



IMPACT OF THE FINANCE ACT 2024 AMENDMENT TO THE EXPORT FINANCING SCHEME

HOW TO MITIGATE THE CONSEQUENCE

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**SOCIOECONOMIC INSIGHTS AND
ANALYTICS**

Executive Summary

IMPACT OF THE FINANCE ACT 2024 AMENDMENT TO THE EFS HOW TO MITIGATE THE CONSEQUENCE

The Export Facilitation Scheme (EFS) was launched to strengthen Pakistan's export competitiveness by simplifying tax processes, lowering operational costs, and providing tax relief. The scheme aimed to address long-standing challenges, including procedural inefficiencies, refund delays, and compliance burdens. However, the amendments introduced in the Finance Act 2024 have disrupted this balance, particularly by imposing an 18% sales tax on locally procured inputs while maintaining zero-rating for imported inputs. This has created a disparity that is detrimental to local producers, especially in the textile industry, which contributes 60% of the country's exports.

Key Issues

The imposition of sales tax on local inputs has led to several economic and sectoral challenges. For domestic producers, the requirement to pay sales tax upfront and then seek refunds has created severe liquidity issues, as refund processing in Pakistan remains plagued by delays and inefficiencies. These challenges are exacerbated by the continued zero-rating of imported inputs, which makes imported goods more competitive than locally produced alternatives. This imbalance has particularly impacted the upstream segments of the textile value chain, such as spinning units and cotton growers, leading to closures and significant job losses.

The economic consequences of these changes are severe, with the textile sector experiencing an estimated loss of Rs. 1.7 trillion—equivalent to 1.7% of Pakistan's GDP. Closures of spinning units and power looms have not only disrupted industrial production but have also resulted in widespread unemployment, affecting millions of individuals reliant on the sector for their livelihoods. This has also incentivized the informal economy, where many actors avoid taxes, further eroding government revenue and undermining the formal sector's viability.

Frequent policy changes and the lack of stability have further compounded the situation. Policy volatility discourages investment and disrupts long-term planning, undermining the trust of stakeholders in government initiatives. Despite the potential benefits of the EFS, these shortcomings hinder its effectiveness in promoting sustainable growth and export competitiveness.

Global Comparisons and Lessons

In contrast to Pakistan's approach, countries like India, China, Bangladesh, and Vietnam have implemented policies that protect local industries while maintaining export competitiveness.

These measures include streamlined tax refund mechanisms, incentives for technology adoption, and simplified compliance processes. For example, India's Goods and Services Tax (GST) framework ensures timely refunds for exporters, while China uses a combination of protection and value-added tax (VAT) rebates to support its textile industry. These global examples highlight the importance of aligning export policies with broader economic strategies to sustain growth.

Recommendations

To address the challenges introduced by the Finance Act 2024, Pakistan needs to implement urgent reforms. A critical first step is revisiting the tax framework to eliminate the disparity between domestic and imported inputs, providing for a level playing field. Additionally, streamlining the refund system through digitization and automation is essential to reduce delays and restore trust among exporters. The use of real-time data analytics and algorithms for refund reconciliation could enhance efficiency and improve liquidity for businesses.

The EFS framework also requires stronger enforcement to prevent misuse. Reducing the reconciliation period from five years to six months and enhancing real-time monitoring of transactions could significantly improve compliance. Establishing stringent penalties for malfeasance while maintaining transparent processes would ensure the scheme's credibility and effectiveness.

Policy stability is another critical factor for fostering long-term growth. Consistent and predictable policies attract investments and enable businesses to plan effectively. Ensuring a realistic exchange rate and maintaining low tariffs would further integrate Pakistan's value chain with global markets, enhancing export potential.

Finally, the government must prioritize support for local value chains by addressing liquidity challenges, promoting domestic production, and investing in technological upgradation. Initiatives that encourage higher value addition and skill development in the textile sector would enable Pakistan to move up the value chain and enhance its competitiveness in global markets.

Conclusion

The Finance Act 2024 amendments to the EFS have disrupted Pakistan's export ecosystem, particularly for the textile industry, with far-reaching economic and socio-economic consequences. Addressing these challenges requires a comprehensive and balanced approach that prioritizes policy stability, robust enforcement, and support for local industries. By implementing these measures, Pakistan can restore trust among stakeholders, enhance export competitiveness, and achieve economic growth.

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IMPACT OF THE FINANCE ACT 2024 AMENDMENT TO THE EFS

HOW TO MITIGATE THE CONSEQUENCE

The Export Facilitation Scheme (EFS) is the latest in the series of a policy initiatives aimed at supporting exporters by simplifying procedural requirements, lowering operational costs, and providing tax relief on inputs and goods used in the production of export items. By leveraging modern technology and addressing the bottlenecks in previous systems, the EFS was designed to boost the global competitiveness of exporters while enhancing ease of doing business.

There have been more than ten initiatives to increase exports with varying degrees of success. Early export promotion measures were primarily designed to offset the disadvantages faced by exporters in a highly regulated and import-dependent economy. The focus was on refunding taxes, providing duty-free imports of raw materials, and incentivizing exports. However, these measures often suffered from inefficiencies, including delays, lack of transparency, and a heavy compliance burden. A study by Haque and Kemal (2006) showed that the old export financing initiatives were not significantly involved in increasing exports. Several evaluations have substantiated that cumbersome documentation as well as continued worry about misuses of schemes are main reasons that exports do not grow.

EFS originally allowed exporters to import inputs duty-free, with domestic inputs also being exempt from taxation to maintain parity. However, recent amendments in the 2024-2025 budget have introduced significant changes to this framework. Exporters are now required to pay sales tax on locally procured input goods used in the production of export items. This marks a departure from the previous exemption, aligning domestic input taxation with standard tax regimes.

Despite the changes to domestic input taxation, exporters can continue to import raw materials without paying customs duties, federal excise duties, sales tax or withholding tax under the new SRO.1042(I)/2024.

The reasons for introducing the general sales tax (GST) on local inputs to the exports are understandable. The GST system in value added tax (VAT) mode requires an adjustable tax to be collected along the entire value chain. By standardizing tax treatments, the government aims to enhance revenue collection and reduce sector-specific exemptions. In addition, aligning with global trade practices and meeting conditions set by international financial institutions, such as the International Monetary Fund (IMF), necessitates requires this¹.

While agreeing with this need to develop the VAT system, we analyze in detail the implications of this imposition of sales tax on local inputs. In particular we will analyze the following possibilities:

¹ https://www.reuters.com/markets/asia/pakistans-tax-heavy-budget-likely-land-imf-bailout-stoke-tensions-2024-06-14/?utm_source=chatgpt.com

1. This change will affect exporters' cash flows, as they will need to pay the tax upfront and subsequently seek refunds through the input tax credit mechanism. Given continued delays in the refund system, this is likely to be a substantial issue.
2. In addition, navigating the refund process for sales tax may increase administrative responsibilities for exporters, particularly for small and medium-sized enterprises (SMEs) with limited resources, thereby increasing cost of compliance and overall cost of conducting business.
3. Does the introduction of VAT on locally purchased inputs allow exporters to claim refunds for the VAT on goods and services used in their export activities, potentially reducing their overall tax liability?
4. Would this change put the local input producers at a disadvantage, especially those upstream, i.e., growers, ginners and yarn manufactures? Should we envisage a large change in these areas and what will they be?
5. Would the compliance regime impact the value chain and how?

