTUs. At end-April 2009, the FBR also issued a notice re-allocating responsibilities for collecting sales, income and excise taxes between the Customs and Excise Group and the Income Tax Group, and shifting officers to reflect the re-allocation in the Lahore LTU.

63. **The World Bank welcomed the renewed momentum in the reorganization of tax administration reflected in these decisions.** At the same time, the World Bank team noted that concerns had been raised about *how* to achieve this integration of domestic tax administration. In April 2009, the TARP team commended the acceleration in the implementation of the TARP and reform processes over the past year. While the administrative merger of the two civil service groups was consistent with the expressed long-term strategy to ultimately have a full merger of sales and income tax, the mission noted that career development of this integrated stream was still a source of concern for some staff. The World Bank did not recommend a specific administrative course of action, but called for

effective human resource planning and outlining a career path in conjunction with the Establishment Division so that staff concerns could be effectively addressed.

64. **By mid-May 2009, the FBR had reversed its decisions taken during the previous four months on the reorganization** in response to a legal challenge by individual Customs and Excise officers in the Islamabad High Court. At the same time, a new leadership team was appointed at the FBR and at the Revenue Division of the Ministry of Finance. The new team launched a more extensive and systematic process of consultation within the FBR as well as with the Establishment Division and Law Division to plan an administrative reorganization of the FBR in accordance with Pakistan law and civil service procedures (see Annex 9 for a list of formal meetings/consultations held by the FBR Chairman with officers). The World Bank did not participate in the discussions with the Establishment and Law Divisions. In June 2009, the FBR presented to the World Bank a new reorganization plan centered around the creation of an IRS and the provision of voluntary options for all officers of the Customs and Excise Group and the Income Tax Group to join the IRS or remain in their existing groups. Further discussions on the plan with the World Bank and IMF were held in July 2009 in Istanbul as part of the Second Review of the IMF SBA.

65. The reinvigorated commitment to the reform agenda by the Ministry of Finance and the new FBR management and the clear reorganization plans presented in the June and July consultations held out the promise that **the institutional integration so critical to the successful implementation of the TARP was resuming its course**. Though Management had already begun preparations for the closure of the TARP at the scheduled end-date of December 31, 2009, the actions proposed by the FBR were seen as a positive step towards achieving the original development objectives agreed in the project. As a result, World Bank management agreed to link the possible restructuring and extension of the TARP beyond the original closing date to the implementation of the FBR's reorganization plan outlined in the July 10, 2009 agreement. This was conveyed to the FBR management through a letter by the Country Director on July 27, 2009 (see Annex 10).

66. **Though the establishment of the IRS was not included as part of the original TARP Implementation Plan, nor was it directly financed through TARP investments, it was consistent with the overall development objectives of the project** and was seen by the World Bank as an indication of the commitment by the Ministry of Finance and above all by the FBR to accelerating its own strategy of institutional reform in the face of increasingly challenging fiscal constraints. The World Bank welcomed the FBR's renewed commitment to its own long-term institutional reform goals and reflected the FBR's own reorganization plans in the proposed restructuring and extension of the TARP.

67. *Management contends that the decision to merge all direct taxes in a new IRS was not a "deviation from the original action plan of TARP" as claimed by the Requesters. It was consistent with the FBR's own long-term comprehensive strategy and nearly 10 year process of reforms at the FBR. It followed as a natural progression from the gradual reform efforts—including co-location, re-engineering of business processes and creation of*

common functions across all services—implemented under the TARP. It responded to the limited results in terms of increasing revenue generation under the TARP in the face of mounting revenue pressures from the domestic economic and global financial crisis. The FBR designed the reorganization plan in conjunction with the Establishment Division and Legal Division within the framework of Pakistan law and civil service procedures. The World Bank fully supported the FBR’s plan as part of its long-term engagement on tax administration reform, and linked the TARP extension to consistent implementation of this plan.

C. Fair and Equitable Treatment: The Design and Implementation of the IRS

68. From the very beginning, the TARP documents explicitly recognized the risks to the FBR’s institutional reform agenda associated with potential “**staff resistance to change.**” (PAD, p. 35). The PAD stressed the importance of providing “assurances to staff at all levels of fair and equitable treatment during implementation through change management leadership... In addition, there need to be mechanisms built into the reform program which would gather feedback during implementation to incorporate lessons and ensure continued support from the stakeholders.”

69. A July 2009 mission of the TA team also acknowledged **the potentially negative impacts of internal discord as a result of the FBR’s proposed reorganization** and recommended that changes in the HR policies required careful implementation and would take a significant amount of time. The project team also noted that this was an area that required thoughtful analysis and decisions made taking due consideration of pre-existing rights, in order to avoid unnecessary litigation and to provide sustainability to the reforms.

70. Following the FBR’s consultations in June and July 2009, the leadership proceeded to develop an implementation plan with the Establishment Division and the Legal Division for the creation of the IRS and merger of the two administrative services that would **ensure a fair and equitable treatment to all staff.** These efforts resulted in the FBR’s Office Order No. 9(3)/2009-M.I and the Establishment Division's Office Memorandum No.F.6/2/2009- CP.II which set out the following principles:

- Each officer has the option, but not the obligation to join the new service and, as a result, the integration of the services is strictly voluntary;
- Neither the Customs Group nor the Income Tax Group have been abolished as a viable career path for officials who choose to remain in those groups and not join the IRS;
- All officers joining the new IRS or remaining in their existing groups retain seniority as determined by the dates of joining their respective groups;
- The terms and conditions of employment, compensation, appraisal, mobility, and promotion of all officers—both IRS and Customs—are covered by the same civil service rules as enshrined in the Civil Service Act of 1972, which continue to apply;

- A special committee has been established to settle any service disputes in conjunction with the creation of the IRS and transfers from the existing service groups;
- Horizontal mobility across the administration is not blocked as the FBR management can assign staff to other functions at their request.

71. In addition, as a result of reorganization, **the share of senior FBR management positions held by Customs and Excise officers increased.** Six FBR Board members were chosen from the Customs and Excise group (with 542 officers), while five members are from the former Income Tax group (with 977 officers). Thus, relative to the size of the group, Customs officers had a higher level of representation in senior management as a result of the reorganization.

72. Most importantly, the FBR decided that **the reorganization and the establishment of the IRS would not entail any staff redundancies** among the service groups. This was a significant change from the original 2003 comprehensive strategy which called for a “staff reduction program” as part of the overall reorganization.

73. *Management recognizes that all changes in civil service organization engender legitimate concerns about career prospects, status, prestige, and the impact on established routines. However, Management acknowledges the substantial efforts made by the FBR and Establishment Division to ensure fair and equitable treatment of FBR staff in the reform process and to mitigate potential harm to any specific group. Management underscores that there have been no financial losses that might have been associated with redundancies. There has been no loss of formal status as existing seniority levels have been protected. There remain substantial prospects for promotion and mobility both within the IRS and within the original service groupings and officers are free to choose which career path offers the most promising opportunities. Though integration may have increased the number of potential candidates for each available merit-based promotion opportunity, it has not limited the overall stock of senior positions.*

74. **Clearly, officers of the Income Tax Group have found the IRS a more attractive option than the officers of the Customs and Excise Group.** As of January 19, 2010, while 920 out of 977 Income Tax officers voluntarily transferred to the IRS, only 57 out of 542 Customs and Excise Officers chose to make the transfer. While this might reflect issues of status and prestige as suggested by the Requesters, there are other reasons for the imbalance. The merger of sales, income and excise taxes did not necessarily affect the collection of customs duties and there remains considerable demand for officers with specialized skills in the customs area. Moreover, the issues of status and prestige are also quite complex. Of the 57 Customs and Excise officers that made the transfer, 22 were at the comparatively senior level of Grade 20 (out of 21 ascending Civil Service grades). **Thus, not all officers at the senior ranks of the Customs and Excise Group have seen the IRS as a loss of status or prestige.** *While there has been a clear imbalance of views with regards to the IRS between the two existing occupational groups, Management would question whether the “entire work force” was opposed to the IRS as claimed in the Request.*

D. The Legal Challenges

75. **Management is mindful of the legal challenges filed against the establishment of the IRS by individuals and groups of Customs and Excise officers, and is closely monitoring the development of events on that front.** In this respect, Management has taken note of the January 7, 2010 and January 27, 2010 rulings of the Lahore High Court which dismissed several writ petitions of the Customs and Excise officers. See Annex 4 for a copy of these rulings.

76. In its January 7, 2010 ruling, the Lahore High Court dismissed the writ filed by the Customs and Excise officers on jurisdictional grounds, sustaining that any dispute related to the “terms and conditions” of service of the petitioners were the exclusive jurisdiction of the Federal Services Tribunal.

77. In its January 27, 2010 judgment, the Lahore High Court went even further and, ruling on the merits of the case, stated that **“the merger of Sales Tax, Federal Excise or the Income Tax into one group, i.e. IRS, does not in any way reflect anything contrary to the fundamental rights of the petitioners** or derogatory to the settled principles in that respect. The only visible impression behind such exercise appears to bring different organs of tax collecting agencies into one, which exercise apparently would benefit the taxpayers and would ultimately result in widening the tax net.”

78. Management also notes that in both rulings, **the Lahore High Court challenged the arguments raised by the Customs and Excise officers in their complaints.**

79. First, in terms of the grievance that “sales tax has been transferred from their sphere of responsibility and placed in the care and control of the newly-constituted Inland Revenue Service...**the petitioners did not put forward any convincing argument to support their right to retain the sales tax business.**” The High Court concurred with the FBR’s proposition that “the Federal Government has the absolute right to review the arrangements from time to time as may be in the interest of sales tax.” Moreover, the Court admitted that “to maintain a department, create a new one, or merge any department into some other, was/is always a policy matter to be taken by the executive or the legislature, keeping in view the surrounding circumstances, as after all it is their primary function, rather duty, to make the Government effectively run and in doing so they definitely are within their right to make equilibrium amongst the departments.”

80. Second, **the High Court also underscored that the transfer of the Customs and Excise officers to the IRS was made on a voluntary basis.** It emphasized that, “[i]n the present case, no question of re-allocation is involved as neither the petitioners are seeking re-allocation to another service nor are the respondents [FBR] forcing the petitioners to join another service but are only giving them the option to do so which they are free to accept or reject.” This earlier statement of the Court was again confirmed in its ruling of January 27, 2010 whereby the Court acknowledged that “in any eventuality, the option [to join the IRS] was not at all compulsory for the petitioners or others. Either they opt or abstain, their future service was not at all being affected by mere creation of the

Inland Revenue Service and even the persons giving their option, would retain their actual *inter-se* seniority. **In this view of the matter, hardly any grievance is left with the petitioners, if at all they ever had.**”

81. Third, **the Court also questioned the grievance alleged by the Customs and Excise officers that the creation of the IRS would affect their vested rights, as it would imply fewer posts available in their group and thereby jeopardize their prospects of promotion.** In its ruling of January 7, 2010, the Court cited precedents that “provide authority for the proposition that consequent upon re-organization or restructuring of services the prospects of promotion, being far-fetched, cannot be raised as a grievance in constitutional jurisdiction.”

82. In its judgment of January 27, 2010 the Court ventured even further and argued that, in view of the reassurance provided by the representatives of the FBR that by creating the IRS, “the future promotion prospect of the petitioner or other similarly placed employees would not be affected and [...] that for future promotion mechanism/Promotion Policy as in vogue at the present, would remain the same as is being adopted for other occupational groups, and there would be no separate policy after creation of the Inland Revenue Service,” the petitioners **“had no such enforceable vested rights and further, if at all they have, in view of the above explicit statement, the same were not being infringed through the impugned Office Memorandum or office orders [establishing the IRS].”**

83. Lastly, **the Court questioned the claim of the Customs and Excise officers with regards to the negative impact of the reforms on the national economy of Pakistan.** The Court stated that the contention “that by creation of Inland Revenue Service and merger of the other wings in this new group would adversely affect the tax collection, is merely an apprehension with no basis thereto and furthermore there is no cavil to the proposition that no writ can be issued on mere apprehensions or to block future eventualities.”

84. *Management notes that the contentions of the Requesters that the creation of the IRS contravened the Constitution of Pakistan and related administrative statutes and that “the advice given to Government of Pakistan by people working for the World Bank has caused violation of the law of the land” have not been supported by Pakistan’s national courts. Management will continue to follow closely the pending petition on this matter before the Sindh High Court.*¹⁶

E. Impact on the National Economy

85. *Management regrets that both the internal divisions sparked by the administrative merger of the two services and the numerous legal challenges have caused disruptions*

¹⁶ The World Bank is not aware of the pending case in Sindh; and, to the knowledge of Management, no challenge was filed with the Federal Service Tribunal (as suggested by the ruling of January 7, 2010 of the Lahore High Court).

within the FBR with potential implications for the standards and quality of service delivery to Pakistan's taxpayers. However, Management suggests that the claim that the TARP has thus caused harm to the national economy of Pakistan is not supported by the empirical evidence.

86. Though the growth in FBR tax revenue in nominal rupee terms has slowed in the past 18 months and contracted as a share of GDP, this **can be attributed to the sharp overall slowdown in economic activity and trade as a result of Pakistan's economic crisis** and the global financial crisis, as shown in Annex 5. Specifically, the significant contraction of the large scale manufacturing sector (the single most important driver of tax revenues), which has led to a decline in corporate sector earnings and a sharp deceleration of imports, has translated into reduced tax collection. This cannot be attributed to the merger of the occupational groups.

87. While the Customs and Excise Group is popular among the new civil service entrants, **Management questions whether this is related to the fact that it has performed better than the Income Tax Group on tax collection.** The share of revenues from customs duties, federal excise tax and general sales tax—that is, taxes the Customs and Excise Group used to administer—account together for about 60 percent of total FBR tax collection at the moment. However, this large share in total tax revenues does not necessarily reflect superior performance of the Customs and Excise Group, but simply Pakistan's tax structure. The general sales tax is the main source of revenue in Pakistan's tax system, accounting for about 40 percent of total FBR tax revenues. At the same time, it has been conspicuously under-performing relative to its potential.¹⁷ Therefore, the Government of Pakistan is planning to replace it with a broad-based VAT. Also, as Annex 5 shows, the combined share of collection of customs duties, general sales tax and federal excise taxes in total FBR revenues has declined from 69 percent in 2004/05 to 62 percent in 2008/09. The share of customs duties in total FBR revenues has steadily declined since 2004/05. By contrast, the share of income taxes (direct taxes), which are the second largest revenue generator, has increased from 31 percent in 2004/05 to 38 percent in 2008/09.

F. Consultations and Communication

88. **Management reiterates that the key to minimizing disruptions that could result from the ambitious institutional reform undertaken by the FBR is effective consultation and communication.** Management notes that this is consistent with the recommendations of both the TARP and the TA program of support to the FBR.

89. As stated in the TARP PAD, **the World Bank advised the FBR to engage in effective change management leadership and to build mechanisms into the reform program “which would gather feedback during implementation** to incorporate lessons and ensure continued support from the stakeholders” (p. 36). In 2007/08, an HR Consultant and a Management Development Consultant were hired to, among other tasks,

¹⁷ Pakistan Tax Policy Report, Tapping Tax Bases for Development, Report no. 50078-PK, World Bank, 2009.

conduct change management workshops on various components of TARP-financed reforms. A “train the trainers” workshop on change management for senior FBR officials was conducted in October 2007.