The present deals with these issues in seven sections. After providing a brief introduction to the EFS in section one, the next section will deal with textile exports in Pakistan. Section three will discuss the textile industry in Pakistan, with a focus on cotton, while section will talk about the fundamentals of getting the exports right, which was the very purpose of introducing the EFS. The amendment in the EFS in the Finance Act 2024 brought serious consequences for the players involved in it. Section five gives estimates for the economic, employment and livelihood costs of the amendment. Section six will discuss some of the major loopholes identified in the scheme and how it can be refined. The last section, section seven, will list recommendations to fix the wrong done by the amendment and on how to make the scheme more efficient.

1: EXPORT FINANCING SCHEME- AN OVERVIEW

The EFS claimed to incorporate lessons from earlier initiatives while focusing on simplifying procedures and preventing misuse. The emphasis was on aligning with global best practices to ensure compliance with international trade agreements and commitments. Earlier schemes provided duty waivers (e.g., Advance Authorization, Duty Drawback) but required exporters to apply separately for each benefit. EFS integrated these benefits, offering a unified solution. Unlike older schemes, EFS utilized digital platforms for faster processing, reducing manual interventions and delays. Earlier schemes often imposed rigid compliance requirements, whereas EFS offered more flexible options, including online submissions a

Box 1: Key Features of EFS

Unified Approach: Combines features of multiple schemes like duty drawback, advance authorization, and input facilitation under one framework.

Technology-Driven Implementation: Automated application and approval processes ensure faster turnaround and transparency.

Lower Compliance Burden: Minimal documentation requirements and seamless integration with customs and taxation systems.

Broader Accessibility: Available to a wider range of exporters, including MSMEs, which previously faced barriers to entry under older schemes.

nd approvals. However, as we will show later, the refund scheme still leaves a lot to be desired and the delays therein remains a major hindrance and a cause of liquidity shortages in the system.

Box 2: Basic Framework of the EFS

Registration Requirements:

Apply online via WeBOC or PSW platforms with the following documents:

- ISO certification (if applicable).
- Ownership/lease documents for manufacturing or business premises.
- Bank statements (last two years or since incorporation).
- Export performance summary with foreign exchange realization.
- Input-output ratio and list of plant/machinery (for manufacturer-exporters).
- Recommendation letter from the Chamber of Commerce, trade association, or SMEDA.

Exporter Categories:

Category A: Established exporters with consistent, high export performance and no significant non-compliance history.

Category B: Mid-tier exporters with moderate export performance or limited compliance history.

Category C: New or smaller exporters with minimal export track records or higher compliance risks.

Ensuring Exports-Only Usage:

Post-Clearance Audits: Verifies inputs are used solely for export production.

Utilization Periods: Inputs must be used within specific timeframes (based on exporter category).

Export Monitoring: Regular review of export performance records.

Audit Frequency by Category:

Category A: Once every 5 years.

Category B: Once every 4 years.

Category C: Once every 3 years.

This tiered audit system reflects the exporter's reliability, ensuring oversight while minimizing compliance burdens for high-performing exporters.

The EFS operates alongside other export promotion schemes that address various aspects of the export ecosystem. These include:

- i. *Production-Linked Incentive (PLI) Scheme*: Targets specific industries (e.g., electronics, pharmaceuticals) to enhance production capacities and boost export-oriented manufacturing.
- ii. *Remission of Duties and Taxes on Exported Products (RoDTEP)*: Replaces older schemes like MEIS (Merchandise Exports from India Scheme) and offers refunds on unrefunded taxes such as electricity duty and value-added tax (VAT) embedded in exports.
- iii. *Special Economic Zones (SEZs)*: SEZ-based exporters enjoy tax holidays, duty-free imports, and simplified compliance. While SEZs are location-specific, EFS applies universally across industries.
- iv. *Market Access Initiative (MAI)*: Provides financial support for exporters to explore new markets, participate in trade fairs, and conduct market research.
- v. *Export Credit and Insurance Facilities*: Institutions like the Export Credit Guarantee Corporation (ECGC) protect exporters against credit risks, while banks offer export-specific loans at preferential rates

1.1: Global Comparison of Export Facilitation

In June 2024, Pakistan introduced a tax-heavy budget aimed at increasing revenue to meet International Monetary Fund (IMF) conditions for a loan. This budget included significant tax hikes affecting various sectors, including textiles. The textile industry criticized the budget as extremely regressive, expressing concerns about its potential negative impact on textile exports.

If we look at the examples in some of the other countries in the region that produce and export textile, we see policies going in a direction conducive to trade. And more importantly, remedial actions are taken promptly to save the country's interests. For instance, in January 2025, India announced plans to boost its textile and garments industry in response to a political crisis in Bangladesh that disrupted its garment exports. The Indian government is considering financial support, tariff cuts on key inputs, and incentives to enhance local production. This initiative aims to capitalize on increased demand from U.S. companies seeking alternative suppliers.

Likewise, we see countries protecting their local industry by imposing import quotas. In October 2023, China's National Development and Reform Commission (NDRC) set the 2024 import quotas for cotton at 894,000 tons, with approximately 33% allocated to state-owned enterprises. This quota system continues to regulate the volume of cotton imports, balancing domestic production with industry demand.

These developments reflect each country's efforts to adapt to changing economic conditions, address industry challenges, and capitalize on emerging opportunities in the global cotton

market. The table below gives a summary of the various tax and tariff policies adopted by India, China, Bangladesh and Vietnam to balance domestic production support with international trade competitiveness in the cotton and textile industries.

Table 1: Tax and Tariff Policies in Selected Textile Exporting Regional Countries

Country	Tax Exemptions & Refunds	Tariff Policies	Subsidies	Protection
India	GST Refunds: Exporters can claim refunds on Goods and Services Tax (GST) paid on inputs under the Remission of Duties and Taxes on Exported Products (RoDTEP) scheme, enhancing liquidity for exporters.	- Import Tariffs: India imposes import duties ranging from 11%-27% on raw materials like polyester and viscose staple fiber, impacting garment exporters. - Export Challenges: Indian cotton textiles face import duties in markets like the EU, China, Turkey, and Vietnam, ranging from 8%-12%, while competitors like Pakistan and Bangladesh enjoy duty-free access.	- Minimum Support Price (MSP): The government sets an MSP for cotton to ensure farmers receive a fair price, stabilizing income and encouraging production. - Technology Upgradation Fund Scheme (TUFS): Provides financial assistance to upgrade technology in the textile sector, improving productivity and competitiveness.	- Import Tariffs: Duties ranging from 11% to 27% are imposed on raw materials like polyester and viscose to protect domestic producers and encourage local sourcing.
China	- VAT Rebates: Exporters receive rebates on Value Added Tax (VAT) paid on inputs, reducing the tax burden and promoting exports.	- Tariff-Rate Quota (TRQ): China implements a TRQ system with an in-quota tariff of 1% for the first 894,000 tonnes of cotton imports annually. Imports beyond this quota face a sliding scale tariff, effectively up to 40%, to protect domestic producers.	- Direct Subsidies: Farmers receive subsidies based on the area of cotton cultivation, ensuring income stability and encouraging production. - Mechanization Support: Financial assistance is provided for mechanized harvesting, reducing labor costs and increasing efficiency.	- Tariff-Rate Quota (TRQ): A quota system with a 1% in-quota tariff for the first 894,000 tonnes of cotton imports annually. Imports beyond this quota face higher tariffs, up to 40%, protecting domestic producers.