90. In July 2009, the TA team also recommended that the **FBR management develop and execute a communications plan to address technical and organizational issues regarding the new administrative structure** and to clarify misconceptions of staff of LTUs and RTOs about changes and receive feedback from them to improve the process. The mission proposed the development of an HR management strategy and the establishment of a new position, Director General Human Resources, to handle the significant HR actions required to effectively institute the new administrative structure.

91. *Management underscores that the preparation and implementation of the TARP have involved extensive consultations according to the requirements of the World Bank’s operational policies.*

92. **The consultations to support the World Bank’s engagement on tax administration reform began as early as 2000** and were bolstered initially by a \$0.5 million Institutional Development Fund Grant and then, as the TARP came into the operational pipeline, a \$2.9 million Project Preparation Facility in 2002. As a result, the preparation of the TARP was built upon a series of strategic inputs, several of which including extensive consultation with stakeholders, including:¹⁸

- A specially commissioned 11 member Task Force on Tax Administration whose April 2001 report, *Reform of Tax Administration in Pakistan*, was prepared on the basis of extensive consultations within the FBR and the Ministry of Finance as well as with the Institute of Chartered Accountants, Pakistan Tax Bar Association, the Chambers of Commerce of Karachi and Lahore, the Overseas Chamber of Commerce, and the Lahore University of Management Sciences;
- A *Strategic Framework Paper* produced by the FBR management in November 2001 which built on the above Task Force Report and consultations held during its preparation. In addition, the FBR held a conference towards the end of 2001 in which all FBR commissioners and collectors participated, representing all taxes

¹⁸ A May 14, 2008 Quality Enhancement Review of TARP suggested that many of the strategic inputs into the preparation of TARP were done by consultants without sufficient consultation with FBR staff and other stakeholders. This would appear to refer primarily to the Maxwell Stamp Report cited below, which was commissioned by the FBR but prepared by consultants. Though recommendations of the Maxwell Stamp report were used by the FBR as the basis for its 2003 strategy, *Pakistan Tax Administration Reform: Comprehensive Medium and Long Term Strategy*, there were also a wide range of other inputs into that strategy document including policy papers prepared directly by the Customs Wing and Income Tax Wing. In addition, the Task Force that launched much of the strategic work on tax administration reform, and which fed into the 2003 comprehensive strategy, included a very broad range of consultations over more than a year that does not appear to be recognized in the QER report. Also, the Strategic Framework Paper prepared by the FBR management on 2001 and which was an input into the 2003 comprehensive strategy, had involved separate consultations with the FBR staff.

and all members, and where the key elements of the strategy were finalized after significant deliberations;

- A *Vision for Customs* produced by the Customs Wing of the FBR in 2002;
- A report on the *Reorganization of Income Tax*, prepared by the Policy and Tax Reform Wing in September 2002;
- A report prepared by a team of Customs officers in 2002 recommending changes in Customs procedures and business organization entitled, *CARP – The Vision*;
- A report by Maxwell Stamp, entitled, *Draft Tax Administration Reform Strategy Document*, commissioned by the FBR and the World Bank in 2003;
- The above inputs were integrated by the FBR management into a strategy document in May 2003, *Pakistan Tax Administration Reform: Comprehensive Medium and Long Term Strategy*, which was extensively discussed across all departments of the FBR and became the basis for the TARP PAD.

93. *Management believes that these strategic documents, some of which were produced by the stakeholders themselves and financed as part of the World Bank’s policy dialogue and project preparation process, are evidence that the World Bank team did take into account the “voice and concerns” of Customs and Excise officers in designing the TARP and the World Bank’s other forms of assistance in this area.*

94. As regards supervision, **Management believes that the TARP team supervised the project according to the requirements of OP/BP 13.05.** Since the start of the TARP in April 2005, five formal supervision missions have been undertaken and 10 Implementation Supervision Reports have been filed. The number of formal supervision missions has been somewhat less than the World Bank norm of two per year because the Task Team Leaders of the project were both stationed in Islamabad until recently and maintained daily contact with the clients and other stakeholders. Each formal supervision mission included meetings with the top management of the FBR (Chairman and Members of the Board), followed by individual meetings with the Members and their teams. The supervision missions also included site visits to 4 RTOs, 3 MTUs, 2 LTUs, 5 Customs facilities and the Karachi International Container Terminal, where World Bank teams held discussions with a wide range of staff. The mission Aide Memoires list the principal people met. Beyond the FBR, the missions have met with representatives of the Federal and Provincial Chambers of Commerce and Industry, tax lawyers, government agencies and the Ministry of Finance. A list of supervision mission meeting schedules is provided in Annex 6. Management believes that these supervision missions, all of which included meetings with the Member Customs and other representatives of the Customs service in Islamabad and regional offices, provided ample opportunities for representatives of Customs and Excise officers to express their views and concerns to the World Bank team.

95. In addition, **the TA team of tax administration experts has conducted 6 missions to Pakistan since 2008.** During each of these missions, the experts held discussions with top management of the FBR (Chairman and Members of the Board) and individual Members of the relevant units and their teams. The missions also visited RTUs and LTOs

in Karachi, Lahore and Islamabad. Annex 7 provides the mission schedules of the TA team.

96. Management notes that **the FBR took the decision to establish the IRS and merge the two administrative services and, therefore, the FBR has taken the lead in consulting with the stakeholders on the implications of those decisions.** As described above, the new leadership of the FBR held discussions with representatives of the Association of Customs Officers on preparations to establish the IRS shortly after its appointment. The FBR convened one day consultations in June 2009 with representatives of both Associations of Customs and Excise and Income Tax Officers prior to the promulgation of the Office Memorandum of September 2009 creating the IRS (see Annex 8 for a list of participants from both Associations). World Bank staff were invited to participate, specifically to provide information about international experience and practices, and were privy to the concerns expressed by representatives of the participating service groups. In addition, the FBR Chairman addressed the Customs and Excise Officers in Islamabad, Karachi and Lahore during the course of July 2009 to present and discuss the FBR's reorganization plan prior to the promulgation of the reform. Annex 9 provides a list of formal meetings/consultations held with officers of the Customs and Excise Group and the Income Tax Group.

97. Though the issues discussed in these meetings were clearly contentious among certain groups of officers, **the FBR and the Establishment Division sought to incorporate their concerns about management positions, the retention of seniority, and promotion and mobility prospects into the final design of the reorganization.** The World Bank emphasized in its recommendations to the FBR that effective change management efforts would be essential to the successful implementation of the reorganization.

98. Beyond the issue of consultations, the Requesters refer to two concerns regarding the World Bank staff's conduct of communications: 1) that World Bank staff did not respond to a series of e-mails by Customs and Excise officers raising concerns about the administrative merger; and 2) that the World Bank staff disrespected Parliamentary sovereignty in a communication on reform strategies. Management responds to each of these claims in turn:

99. **Management acknowledges that a series of e-mail messages were sent to various members of the World Bank staff** beginning in October 2009, including some that were unsigned and others claiming to represent "All Officers of Customs and Excise Group of Pakistan." The e-mails did not appear to emanate from the Association of Customs and Excise Officers which had represented the group in the official consultations in June 2009, nor was any official correspondence received on behalf of that Association. The e-mails contained personal attacks on named individuals within the FBR management.

100. Management is informed that World Bank staff did not respond to these messages for the following reasons:

- As the matters raised in the e-mails were under jurisdiction in the Pakistan courts, the World Bank staff did not believe it would be appropriate to respond on the substance of the matter as this could be seen as interference in an ongoing domestic legal process;
- As the World Bank had been in communication with the Association of the Customs and Excise Officers, staff did not believe that the e-mails were representative of the officers as a group as claimed by the senders;
- Some e-mails contained unprofessional remarks about specific FBR officials leading staff to believe that the e-mails represented intra-organization or personal rivalries that would be inappropriate for the World Bank to comment on.