Bangladesh	- Duty-Free Imports: Imports of raw cotton and machinery for the textile sector are exempt from duties and VAT, reducing production costs and encouraging industry growth. - Export Incentives: Export-oriented textile units benefit from various tax incentives, enhancing competitiveness in international markets.	- Import Tariffs: Imports raw cotton duty-free, supporting its textile industry's growth.	- Cash Incentives: The government provides cash incentives ranging from 4% to 6% to apparel exporters, supporting the industry's growth and export earnings.	- Duty-Free Market Access: Enjoys duty-free access to major markets like the EU and the U.S. under the Generalized System of Preferences (GSP), boosting export competitiveness.
Vietnam	- Tax Holidays: Foreign investors in the textile sector benefit from tax holidays and reduced corporate tax rates, attracting investment and fostering industry development.	- Import Tariffs: Similar to Bangladesh, Vietnam imports raw cotton duty-free, bolstering its textile manufacturing capabilities.	- Indirect Support: While there are no direct subsidies for cotton production, competitive tax policies and trade agreements support the textile sector's growth.	- Duty-Free Imports: Imports of raw cotton are duty-free, ensuring a steady supply for textile manufacturers. - Free Trade Agreements: Participation in agreements like the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the EU-Vietnam Free Trade Agreement (EVFTA) provides access to international markets with reduced tariffs.

To summarize the policies by each of the selected country:

- India offers a combination of minimum price, tax refunds, subsidies, and import tariffs to support its cotton industry, aiming to enhance both production and export competitiveness.
- Bangladesh benefits from duty-free imports and market access, along with cash incentives for exporters, bolstering its position in the global textile market.

- Vietnam attracts foreign investment through tax incentives and benefits from free trade agreements, supporting its rapidly growing textile sector.
- China utilizes a mix of VAT rebates, direct subsidies, and import quotas to protect and promote its domestic cotton industry.

The above examples clearly show that countries are using incentives to support their exports, and Pakistan has correctly adopted an EFS system that stakeholders agree with. It is important that this system evolve in line with the objective of increasing exports. The system needs adaptation with our business conditions and harmonization with tax systems and other policies.

2: TEXTILES EXPORTS IN PAKISTAN

The textile sector has consistently been a dominant force in Pakistan's economy, representing the largest share of industrial output, employment, and foreign exchange earnings. Over decades, this dependence has been characterized by a strong reliance on cotton as the primary raw material. However, shifts in global market demands, domestic production challenges, and strategic industry initiatives have gradually altered the composition and nature of Pakistan's textile exports.

Cotton has historically been the backbone of Pakistan's textile industry. The country has consistently ranked among the world's top cotton producers, and for many years, local production was sufficient to meet the industry's demands. The cotton-textile value chain—comprising ginning, spinning, weaving, and garment manufacturing—formed a vertically integrated structure that relied heavily on domestic cotton supplies. However, over time, several factors contributed to a gradual decline in the industry's reliance on raw cotton exports:

Diversification into Value-Added Products: The late 1990s and early 2000s saw the emergence of higher value-added segments such as knitwear, bed linens, and ready-made garments. Government incentives and industry-led initiatives encouraged manufacturers to move up the value chain, reducing the relative share of raw cotton and yarn in the export mix. By 2020, garments and other finished products accounted for the bulk of textile export earnings.

Integration of Non-Cotton Fibers: Responding to global demand for blended and synthetic textiles, Pakistan's industry began incorporating materials like polyester and viscose. This shift not only reduced the dependence on cotton but also allowed exporters to cater to a broader range of markets. The inclusion of non-cotton fibers has gradually reshaped the export profile, though cotton remains a significant input.

Impact of Global Trade Dynamics: Changes in global trade policies and buyer preferences have also influenced Pakistan's export composition. With increasing demand for eco-friendly and sustainable materials, the industry has started exploring organic cotton and recycled fibers. Moreover, compliance with international standards, such as the European Union's Generalized

System of Preferences (GSP) Plus, has incentivized higher quality and more diversified product offerings.

In recent years, textiles have maintained their position as Pakistan's largest export sector. As of 2021-22, textiles accounted for over 60% of total exports (PBS, 2022). Within this sector, ready-made garments, bed linens, and knitwear have grown rapidly, while the share of raw cotton and yarn has declined. This reflects both the maturation of the industry and its adaptation to changing global market dynamics.

The shift toward value-added products has also improved export revenues. Finished products command higher prices, allowing Pakistan to capture more value from each unit of cotton processed. Furthermore, the increased use of non-cotton fibers and blended textiles has provided a cushion against the volatility of cotton prices and supply shocks.

2.1: The Evolution of Policy Interventions and Net Exports in Pakistan

Pakistan's net export performance has undergone significant changes over the last several decades. This evolution reflects a complex interplay of policy decisions, global economic shifts, and structural challenges within the domestic economy. Before going into the exports of textiles, analyzing these trends in detail provides a clearer understanding of the factors that have shaped Pakistan's trade balance and its position in global markets.

In the decades following independence, Pakistan's trade balance was relatively modest, with both exports and imports growing at comparable rates. The 1950s and 1960s saw a strong reliance on agricultural commodities, particularly cotton, which constituted the backbone of the country's export portfolio. However, as global demand patterns shifted and the industrialization process gained momentum, Pakistan's trade profile began to diversify.

By the 1980s, manufactured goods such as textiles, clothing, and some basic machinery started to form a larger share of exports. Despite this, the country's export basket remained narrow, and its reliance on a limited range of products—predominantly low-value-added textiles—made it vulnerable to external shocks. Concurrently, imports of industrial machinery, petroleum products, and consumer goods increased, leading to a widening trade deficit.

A series of policy measures have played pivotal roles in shaping Pakistan's export trajectory. These can be grouped into three main categories:

Trade Liberalization and Export Promotion (1980s-1990s): During the late 1980s and early 1990s, Pakistan implemented a series of trade liberalization measures, including tariff reductions and the elimination of quantitative restrictions. These reforms aimed to enhance export competitiveness by reducing input costs and encouraging foreign investment. Although exports

grew in absolute terms, the overall trade deficit persisted as import growth outpaced export growth.

Incentive Schemes and Export Processing Zones (2000s): To stimulate export-oriented industries, Pakistan introduced export processing zones (EPZs), export refinancing schemes, and duty drawback programs. These incentives were designed to lower production costs, improve liquidity for exporters, and facilitate access to international markets. While these measures provided short-term boosts to export volumes, they did not fundamentally alter the underlying structural constraints, such as limited product diversification and insufficient technological upgrades.

Structural Adjustment and Currency Management (2010s): More recently, Pakistan's efforts to stabilize its currency and address macroeconomic imbalances have influenced export performance. Depreciation of the Pakistani rupee during periods of economic adjustment made exports cheaper on global markets, providing a temporary boost to volumes. However, the benefit was offset by higher import costs and continued reliance on imported raw materials, which constrained net improvements in the trade balance.

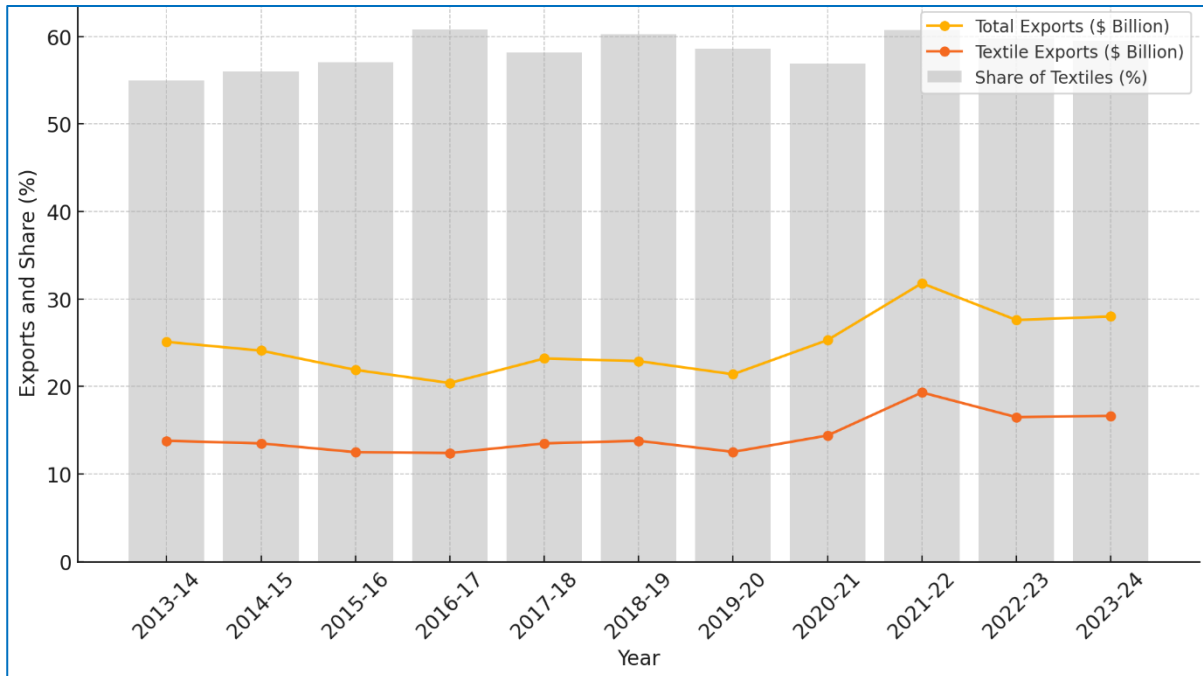
2.2: The Role of Textile Exports in National Economy

The textile industry is a cornerstone of Pakistan's economy, contributing approximately 8.5% to the national GDP and accounting for about 60% of the country's total exports. Measuring the export performance of the industry is not as straightforward a thing as one imagines. There is no universally accepted metric, as some rely on financial indicators, like export sales volume and revenue growth, while others emphasize market penetration or the longevity of international market relationships.

Despite its strengths, the industry faces several challenges. High and inconsistent energy tariffs impact production costs and competitiveness. There is an increasing dependence on raw material imports due to fluctuations in local cotton production and policy changes. Global competition with the newer players, like Bangladesh and Vietnam, add to the challenges.

Figure 1 below illustrates the trends in total exports, textile exports, and the share of textiles in Pakistan's total exports over the years. As can be seen from the figure, the share of textiles in total exports peaked in years with robust textile performance (e.g., 2021-22). Likewise, declines in total exports or textile exports have led to proportional shifts in this share. This high share highlights the critical importance of the textile sector to Pakistan's economy.

Figure 1: Textile Exports and Share in Total Exports: 2013-2024



Following the COVID-19 pandemic, textile exports saw significant growth in 2021-22, driven by increased global demand and government incentives. However, this growth slowed in subsequent years, reflecting challenges such as energy costs, high interest rates, and global economic uncertainty. Despite growth in some years, the decline in textile exports in 2022-23 and 2023-24 could signal rising production costs or loss of competitive advantage in global markets.

Pakistan's textile exports have shown varying trends over recent years:

Fiscal Year 2021-2022: Exports reached a record of \$19.33 billion, marking a 25.5% increase from the previous fiscal year.

Fiscal Year 2023-2024: Exports remained relatively flat at \$16.655 billion, a slight increase of 0.93% compared to \$16.501 billion in the prior year.

September 2024: A notable surge of 17.6% was observed, with exports totaling \$1.605 billion compared to \$1.364 billion in September 2023.

The primary markets for Pakistan's textile products include the United States, United Kingdom, Germany, Netherlands, Spain, and other European destinations.

2.3: Impact of Policy Volatility on Exports

Random policy interventions have their cost, including unexpected ones. Cotton industry is not immune to such policy changes, and has experienced several setbacks, including:

Production Decline or Hesitance to Declare Production? Inconsistent public policies have adversely affected declared cotton production in Pakistan. Increased taxes, impacting the

entire textile value chain, has either led to sudden declines in production or has discouraged people from declaring their production.

Export Competitiveness: Changes in tax regimes, such as the proposed shift from a 1% turnover-based Final Tax Regime (FTR) to a 29% standard taxation, have been met with strong opposition from exporters. They argue that such changes could severely harm exports and exacerbate the trade deficit. While we can contest the pros and cons of both the policies, but sudden changes are invariably counter-productive.

Industry Protests: The textile industry has protested over massive taxation on exports and the issuance of SRO 350 by the government, stating that these measures are severely detrimental to the textile and apparel sector, and the overall economy.

3: THE TEXTILE AND COTTON INDUSTRY

The textile industry is of critical importance to Pakistan, not just in the context of exports but also in context of overall economic growth and contribution to macroeconomic variables of importance (investment, job creation, etc.). Exports command a critical importance in Pakistan's economy, especially in context of the heavy external debt burden and persistent Balance of Payment (BOP) crisis afflicting Pakistan over the decades. Higher export earnings are considered the key to easing Pakistan's external payment burden.

Overall, the sector consists of around 13.5 million spindles, 200 thousand rotors, 375,000 power looms, 18,000 knitting machines and processing capacity of 5.2 billion sq. m. It has 700,000 industrial and stitching machines. There are around 400 large industrial units (including 225 large spinning mills), around 600 medium sized factories and an estimated 2000 small factories. To meet its manufacturing targets, it needs an estimated 14 million bales per year.