101. *Management recognizes that the World Bank staff made an error in not acknowledging receipt of the e-mails as the responses could have been handled in an appropriate manner respecting the ongoing legal process. Management regrets this error and has provided appropriate instruction to the relevant teams on proper guidelines for responding to such external requests. However, Management notes that the World Bank staff did meet with representatives of the Association of Customs and Excise Officers as part of the FBR's consultations on the establishment of the IRS and subsequently incorporated concerns raised by the Customs Officers in the World Bank's communications with the FBR.*

102. Management also acknowledges that a mission report of October 19, 2009, prepared by a team of World Bank-funded tax administration consultants contained a regrettable reference to the legislative process in Pakistan, as follows:¹⁹

“A second option may be to send the package of legal reforms to Parliament, or include them as part of the budget submission for the next fiscal year. This will significantly delay the implementation of the harmonized procedures, but more importantly, may be subject to changes in Parliament that might bring undesired consequences.”

103. Management recognizes that this was a failure of oversight by the World Bank not to adequately vet the document prepared by the consultants. Alerted to the issue by press reports of the document on November 1, 2009, *Management unequivocally recognized the error and communicated this to the Government of Pakistan.* On November 5, 2009, the Country Director Yusupha Crookes sent a letter to Pakistan's Ministry of Finance stating (see Annex 10):

“With respect to the regrettable phrase in reference to parliamentary procedures in the report of the Bank mission, we unreservedly withdraw the implications in this language. I would like to emphasize our highest regard and respect for Pakistan's

¹⁹ However, it is important to note that the Aide-Memoire reference was not related to creation of the IRS, which was effected through FBR's Office Order No. 9(3)/2009-M.I and the Establishment Division's Office Memorandum No.F.6/2/2009- CP.II, but referred to the amendment of tax legislation.

democratic processes, constitutional arrangements and the sovereignty of Parliament and independence of the judiciary.”

104. *Management notes that, following this error, stricter management review and clearance of subsequent mission reports of the tax administration TA team were put into place.*

G. Conclusion

105. **Though Management recognizes that staff and consultants did make some misjudgments in communication, Management does believe that the World Bank has properly applied its policies and procedures and pursued concretely its mission statement in the context of the project.** In Management’s view, the World Bank has followed the guidelines, policies and procedures applicable to the matters raised by the Request. As a result, Management believes that the Requesters’ rights or interests have not been, nor will they be, directly and adversely affected by a failure of the World Bank to implement its policies and procedures.

ANNEX 1
CLAIMS AND RESPONSES

No.	Claim	Response
	OMS 2.20, Project Appraisal	
1.	<p>We are aggrieved by certain aspects of this Project that have caused harm not only to us as a Group but to the national economy of Pakistan as well and is likely to cause further damage if remedial measures are not undertaken by the World Bank.</p>	<p>Management recognizes the substantial efforts made by the FBR and Establishment Division to ensure fair and equitable treatment of FBR staff in the merger of administrative groups and to mitigate potential harm to any specific group. Management underscores the following aspects of the reorganization plan:</p> <ul style="list-style-type: none"> • Each Customs officer has the option, but not the obligation to join the new service and, as a result, the integration of the services is strictly voluntary; • The Customs Service has not been abolished as a viable career path for officials who choose to remain in that group, though their responsibilities have been focused on the collection of customs duties as per international best practice; • The reorganization of the FBR along functional lines and the establishment of the IRS have not entailed any staff redundancies among Customs officers or the other service groups; • All officers joining the new IRS or remaining in their existing groups retain the seniority as determined by the dates of joining their respective groups; • The terms and conditions of employment, compensation, appraisal, mobility, and promotion of all officers--both IRS and Customs—are covered by the same civil service rules as enshrined in the Civil Service Act of 1972, which continue to apply; • A special committee has been established to settle any service disputes in conjunction with the creation of the IRS and transfers from the existing service groups; • Horizontal mobility across the administration is not blocked as the FBR management can assign staff to other functions at their request. <p>Management recognizes that all changes in civil service organization engender legitimate concerns about career prospects, status, prestige, and the impact on established routines. However, Management notes that as a result of these provisions, there have been no financial losses that might have been associated with redundancies. There has been no loss of formal status as existing seniority levels have been protected. There remain substantial prospects for promotion and mobility both within the IRS and within the original service groupings and officers are free to choose which career path offers the most promising opportuni-</p>

No.	Claim	Response
		<p>ties. Though integration may have increased the number of potential candidates for each available merit-based promotion opportunity, it has not limited the overall stock of senior positions.</p> <p>In addition, as a result of reorganization, the share of senior FBR management positions held by Customs and Excise officers has increased. Six FBR Board members are from the Customs group, while five members are from the former Income Tax group. Thus, relative to the size of the group, Customs officers have a high level of representation in senior management as a result of the reorganization.</p> <p>Management regrets that both the internal divisions sparked by the administrative merger of the two services and the numerous legal challenges have caused disruptions within the FBR with potential implications for the standards and quality of service delivery to Pakistan's taxpayers. However, Management suggests that the claim that the TARP has thus caused harm to the national economy of Pakistan is not supported by the empirical evidence. Though the growth in FBR tax revenue in nominal rupee terms has slowed in the past 18 months and contracted as a share of GDP, this can be attributed to the sharp overall slowdown in economic activity and trade as a result of Pakistan's balance of payments crisis and the global financial crisis, as shown in Annex 5. Specifically, the significant contraction of the large scale manufacturing sector (the single most important driver of tax revenues), which has led to a decline in corporate sector earnings and a sharp deceleration of imports, has translated into reduced tax collection. This cannot be attributed to the merger of the occupational groups effected by the FBR or to the TARP.</p>
2.	<p>Federal Board of Revenue (FBR) is [...] responsible for collecting and administering four main federal levies which are income tax, customs duty, federal excise duty and general sales tax. Tax administration is part of the federal civil structure which is known as the Central Superior Services (CSS). CSS consists of twelve so-called 'Occupational Groups' which are governed under certain laws and statutes. Each occupational group maintains a separate seniori-</p>	<p>Reorganization of the FBR along functional lines is part of a comprehensive long term tax administration reform strategy, developed by the Government of Pakistan through more than a decade of strategic planning and consultations (see full discussion of this process in Section 7). One of the salient features of tax administration reforms during the last 30 years has been the organizational shift from a type-of-tax model to a functional one to achieve increased administrative efficiency. Revenue administrations organized by type of tax rather than by functions are relatively more prone to corruption and taxpayer abuse for the following reasons: (i) points of contact are multiplied by the number of tax departments; and (ii) separate tax legislations (for example, income and sales tax) lay out independent administrative procedures for areas such as delegation of powers, taxpayer</p>