The share of textiles in Pakistan's total exports has historically been significant, as the textile sector is the cornerstone of the country's economy (as seen in the previous section). Over the past decade, the share has ranged from 50% to 60% of the total exports, as the country's exports had grown and fallen with the trend shown by the textile industry.

Over the past decade, Pakistan's textile and cotton industry has experienced notable fluctuations in both exports and imports, influenced by various economic, environmental, and global market factors. In recent years, 2019-2022 showed growth in the textile and clothing sector demonstrating resilience post-pandemic, with exports increasing from \$12.53 billion in 2019-20 to a peak of \$19.32 billion in 2021-22. This surge was attributed to robust global demand, favorable government policies, and strategic market diversification. Following the peak, exports declined to \$16.50 billion in 2022-23 and slightly recovered to \$16.65 billion in 2023-24, indicating stabilization but remaining below the 2021-22 peak. This modest increase of 0.9% suggests ongoing challenges within the sector.

Table 2: Trade of Raw Cotton

Year	('000 metric tonne)	
	Export	Import
2019-20	13	537
2020-21	0.6	857
2021-22	3	788
2022-23	12	684
2023-24	31	205

Source: PCCC

On the imports front, due to fluctuations in domestic cotton production and frequent changes in the policy framework, Pakistan has adjusted its import levels to meet the demands of its textile industry. In the first five months of FY2025, raw cotton imports surged by 104.33%, reflecting efforts to compensate for domestic shortfalls (PCCC). These shortfalls, some in the industry believe, are artificially induced to make profits in the informal market to avoid the new tax introduced on the domestic inputs.

The erratic numbers for production and yield (see Table 3) show additional level of informality entering the industry, where the producers are tinkering their numbers to maximize profits. This is usually in response to tax policy changes, where the producer shifts to informal buyers/manufacturers to save taxes. Sudden policy changes, and increased taxation are usually counterproductive as they lead to such behavior, and consequently lower revenue generation by the FBR.

Table 3: Production and Average Yield of Cotton by Year and Province

Year	Punjab	Sindh	KP	Balochistan	Pakistan
<i>Production ('000 bales)</i>					
2019-20	6306	2746	0.65	96	9148
2020-21	5044	1862	0.33	158	7064
2021-22	5168	2998	0.51	162	8329
2022-23	3210	1586	0.54	113	4910
2023-24	6028	3879	0.12	315	10223
<i>Yield (kgs/hectre)</i>					
2019-20	570	780	526	443	618
2020-21	555	667	510	465	578
2021-22	687	858	510	432	731

2022-23	367	457	511	280	389
2023-24	610	1054	510	455	717

Source: PCCC.

3.1: The Cotton Value Chain

Production and/or procurement of cotton is just the first step in cotton value chain. It is imperative to understand the stages because each is linked to policy decisions, along with those whose livelihood is attached to it. Any abrupt decision can have major consequences for those associated with that stage.

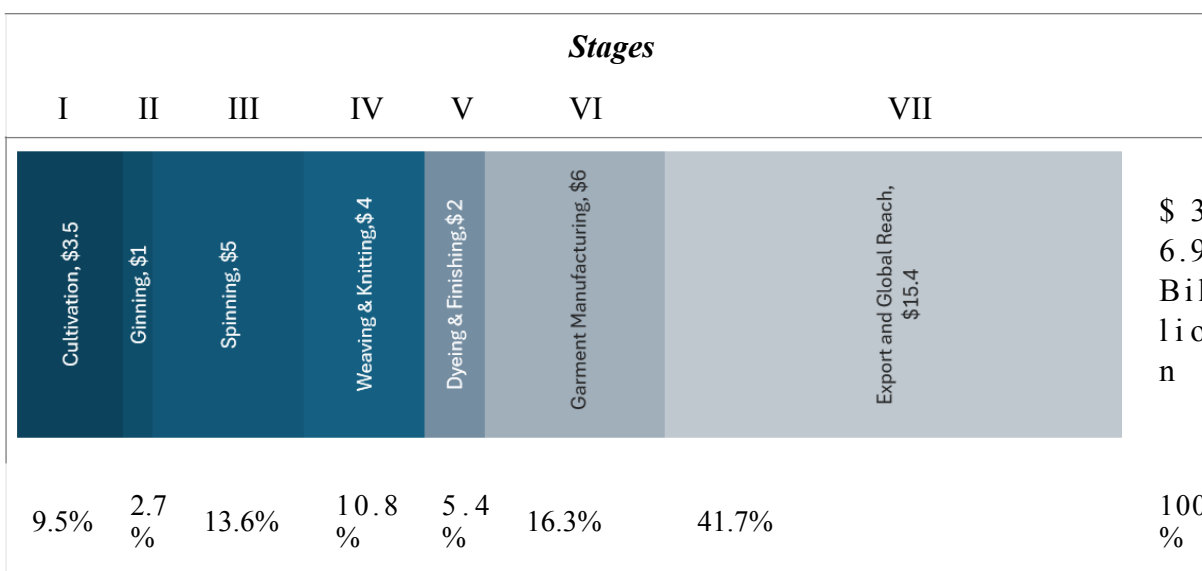
Figure 2 presents the cotton value chain, along with the value added at each step, in both US\$ and percentage added. These are all approximate numbers as no definite estimates are available. The figure shows that if the approximate total value of the chain is estimated at \$36.9 billion (i.e. 100%), the maximum value is added at the final stage of retail/exports (US\$ 15.4 billion or 41.7% of the total value). These values are of significance as the imposed VAT depends on it.

Based on the interviews conducted with stakeholders, it would not be wrong to state that the cotton value chain includes a high number of unregistered players leading to underreporting in the industry. This has significance for the state vis-à-vis tax collection, as many of the actors work beyond the stated boundaries. Some of the instances in this regard are:

- Large number of farmers are too small to be registered- cultivation stage
- Some of the importers exploit the provision of input tax by faking as manufacturers- raw cotton import stage
- A large volume of bales, reportedly over 1.5 million, are under-reported at the ginning stage, referred to as ‘*golmaal*’- ginning stage
- Fake invoices to hide sale to unregistered weaving units- spinning stage
- Huge transactions made through cash- retail stage
- False input tax by using spurious invoices

This, however, does not mean that the value chain is characterized by frauds and illegalities, but is an attempt to point out the loopholes in the complex and inefficient tax framework that can be exploited by the actors. A sudden hike in tax or removal of some incentive usually takes people away from formal to informal transactions. It is understandable that the GST system will take time to evolve with careful administration by the FBR as it gains trust of the value chain.