No.	Claim	Response
	<p>ty of its officers which is based on the merit determined at the time of entry in any given occupational group after qualifying the nationwide competitive exam conducted by the Federal Public Service Commission. [...] Two of these twelve occupational groups of the federal civil service fall under the administrative control of the Federal Board of Revenue. These are Customs and Excise Group and Income Tax Group. [...] This scheme of things has continued till a very recent decision of Government of Pakistan whereby a new occupational group has been created within the umbrella of the CSS by the name of Inland Revenue Service (IRS) which has been entrusted to collect and administer all domestic federal taxes. This has been done as part of Tax Administration Reform Program (TARP) on the pretext of bringing in functional integration of all domestic taxes.</p> <p>TARP was launched in 2004 with World Bank's assistance. Its aims and objectives were to fundamentally reform the Central Board of Revenue (FBR), which is now known as Federal Board of Revenue (FBR), and to create a more efficient and effective revenue administration system. [...]</p> <p>According to Project Information Document, this Project was designed around a comprehensive reform strategy that included [...] seven components [...] Within the Management and Institutional Development [component] the aim was to introduce strategic changes within FBR's organizational struc-</p>	<p>obligations, establishment of penalties, criminal procedures and procedures for appeals, increasing opportunities for discretion by tax officials. Functionally-based organizations allow economies of scale in key tax administration functions and fair application of tax legislation. Under this model, there are standard and unified business processes across the organization in audits, collection, processing of tax returns, taxpayer assistance, and criminal investigation. It also allows application of standard procedures for information technology, human resources, financial management and accounting. As a result, taxpayers benefit from a single point of contact, unified services and common procedures to obtain registration, file returns, make payments, manage audits and file appeals. Therefore, functionally-based administration is considered not only to promote efficiency but also transparency.</p> <p>Based on this approach, the FBR developed a broad strategy for reform that included restructuring of the FBR along functional lines and integration of income, sales and excise taxes. This reform was also included as one of the main pillars of the FBR's <i>Pakistan Tax Administration Reform: Comprehensive Medium and Long Term Strategy</i> of May 2003.</p> <p>The TARP was developed with the FBR to implement its stated strategy. The TARP PAD states: "The strategy is to restructure the FBR along functional lines and have an integrated tax administration over the long term.... Merging of direct and sales tax will be phased over a realistic period considering legal, political, geographical, taxpayer type, and revenue implications" (p. 10).</p> <p>The TARP explicitly endorsed the need for a gradual approach to institutional reform. The TARP documents, following the FBR's own strategy, do not explicitly call for a reorganization of the civil service groupings along which the existing officers were organized. The TARP does consistently support "abolishing the special management structures for administering income tax and sales tax." It was envisioned that after 2007 at the Board level, the separate functions of a Member Income Tax and Member Sales Tax "would be merged into a 'Taxation' or 'Revenue Functions' function."</p> <p>In September 2008, in response to the slow pace of implementation of the FBR's own reform strategy, the Ministry of Finance requested the World Bank to support a TA team of international tax administration experts outside the framework of the TARP to work directly with the senior FBR management to support tax</p>

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	<p>ture that would result in the redesigning of FBR headquarters and field formations on a functional basis and integration of all domestic taxes (direct and indirect) along functional lines". (<i>Source: excerpt from the Project Information Document (PID) Report No. 30640</i> [...]).</p> <p>A perusal of similar other Project Appraisal Documents and Project Information Documents related with TARP shows that although the functional integration of domestic taxes was envisaged right from the initiation of tax reforms in Pakistan under this project but what was <i>not</i> envisaged was the administrative merger of Customs and Excise Group and Income Tax Group into one cadre and creation of a brand new service group in total disregard to the Constitution of Pakistan and all laws and statutes that deal with service matters. Under immense pressure from the World Bank staff, Federal Board of Revenue through its Office Order No. 9(3)/2009-M.I dated 12.09.2009 and Government of Pakistan through the Establishment Division's Office Memorandum No.F.6/2/2009- CP.II dated 12.09.2009 have created Inland Revenue Service and have asked, inter-alia, the officers of the existing Customs & Excise Group (CEG) and Income Tax Group (ITG) to submit irrevocable options for inclusion or otherwise in the IRS (copies of these letters are attached as Annex-I and Annex- II).</p>	<p>administration reforms (see Annex 2 for Terms of Reference for technical assistance). The team carried out an assessment of Pakistan's tax administration. Among other things, the assessment highlighted that while the "general move towards a functional organization structure" has begun "the more difficult elements like full organizational integration of sales and income taxes ... are yet to be started." The TA team recommended a set of options for consideration by the FBR management and over subsequent missions worked with the FBR management to develop a detailed Action Plan as a management tool to help the FBR management monitor the implementation of institutional and policy reforms.</p> <p>The FBR's decision to establish the IRS in September 2009 as a means of integrating income, sales and excise taxes was consistent with its long-term strategy of reorganizing tax administration along functional lines. The decision built upon several actions put in place under the TARP such as co-location of income and sales taxes through RTOs and LTUs and introduction of new automated systems. It followed upon nearly a decade of gradual reforms to shift to a functional type organization and was consistent with international best practice.</p> <p>Though the establishment of the IRS was not part of the original TARP Implementation Plan, nor has it been directly financed through TARP investments, it is consistent with the overall development objectives of the project and is a strong indication of the FBR's commitment to accelerating its own strategy of institutional reform in the face of increasingly challenging fiscal constraints. As World Bank management was not satisfied with the overall progress towards achieving the project's development objectives, it welcomed the FBR's renewed commitment to institutional reforms as reflected in the decision to establish the IRS. As a result, though the TARP was intended to close on December 31, 2009 at the end of its initially scheduled 5 year term, World Bank management agreed with the FBR that it would consider extending and restructuring the TARP for an additional two year term if satisfactory progress was made by the FBR in implementing its own organizational restructuring.</p> <p>The decision to establish a new service group was part of a nearly 10 year progression of reforms at the FBR based on its own comprehensive strategy. Though this organizational reform was not explicitly incorporated in the TARP program, the FBR's decision was welcomed by the World Bank as an important step</p>

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		<p>in achieving the project’s development objectives, especially in light of the unsatisfactory progress of the TARP prior to the proposed organizational reforms. The World Bank has fully supported the implementation of this comprehensive strategy through the TARP and the provision of direct TA to the FBR management, as well as through the single-tranche Development Policy Lending program based on Pakistan’s PRSP-II.</p> <p>Management believes that the issue of whether the administrative merger of two groups into one cadre is “in total disregard to the Constitution of Pakistan and all laws and statutes that deal with service matters” is a matter for the Pakistan Courts and relevant administrative tribunals to decide. Management refers to the recent decision of the Lahore High Court (described in Section 3 and reprinted in Annex 4).</p>
3.	<p>Those officers of the existing Customs and Excise Group who would not join IRS would become part of a truncated Pakistan Customs Service which will be responsible to collect and administer customs duties only. The above mentioned Office Order and Office Memorandum have contravened the Constitution of Pakistan, the Occupational Groups and Services (Probation, Training & Seniority) Rules, the Federal Public Service Commission Ordinance, 1977, the Civil Servants Act, 1973, Civil Servants (Confirmation) Rules, 1993 and Civil Servant (Appointment, Promotion, Transfer) Rules 1973. Officers of Customs and Excise Group have already filed a law suit before Lahore High Court and the court has issued an order of restraint to Government of Pakistan and to Federal Board of Revenue stopping them from going further ahead till a final judgment on the legality of this issue is announced by the Court (copies of the law suits filed before the Superior</p>	<p>Management is mindful of the legal challenges filed against the establishment of the IRS by individuals and groups of Customs and Excise officers, and is closely monitoring the development of events on that front. In this respect, Management has taken note of the January 7, 2010 and January 27, 2010 rulings of the Lahore High Court which dismissed several writ petitions of the Customs and Excise officers. See Annex 4 for a copy of these rulings.</p> <p>In its January 7, 2010 ruling the Lahore High Court dismissed the writ filed by the Customs and Excise officers on jurisdictional grounds, sustaining that any dispute related to the “terms and conditions” of service of the petitioners were the exclusive jurisdiction of the Federal Services Tribunal.</p> <p>In its January 27, 2010 judgment, the Lahore High Court went even further and, ruling on the merits of the case, stated that “the merger of Sales Tax, Federal Excise or the Income Tax into one group, i.e. IRS, does not in any way reflect anything contrary to the fundamental rights of the petitioners or derogatory to the settled principles in that respect. The only visible impression behind such exercise appears to bring different organs of tax collecting agencies into one, which exercise apparently would benefit the taxpayers and would ultimately result in widening the tax net.”</p> <p>Management also notes that in both rulings, the Lahore High Court challenged the arguments raised by the Customs and Excise officers in their complaints.</p> <p>First, in terms of the grievance that “sales tax has been trans-</p>

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	<p>Courts and copies of Stay Orders issued by the Courts are attached as Annex-III and Annex-IV).</p> <p>It is pertinent to mention that because of wider operational latitude and better chances of horizontal and vertical mobility, traditionally, the Customs & Excise Group has remained amongst top three choices / options of the candidates qualifying the Central Superior Services exam, while Income Tax Group is usually the 5th or 6th choice. Despite being fewer in number the officers of Customs and Excise Group have a proven track record of collecting more revenues than Income Tax Group as the taxes presently being manned and managed by the officers of the Customs and Excise Group constitute more than 60% of the entire national tax collection while direct taxes account for around 40% of the total federal revenues. Moreover a substantial chunk of the 40% revenue collected by Income Tax Group is in fact collected by the officers of CEG in the form of withholding tax at import stage. It is indeed unjust that a service group which is better performing in all respects is being made to suffer the most. By forcing officers of Customs and Excise Group to either join IRS or a truncated Pakistan Customs Service, the experience, knowledge and skills that have been accumulated over a period of decades will be wasted away, which our tax administration can ill afford at this critical juncture.</p>	<p>ferred from their sphere of responsibility and placed in the care and control of the newly-constituted Inland Revenue Service...the petitioners did not put forward any convincing argument to support their right to retain the sales tax business.” The High Court concurred with the FBR's proposition that “the Federal Government has the absolute right to review the arrangements from time to time as may be in the interest of sales tax.” Moreover, the Court admitted that “to maintain a department, create a new one, or merge any department into some other, was/is always a policy matter to be taken by the executive or the legislature, keeping in view the surrounding circumstances, as after all it is their primary function, rather duty, to make the Government effectively run and in doing so they definitely are within their right to make equilibrium amongst the departments.”</p> <p>Second, the High Court also underscored that the transfer of the Customs and Excise officers to the IRS was made on a voluntary basis. It emphasized that, “in any eventuality, the option [to join the IRS] was not at all compulsory for the petitioners or others. Either they opt or abstain, their future services was not at all being affected by mere creation of the Inland Revenue Service and even the persons giving their option, would retain their actual <i>inter-se</i> seniority. In this view of the matter, hardly any grievance is left with the petitioners, if at all they ever had.”</p> <p>Third, the Court also questioned the grievance alleged by the Customs and Excise officers that the creation of the IRS would affect their vested rights, as it would imply fewer posts available in their group and thereby jeopardize their prospects of promotion. In its ruling of January 7, 2010, the Court cited precedents that “provide authority for the proposition that consequent upon re-organization or restructuring of services the prospects of promotion, being far-fetched, cannot be raised as a grievance in constitutional jurisdiction.”</p> <p>In its judgment of January 27, 2010 the Court ventured even further and argued that, in view of the reassurance provided by the representatives of the FBR that by creating the IRS, “the future promotion prospect of the petitioner or other similarly placed employees would not be affected and [...] that for future promotion mechanism/Promotion Policy as in vogue at the present, would remain the same as is being adopted for other occupational groups, and there would be no separate policy after creation of the Inland Revenue Service,” the petitioners “had no such enforceable vested rights and further, if at all they have, in view of the</p>

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		<p>above explicit statement, the same were not being infringed through the impugned Office Memorandum or office orders [establishing the IRS].”</p> <p>Management notes that the contentions of the Requesters that the creation of the IRS contravened the Constitution of Pakistan and related administrative statutes and that “the advice given to Government of Pakistan by people working for the World Bank has caused violation of the law of the land” have not been supported by Pakistan’s national courts. Management will continue to follow closely the pending petition on this matter before the Sindh High Court.</p> <p>While the Customs and Excise Group is popular among the new civil service entrants, Management questions whether this is related to the fact that it has performed better than the Income Tax Group on tax collection. The share of revenues from customs duties, federal excise tax and general sales tax—that is, taxes the Customs and Excise group used to administer—account together for about 60 percent of total FBR tax collection at the moment. However, this large share in total tax revenues does not necessarily reflect superior performance of the Customs and Excise group, but simply Pakistan’s tax structure. The general sales tax is the main source of revenue in Pakistan’s tax system, accounting for about 40 percent of total FBR tax revenues. At the same time, it has been conspicuously under-performing relative to its potential (see the Tax Policy Study 2009). Therefore, the Government of Pakistan is planning to replace it with a broad-based VAT. Also, as Annex 5 shows, the combined share of collection of customs duties, general sales tax and federal excise taxes in total FBR revenues has declined from 69 percent in 2004/05 to 62 percent in 2008/09. The share of customs duties in total FBR revenues has steadily declined since 2004/05. By contrast, the share of income taxes (direct taxes), which are the second largest revenue generator, has increased from 31 percent in 2004/05 to 38 percent in 2008/09.</p> <p>Given the decision of the FBR to maintain the Pakistan Customs Service at the same time as establishing the new IRS and to offer Customs and Excise officers a voluntary choice among the two service, Management believes that the FBR is acting to ensure that the reorganization does not misallocate the accumulated experience, knowledge and skills of these officers.</p>

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4.	<p>Furthermore the World Bank team that recently visited Pakistan in October-November 2009, to review progress on TARP recommended in their Aid Memoire to Government of Pakistan to bypass the parliament and promulgate changes in the national tax system through a Presidential Ordinance as it would avoid the "undesired consequences" if the reform package was to be sent to the parliament (copy of editorial of daily <i>Business Recorder</i> is attached as Annex-V). It is ironic that the staff of an institution like the World Bank, which is engaged in strengthening democracy in the world, so openly flouts democracy's basic tenets, accepted world-wide: that parliament is supreme. Such sheer disrespect to the sovereignty of the parliament by the World Bank staff should be taken to task.</p>	<p>A mission report of October 19, 2010, prepared by a team of World Bank-funded tax administration consultants independent from the TARP project, contained a regrettable reference to the legislative process in Pakistan, as follows:</p> <p><i>“A second option may be to send the package of legal reforms to Parliament, or include them as part of the budget submission for the next fiscal year. This will significantly delay the implementation of the harmonized procedures, but more importantly, may be subject to changes in Parliament that might bring undesired consequences.”</i></p> <p>Management recognizes that this was a failure of oversight by the World Bank not to adequately vet the document prepared by the consultants. Alerted to the issue by press reports of the document on November 1, 2009, Management unequivocally recognized the error and communicated this to the Government of Pakistan. On November 5, 2009, the Country Director Yusupha Crookes sent a letter to Pakistan’s Ministry of Finance stating (see Annex 10):</p> <p><i>“With respect to the regrettable phrase in reference to parliamentary procedures in the report of the Bank mission, we unreservedly withdraw the implications in this language. I would like to emphasize our highest regard and respect for Pakistan’s democratic processes, constitutional arrangements and the sovereignty of Parliament and independence of the judiciary.”</i></p> <p>Following this error, stricter management review and clearance of subsequent mission reports of the Tax Administration TA team were put into place. However, it is important to note that the mission report reference was not related to creation of the IRS, which was effected through an FBR Office Order No. 9(3)/2009-M.I and the Establishment Division's Office Memorandum No.F.6/2/2009- CP.II, but referred to the amendment of tax legislation.</p>
5.	<p>The way TARP has been mishandled in the recent past by a group of consultants has also been criticized by the World Bank staff. A copy of one such email which expresses grave concerns on the lack of understanding on the part of</p>	<p>Management notes that the issues raised in the e-mail referred to in the Request relate to internal disagreements regarding the most appropriate strategy for revamping the FBR’s IT systems and have no bearing on the issue of the merger of administrative groups or the creation of the IRS.</p> <p>More generally, Management believes that professional differ-</p>