Figure 2: Cotton Value Chain: Value Added at Each Step (%) and Worth (in USD)

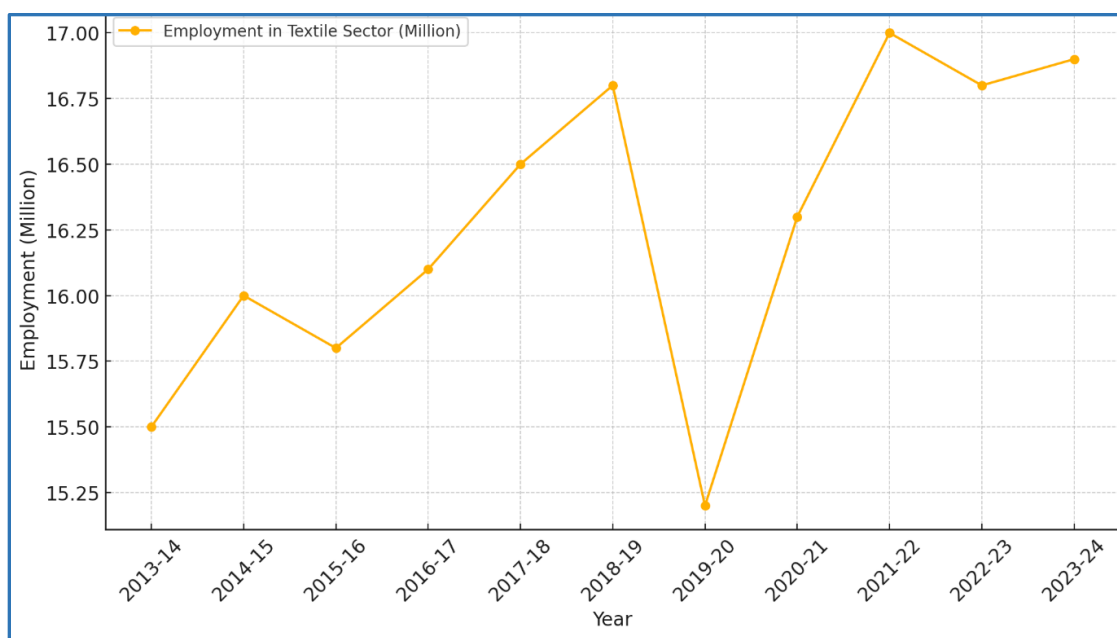


3.2: Employment in the Textile Industry

The cotton and broader textile industry in Pakistan has historically been a major employer and economic contributor, recent challenges have led to employment declines. Figure 3 shows fluctuations in the number employed over time, in response various natural and man-made factors.

Considering that a large number of people are employed in the sector, any setback, be it in the shape of a natural calamity like floods, an epidemic like Covid, or a tax shock, affects the livelihood of a lot of people. Even if we consider 17 million people employed in the sector, which to many stakeholders is a conservative estimate, and the average household size at 6.4 members, there is a crude total of 110 million individuals' lives linked to the textile industry.

Figure 3: Employment in Pakistan's Textile Sector: 2013-2024



Source: Pakistan Economic Survey, various issues.

4: GETTING EXPORT-LED GROWTH RIGHT

Export-led growth has emerged as a key strategy for driving economic development, particularly among developing and emerging economies. For Pakistan, adopting this approach could be transformative, given its strategic location, abundant human resources, and existing trade partnerships. This is an opportune moment to refresh our memory on the key ingredients of export led growth –something our policymakers love to parrot but have little understanding of.

Export-led growth has been driven by several interrelated factors.

1. Trade liberalization is a foundational element, enabling countries to integrate into global markets. The reduction of tariffs and non-tariff barriers has allowed export-oriented industries to thrive. East Asian economies, including South Korea and Taiwan, have exemplified this approach by aggressively pursuing trade agreements and reducing barriers to entry in global markets (Hausmann, 2024). Pakistan could benefit from similar efforts by simplifying its tariff structure and fostering regional trade agreements, particularly with neighboring countries and key global markets. This also includes an end to the import-substitution policies that Pakistan continues to favor.
2. Targeted government policies have also played a pivotal role in export-led growth. Governments in export-driven economies provided extensive support to industries through tax incentives, subsidies, and infrastructure development. For instance, China's establishment of special economic zones (SEZs) offered tax breaks and streamlined

regulations to attract foreign investment and stimulate export-oriented production (Xie & Lu, 2022). Pakistan's SEZs under the China-Pakistan Economic Corridor (CPEC) have the potential to replicate this success, but better policy implementation and transparency are essential.

3. Human capital investment is another cornerstone of export-led growth. Governments in successful export-led economies emphasized education and skill development to prepare their workforces for high-demand industries. South Korea's focus on technical and vocational training enabled the transition from low-skill manufacturing to advanced technological industries (Makhlouf, 2016). Pakistan faces a significant skills gap, with only a fraction of its labor force formally trained. Addressing this gap through investments in vocational education and partnerships with private sector organizations could significantly enhance its export potential.
4. Technological upgradation has been equally critical. Many nations actively imported advanced technologies and fostered innovation to enhance the competitiveness of their export sectors. Taiwan, for example, transitioned from being a producer of textiles to becoming a global leader in semiconductors and electronics (Corbo, 2001). Pakistan's export base remains largely reliant on low-value-added products like textiles and agricultural goods. Investments in technology adoption, coupled with policies encouraging value addition, could help Pakistan diversify and upgrade its export portfolio.
5. A stable macroeconomic environment has underpinned the success of export-led strategies. Low inflation, competitive exchange rates, and controlled public debt levels provided the confidence necessary for sustained investment and trade. Active management of exchange rates, as practiced by East Asian countries, ensured that exports remained competitively priced in global markets (Baccaro & Höpner, 2022). For Pakistan, addressing its chronic macroeconomic instability—including fluctuating exchange rates and high inflation—is vital to create a conducive environment for exports.
6. Policy stability has been a cornerstone of export-led growth. Consistent policies create a predictable environment for long-term investments by domestic and international businesses. South Korea and Singapore exemplify this, maintaining steadfast policy frameworks over decades to build trust and attract investment. In Pakistan, frequent policy reversals and political instability have deterred investment and disrupted trade. Ensuring stable and transparent policies is essential for the success of any export-led growth strategy.

7. In contrast to Pakistan, the approach to tax targets in export-led economies has been more pragmatic than frenetic. These countries often prioritized creating a favorable environment for growth over strict adherence to tax collection goals. Generous tax holidays and reductions were employed to encourage investment and bolster export-oriented industries. For instance, special economic zones in China offered significant tax incentives to attract foreign direct investment and stimulate industrial growth (Khan & Khan). Pakistan can adopt similar measures but must balance these incentives with efforts to broaden its tax base and ensure fiscal sustainability.

Table 4 illustrates the GDP growth trajectories of selected East Asian economies, highlighting their accelerated growth during periods of export expansion (World Bank data). Similarly, Table 5 demonstrates the relationship between trade liberalization and export performance, using data from the WTO.

Table 4: Annual GDP and Export Growth Rates (1980-2020)

Country	Export Growth (% annual)	GDP Growth (% annual)
South Korea	15%	7%
Taiwan	12%	6%
Singapore	18%	8%

Source: World Bank.

Table 5: Estimated Impacts of Key Policies on Export Growth

Factor	Impact on Exports
Trade Liberalization	+20%
SEZ Policy Implementation	+15%
Human Capital Development	+18%
Macroeconomic Stability	+12%

Source: Authors' calculations based on WTO Data.