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	<p>these consultants about issues in Pakistan's tax administration is attached with our complaint (Annex-VI). It is thus quite clear that the advice given to Government of Pakistan by people working for the World Bank has caused violation of the law of the land and a violation of principles of merit, justice and parliamentary supremacy by unduly pressurizing the Government of Pakistan to create Inland Revenue Service through a Presidential Ordinance.</p>	<p>ences of opinion expressed internally within teams regarding issues as complex as tax administration reform are to be expected and are part of the deliberative decision-making process of an institution like the World Bank. Such differences of opinion cannot be construed as evidence of wrongful advice. On the contrary, these differences support a more robust process of vetting that advice. Management believes that the single e-mail presented in the complaint has no bearing on the issues raised with regards to the World Bank's respect for the principles of merit, justice and Parliamentary supremacy.</p> <p>Whether tax administration reforms supported were consistent with Pakistan's laws is to be determined by Pakistan's courts. On this issue, Management refers to the results of the Lahore High Court rulings described in Section 3.</p> <p>Management also notes that in contrast to the claim regarding undue pressure on the Government of Pakistan "to create Inland Revenue Service through Presidential Ordinance," the IRS was established through an Office Order of the Establishment Division and an Office Memorandum of the FBR and not through a Presidential Ordinance. The reference to a Presidential Ordinance in this section refers to an entirely different matter, namely the revision of regulations associated with RTOs and LTUs.</p>
6.	<p>The deviation from the original action plan of TARP which only envisioned merger of functions of all domestic taxes and not a merger of two service groups into one, has given rise to a huge controversy and legal battles which carry the risk of derailing the whole taxation system of Pakistan.</p>	<p>As described above, though the TARP supported the FBR's own strategy for gradually shifting towards a modern, functionally integrated tax administration, the TARP consistently maintained a longer term reform vision as stated in the Project Implementation Plan (PIP): "The longer-term intention is that the two streams [income and sales and excise tax] will integrate fully into one stream organized by type of taxpayer" (p. 36). Therefore, the merger of the two service groups into one cannot be seen as a deviation from the original action plan of the TARP.</p> <p>The TARP PIP did recognize that the merger would need to be "phased carefully over a realistic period" considering all the implications including legal (p10-11). The TARP was intended to support the initial phases of this reform process, including co-location through RTOs and LTUs, integration of business processes, and integration of functions such as registration, collection and enforcement.</p> <p>The claim that re-organization of the FBR has derailed the whole taxation system and harmed the economy of Pakistan is not sup-</p>

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		<p>ported by empirical evidence. In particular, a suggestion that FBR tax revenues have declined because of FBR restructuring cannot be supported by data. The growth in FBR tax revenues in nominal rupee terms has slowed in the past 18 months, and contracted as a share of GDP. However, as shown in Annex 5, this slowdown in tax revenues is explained by the sharp overall slowdown in economic activity and trade as a result of Pakistan's balance of payments crisis and global financial crisis. Specifically, the significant contraction of the large scale manufacturing sector (the single most important driver of tax revenues), which has led to a decline in corporate sector earnings and a sharp deceleration of imports, has translated into reduced tax collection.</p>
7.	<p>We also believe that some of the required safeguards were not followed before and during the execution of TARP. In support of this view Para II.D.4 of Section II of the Integrated Data Sheet (Report No. AC466) prepared/updated on 11/03/2004 pertaining to TARP is reproduced as follows:</p> <p>"identify the key stakeholders and describe the mechanisms for consultation and disclosure on safeguard policies, with an emphasis on potentially affected people.</p> <p>This project does not trigger any of the safeguard policies; however, keeping in view the social impact of any of the project activities on lives of the people, stakeholder consultations have been ongoing. The stakeholders include the following:</p> <p>(i) Staff of FBR, (ii) Government and agencies and autonomous bodies, (iii) accounting firms and bodies, (iv) tax lawyers, (v) trade associations, (vi) Federal and Provincial Chambers of Commerce, (vii) Private Sector businesses, (viii) individual taxpayers, and (ix) civil society at large. A series of</p>	<p>The preparation and implementation of the TARP have involved extensive consultations and inputs from a wide range of stakeholders per the requirements of the World Bank's relevant operational policies.</p> <p>The consultations to define the tax administration reform began as early as 2000 and were supported initially by a \$0.5 million Institutional Development Fund Grant and then, as the TARP project was in the pipeline, a \$2.9 million Project Preparation Facility in 2002. Some of the key consultative inputs into the preparation of the TARP included:</p> <ul style="list-style-type: none"> • A specially commissioned 11 member Task Force on Tax Administration whose April 2001 report, <i>Reform of Tax Administration in Pakistan</i>, was prepared on the basis of extensive consultations within the FBR and the Ministry of Finance as well as with the Institute of Chartered Accountants, Pakistan Tax Bar Association, the Chambers of Commerce of Karachi and Lahore, the Overseas Chamber of Commerce, and the Lahore University of Management Sciences; • A <i>Strategic Framework Paper</i> produced by the FBR management in November 2001, which built on the above Task Force Report and consultations held during its preparation. In addition, the FBR held a conference towards end-2001 in which all FBR commissioners and collectors participated, representing all taxes and all members, and where the key elements of the strategy were finalized after significant deliberations; • A <i>Vision for Customs</i> produced by the Customs Wing of the FBR; • A report on the <i>Reorganization of Income Tax</i>, prepared by

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	<p>consultations were held with these groups in different parts of the country to inform them about project design and its objectives and receive feedback. Regular consultations are also built-in as part of project design for disseminating information and assessing the impact." Contrary to what is stated in the above quoted paragraph, voice and concerns of Customs and Excise Group, which is one of the most important stakeholders in the entire reforms process, were never taken into account by the staff of the World Bank that has remained associated with TARP, which is a clear violation of Bank's policy of ensuring social safeguards. The World Bank staff was made aware of our legitimate concerns through several emails that were sent to them but we did not receive any response which again is a violation of para 10 of the World Bank's Operational Manual- BP 13.05- Project Supervision document which clearly stipulates that "As appropriate, the TT (Task Team) visits the project sites and facilities to review progress, provide advice, meet with project beneficiaries and stakeholders..." Despite several attempts by the Association to arrange a meeting with the visiting World Bank Task Team to apprise them of our concerns, we did not receive any response from them whatsoever. Copies of some of these emails are attached as Annex-VII (a-f).</p>	<p>the Policy and Tax Reform Wing in September 2002;</p> <ul style="list-style-type: none"> • A report prepared by a team of Customs officers recommending changes in Customs procedures and business organization entitled, <i>CARP – The Vision</i>; • A report by Maxwell Stamp, entitled, <i>Draft Tax Administration Reform Strategy Document</i>, commissioned by the FBR and the World Bank; • The above inputs were integrated by the FBR management into a strategy document, <i>Pakistan Tax Administration Reform: Comprehensive Medium and Long Term Strategy</i>, which was extensively discussed across all departments of the FBR and became the basis for the TARP PAD. <p>As regards supervision, Management believes that the TARP team supervised the project according to the requirements of OP/BP 13.05. Since the start of the TARP in April 2005, five formal supervision missions have been undertaken and 10 Implementation Supervision Reports have been filed. The number of formal supervision missions has been somewhat less than the World Bank norm of two per year because the Task Team Leaders of the project were both stationed in Islamabad until recently and maintained daily contact with the clients and other stakeholders. Each formal supervision mission included meetings with the top management of the FBR (Chairman and Members of the Board), followed by individual meetings with the Members and their teams. The supervision missions also included site visits to 4 RTOs, 3 MTUs, 2 LTUs, 5 Customs facilities and the Karachi International Container Terminal, where World Bank teams held discussions with a wide range of staff. The mission Aide Memoires list the principal people met. Beyond the FBR, the missions have met with representatives of the Federal and Provincial Chambers of Commerce and Industry, tax lawyers, government agencies and the Ministry of Finance. A list of supervision mission meeting schedules is provided in Annex 6. Management believes that these supervision missions, all of which included meetings with the Member Customs and other representatives of the Customs service in Islamabad and regional offices, provided ample opportunities for representatives of Customs and Excise officers to express their views and concerns to the World Bank team.</p> <p>In addition to the TARP team, the Ministry of Finance also requested an independent team of tax administration experts to provide direct TA to the FBR management. Since 2008, this</p>