In conclusion, export-led growth offers valuable lessons for Pakistan. By adopting policies that prioritize trade liberalization, targeted incentives, human capital development, and macroeconomic stability, Pakistan can unlock its export potential. Ensuring policy stability and

pragmatically balancing tax incentives with fiscal responsibility will be critical. With these measures, Pakistan can create an enabling environment for industries to thrive and integrate into the global economy, paving the way for sustained growth and development.

4.1: Policy Instability and Exports

All commentators note that political and policy instability is perhaps the biggest problem in Pakistan. Economic theory notes that instability is priced in the market. Since we are so focused on politics, few research investigations have been made into showing the costs of policy instability.

Constructing a variable for policy uncertainty is time consuming and perhaps an investment that needs to be made. Here we use IMF programs as proxy for uncertainty given that each program sets tax targets and other quantitative targets based in arbitrary structural benchmarks and no fundamental reforms. When these quantitative targets are not met and the status quo games the structural benchmarks, the program sets in motion further arbitrary taxes and structural benchmarks that destabilize the business environment.

With this economic uncertainty variable, we use a simple export model where exports are regressed on the real exchange rate and the instability variable (years in which Pakistan was in IMF programs). For an index of openness, we use the average tariff for a year with obviously lower tariffs being a measure of openness. The interaction term of IMF programs and real exchange rate appreciation measures how the event of “extreme instability” where policy failure and instability combine.

Box 3: An Econometric Model for Exports: 2000-2023

Model

$$\ln(\text{exp-to-gdp ratio}) = 5.8854 - 0.5919 \cdot \ln(\text{reer}) - 0.0795 \cdot \text{imf} - 0.0949 \cdot \ln(\text{ave trff}) - 0.0274 \cdot \text{trend}$$

Key Coefficients:

Constant: 5.8854 ($p < 0.001$, highly significant)
ln(reer): -0.5919 ($p = 0.063$, marginally significant)
imf: -0.0795 ($p = 0.044$, significant)
ln(ave trff): -0.0949 ($p = 0.361$, not significant)
trend: -0.0274 ($p < 0.001$, highly significant)

Model Fit:

R-squared: 0.906
Adjusted R-squared: 0.881
F-statistic: 36.09 ($p < 0.001$)

Interpretation:

The *Trend* variable shows a highly significant annual decline of 2.74% in the exports-to-GDP ratio.

IMF Program participation is associated with a significant reduction of 0.0795 in the log of the exports-to-GDP ratio.

Log of REER has a marginally significant negative coefficient, indicating that a 1% appreciation in REER is associated with a 0.592% reduction in the exports-to-GDP ratio.

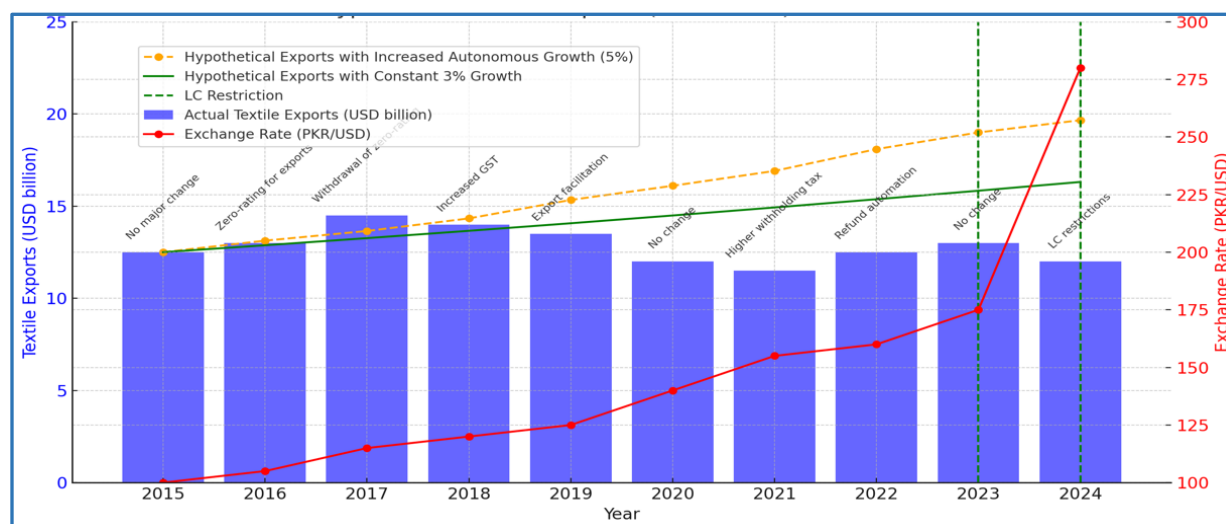
The regression model in Box 3 shows some interesting results:

1. The trend variable shows that the export to GDP ratio is on a shallow declining trend which should be of great concern for the country. Despite our exhortations of export led growth our exports are showing a shallow declining trend.
2. Contrary to popular belief the exchange rate does have a marginally significant negative impact on the export to GDP ratio with an estimated elasticity of about.
3. The policy uncertainty variable, IMF, has a significant and negative impact. As expected, the changes in tax rates and continuous changes to policy of unachievable targets is eroding export growth.
4. The openness variable is of the right sign but not very significant. But this variable has not been detailed enough to catch the non-quantitative restrictions that are frequently used in place of tariffs.

Figure 4 shows a simulation model of export evolution in an environment of policy volatility in Pakistan. Here we use trend growth rates of 3% per annum (green line) and 5% per annum (orange dotted). For the simulation we use negative policy changes such as tax increases and LC restrictions as reducing trend growth by 1 or 1.5% while events such as refund automation and export facilitation schemes as allowing a 1% extra growth.

Actual exports show a declining or flat trend in this period i.e. exports are growing at a lower rate than GDP growth even when the exchange rate is depreciating in nominal terms. It should be noted however, that the real exchange rate has not depreciated over this period. Indeed, it has had significant periods of overvaluation.

Figure 4: Simulation of Actual vs Hypothetical Textile Exports with 3% Growth: 2015-25



We project the trend growth in cotton export to GDP ratio to grow at 5% per annum. Policy shocks are classified as positive a negative and growth increased by 1% for the EFS scheme discounted by 1% for negative shocks. Clearly, a stable policy outshines and unstable policy. This is a lesson policymakers need to learn. Too often, stable policy is confused with stable rule.

The simulation shows that exports would have grown consistently had the policy been stable. Export-GDP ratio has not shown significant growth over this period. It has remained range bound between 10 and 14 %. Even with moderate growth it would have surpassed 15% while with faster growth could have been 18% of GDP but with a stable policy not continuous changes of tax, documentation and other negative interventions by the government.

Since policy sets the rules which include taxation as well as the relationships along the value chain, perhaps the biggest lesson that policymakers need to learn is that stability will allow businesses to flourish eventually flourishing businesses will find it easier to pay more taxes.