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		<p>team of experts has conducted 6 missions to Pakistan. During each of these TA missions, the tax administration experts held discussions with top management of the FBR (Chairman and Members of the Board) and individual Members of the relevant units and their teams. The TA missions also visited RTOs and LTUs in Karachi, Lahore and Islamabad.</p> <p>Management notes that the FBR took the decision to establish the IRS and merge the two administrative services and, therefore, the FBR has taken the lead in consulting with the stakeholders on the implications of those decisions. The new leadership of the FBR held discussions with representatives of the Association of Customs Officers on preparations to establish the IRS shortly after its appointment. The FBR convened one day consultations in June 2009 with representatives of both Associations of Customs and Excise and Income Tax Officers prior to the promulgation of the Office Memorandum of September 2009 creating the IRS (see Annex 8 for a list of participants from both Associations). World Bank staff were invited to participate and were privy to the concerns expressed by representatives of the participating service groups. In addition, the FBR Chairman addressed the Customs and Excise Officers in Islamabad, Karachi and Lahore during the course of July 2009 to present and discuss the FBR's reorganization plan prior to the promulgation of the reform. Annex 9 provides a list of formal meetings/consultations held with officers of the Customs and Excise Group and the Income Tax Group.</p>
8.	<p>We the officers of Customs and Excise Group believe that the creation of IRS at the behest of World Bank staff has unduly penalized us as a group and we are being disproportionately disadvantaged. If the new service structure goes ahead as dictated by the World Bank staff, the officers of CEG will lose their operational latitude, promotion and career prospects and it will jeopardize the terms & conditions of their service which are otherwise safeguarded by the Constitution, as well as the rules governing the services of the Federation of Pakistan. As a result of Bank's policies, two</p>	<p>Management's responses to the claims that Customs and Excise officials as a group were unduly penalized by the creation of the IRS, that the new structure was imposed by the World Bank, and that new structure was a deviation from the original development objectives of the reform are set out in Sections 1, 2 and 6, respectively, of this Matrix.</p> <p>Clearly, officers of the Income Tax Group have found the IRS a more attractive option than the officers of the Customs and Excise Group. As of January 19, 2010, while 920 out of 977 Income Tax officers voluntarily transferred to the IRS, only 57 out of 542 Customs and Excise Officers chose to make the transfer. While this might reflect issues of status and prestige as suggested by the Requesters, there are other reasons for the imbalance. The merger of sales, income and excise taxes did not necessarily affect the collection of customs duties and there remains considerable demand for officers with specialized skills in the customs</p>

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	<p>service groups within the Federal Board of Revenue namely the Customs & Excise Group and the Income Tax Group are at loggerheads with each other; the vicious cycle of which has the potential to implode our tax machinery. The controversy surrounding the creation of IRS has taken the focus away from the real issues that the tax reforms were aiming to address. [...] Let us reassure you that we are not against tax reforms as long as they stay focused on achieving their stated and original objectives of making the tax system more transparent, vibrant and taxpayer friendly. If these objectives can be achieved by merging the functions of all domestic taxes under one hierarchy, as was the original plan, we have always been ready for that as well. It is only the deviation from the original objectives which is being carried out in an arbitrary and conspiratorial manner on the advice of a few consultants who do not comprehend the context and nuances of Pakistan's taxation system that has caused a grave concern for us. Instead of creating "champions of change" within Federal Board of Revenue and brining in "improvements in staff productivity and morale" which were among the original objectives of TARP, the misguided policies of the World Bank staff have resulted in a situation where an entire work force is highly disgruntled, demoralized and uncertain. This certainly does not augur well for the continuity and sustainability of the reforms once TARP is over. Because of Bank staff' misguided advice to</p>	<p>area. Moreover, the issues of status and prestige are also quite complex. Of the 57 Customs and Excise officers that made the transfer, 22 were at the comparatively senior level of Grade 20 (out of 21 ascending Civil Service grades). Thus, not all officers at the senior ranks of the Customs and Excise Group saw the IRS as a loss of status or prestige. While there has been a clear imbalance of views with regards to the IRS between the two existing occupational groups, Management would question whether the "entire work force" was opposed to the IRS as claimed in the Request.</p> <p>At the same time, the World Bank has consistently emphasized the critical importance of mitigating internal staff resistance to change in its ongoing dialogue with the FBR. As stated in the TARP PAD, the World Bank advised the FBR to engage in effective change management leadership and to build mechanisms into the reform program "which would gather feedback during implementation to incorporate lessons and ensure continued support from the stakeholders" (p. 36). In 2007-08, an HR Consultant and a Management Development Consultant were hired to, among other tasks, conduct change management workshops on various components of TARP-financed reforms. A "train the trainers" workshop on change management for senior FBR officials was conducted in October 2007.</p> <p>The July 2009 TA mission report recommends that the FBR management develop and execute a communications plan to address technical and organizational issues regarding the new administrative structure and to "clarify misconceptions of staff of LTUs and RTOs about changes and receive feedback from them to improve the process" (p. 6). The mission also recommended the development of an HR management strategy and the establishment of a new position, Director General Human Resources, to handle the significant HR actions required to effectively institute the new administrative structure.</p>

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	<p>FBR and to Government of Pakistan, the entire tax machinery in Pakistan is at a standstill. In all 13 Regional Tax Offices and 3 Large Taxpayers Units all over Pakistan, there is an open confrontation and strive between FBR' s management on one side and staff and officers of Customs and Excise Group on the other side. Copies of some of the letters that have been written by senior officers posted in these field offices to FBR Management in Islamabad Headquarters are attached that depict the gravity of the situation and the mess that has been created in our national tax administration.</p>	
9.	<p>We have complained to the World Bank staff on numerous occasions through emails and have tried to apprise them of ground realities and have requested them to at least listen to our viewpoint but so far we have not received any response from them.</p>	<p>In addition to regular TARP supervision missions and TA visits, all of which included meetings with representatives of the Customs and Excise officials and most of which included visits to RTOs, LTUs, and Customs Posts, the World Bank team maintains active and continuous communication with FBR officials through phone, e-mail, video and audio conferences.</p> <p>During the Fall 2009, after a group of Customs and Excise officers had filed a series of petitions in court against the FBR, the World Bank team began to receive several e-mail messages that claimed to represent the collective views of the Customs and Excise officials. The e-mails did not appear to emanate from the Association of Customs and Excise Officers which had represented the group in the official consultations during June 2009, nor was any official correspondence received on behalf of that Association. The e-mails contained personal attacks on named individuals within the FBR management.</p> <p>The World Bank staff decided not to respond to these messages for the following reasons:</p> <ul style="list-style-type: none"> • As the matters raised in the e-mails were under jurisdiction in the Pakistan courts, the World Bank staff did not believe it would be appropriate to respond on the substance of the matter as this could be seen as interference in an ongoing domestic legal process;

No.	Claim	Response
		<ul style="list-style-type: none"> • As the World Bank had been in communication with the Association of the Customs and Excise Officers, staff did not believe that the e-mails were representative of the officers as a group as claimed by the senders; and • Some e-mails contained unprofessional remarks about specific FBR officials leading staff to believe that the e-mails represented intra-organization or personal rivalries that would be inappropriate for the World Bank to comment on. <p>Management recognizes that the World Bank staff made an error in not acknowledging receipt of the e-mails as the responses could have been handled in an appropriate manner respecting the ongoing legal process. Management regrets this error and has provided appropriate instruction to the relevant teams on proper guidelines for responding to such external requests. However, Management notes that the World Bank staff did meet with representatives of the Association of Customs and Excise Officers as part of the FBR's consultations on the establishment of the IRS and subsequently incorporated concerns raised by the Customs Officers in the World Bank's communications with the FBR.</p>