5: EFS AMENDMENT: ECONOMIC, EMPLOYMENT AND LIVELIHOOD LOSSES

Despite its importance, the textile sector has had to contend with the challenges of discontinuity in policies as well as lack of support over other issues (high energy costs, infrastructure improvement, for example). Post budget 2024-25, another such challenge has been thrown at the textile sector in the form of removal of zero-rating on local supplies under the Finance Act 2024. At the same time, imports have been given a boost by maintaining zero-rating on imported inputs which are duty-free and sales tax free. This incentive to imports is already impacting the balance between using local versus imported supplies as the monthly import of cotton yarn has increased eight-fold Year-on-Year (YOY) basis

EFS leaves all imported inputs free of tariffs or GST while attempting to bring the local inputs in the GST chain. Given this change, the terms of trade especially for the upstream domestic cotton will be adversely affected more than significantly. Although the government contends that this withdrawal will have no impact upon the textile sector since the 18 percent sales tax imposed upon procurement of domestic inputs (raw material and intermediate inputs) will be refundable, this claim does not reflect the numerous issues associated with refunds and removal of zero-rating facility. *For a start, the textile sector has historically had a less-than cordial experience in terms of getting their refunds, which are at least six months late, often returned less than the total amount, and implies certain other expenses on part of textile sector just to get their refunds.*

It is also important to keep in perspective that only those units within the textile industry are affected that are in the formal sector, that is paying their taxes and duties duly while also facing other challenges (like high energy costs). The informal parts of this sector remain out of the reach of the tax machinery and are thus at an advantage against the formal units who have to bear their share of taxes too. Then there are other challenges for the formal sector in the form of unchecked increase in the making use of the EFS. Estimates suggest that over 1800 entities subscribe to the EFS currently, which includes non-manufacturing entities. Misuse by commercial importers is further contributing to the misuse of EFS, as the imports are ending up in local markets. The structure of EFS, which allows a period of up to 5 years for imports to be reconciled with exports is highly liberal and being exploited by unscrupulous elements to misuse the scheme.

The socio-economic consequences can be devastating and tend to cascade through all the sub-sectors within the textile industry. The most pronounced impact has been on the spinning sub-sector which was already facing an uphill challenge due to energy costs. Over 25 percent of spinning units across the country have shut down, with many more on the verge of closure. The

spinning sector, with 13.5 million installed spindles, has the capacity to consume over 16 million bales of cotton/annum. Decline in spinning will inevitably spillover to the cotton sector, threatening the broader cotton economy of Pakistan.

As remarked above, this can have devastating socio-economic consequences. A significant percentage of Pakistan's labor force is associated with the textile industry, not just those specifically work for the textile industry but also agriculture economy where the demand for cotton by the textile industry leads to sustaining millions of livelihoods. The closure of textile units within its sub-sectors, as in cotton spinning, and the sales tax upon inputs which has already led to significant decline in demand for local cotton, means that thousands of individuals have lost their jobs. Thus, all sectors, industry, agriculture and the services, are affected by these decisions. The impact could also be gauged by APTMA's estimate that suggests a staggering, potential loss of \$15 billion to industry in terms of loss in output, 'sunk' costs and other consequences. The end result of all this would be a negative effect upon Pakistan's present and future exports, of which textile is the predominant part, a possibility Pakistan can ill-afford.

The main issue is the absence of level playing field, as zero rating and sales tax exemptions for domestic supplies was removed for exporters in Budget FY 24-25 while imports of the same inputs are still exempted from duty and sales tax. Although the 18 percent sales tax on domestic procurements is refundable, the refunds take considerable time, in cases well over a year. This creates liquidity issues for the genuine manufacturers. The move to impose the 18 percent tax on domestic inputs has industrial, fiscal, and socio-economic consequences, something that policymakers in Pakistan need to take cognizance of before making any new policy. The following paragraphs contain estimates of potential losses (or gains) due to this government policy. The estimates for various losses, and the methodology used to reach these estimates per sub-sector/unit, are as follows.

- i. ***Losses Due to Spinning Units and Spindles' Closure:*** There are 477 spinning units with 13.5 million installed spindles, implying an average of 28,300 spindles per spinning unit. As per APTMA, after the removal of sales tax exemption, an estimated 25 percent spinning units have closed down, while 25 percent are working on half the capacity. This means that a total of 120 units consisting of 3,396,000 spindles are now closed, while approximately 2 million spindles are working on half the capacity.

This would also imply a 'sunk cost' in the form of lost investment, which is calculated keeping in perspective that each spindle on average costs \$1500, and the average size for setting up a spinning unit is 10 kanals of land. With the closure of facilities, there is an equal labor loss-forming the saddest part of the whole hit to the value chain. After making all the estimates, all these losses are aggregated to arrive at an estimated total loss amount.

a. ***Labor and wage losses***

- ii. **Losses Due to Power Loom Closures:** There are an estimated 375,000 power looms, with an average of 5 individuals employed per power loom, implying total employment of 1,875,000. Since the removal of exemption, an estimated 15 thousand power looms have closed down. The estimated average price of a low to medium quality power loom is \$15,000, with top quality looms costing above \$35,000. However, as per the industry sources, only a small portion of the industry has top-quality machines. Therefore, \$15,000 figure is used in the calculations of sunk investment. The average salary of the various kinds of labor was reported at Rs. 100,000. The calculations based on this information is as follows:

a. Labor and wage loss

Number of power looms closed= 15,000

Number of employed labor losing job= $15000 \times 5 = 75,000$

Estimate of income lost by labor= $75,000 \times \text{Rs. } 100,000 = \text{Rs. } 7,500,000,000$

b. Sunk investment

Estimate of sunk investment= average price of a power loom* units closed= Rs. $4,170,000 \times 15,000 = \text{Rs. } 62,550,000,000$ (**Rs. 62.6 billion**)

Merely these two categories have experienced an estimated loss of Rs. 1.69 trillion, or 1.7 percent of Pakistan's GDP. It is important to note here that the losses across other categories like shuttle-less looms, industrial and stitching machines and ginning units, etc., have been left out of the calculations since the basic premise of this paper is to show the considerable extent of losses being suffered by the textile industry. The above stated number should provide ample evidence of this assertion to the policymakers.

The above are the losses inflicted upon the textile sector and its various components. But what policymakers do not realize is that, indirectly, the loss incurs to the national kitty and the overall GDP too. This basically occurs due to the loss of revenue due to lower consumption of public sector goods, specifically electricity, the loss of investment by entrepreneurs, and the loss of jobs leading to lower per capital income and lower direct tax. Also, it affects the GDP growth too as the textile sector has been estimated to be between eight to ten percent of the GDP of Pakistan.² Some economy wide implications, in the form of estimates, are shown below:

- iii. **Loss of Tax Revenue:** The withdrawal of zero-rated exemption on inputs will have various consequences for the government revenues, from loss of revenue from input consumption and sales, etc., to expansion of informal economy which does not pay taxes like the formal sector.

Following methodology is used:

² Estimates of its contribution vary between 8-10 percent. For example, an International Growth Centre (IGC) paper ('A comparative analysis of garments sector of Pakistan') puts the number at 8.5 percent

- The loss in terms of income taxation will be calculated in terms of figure of Rs. 111.23 billion income tax collected from Textile sector in FY 23-24, keeping in perspective the prospective losses of jobs, the incomes from those jobs (as documented above in two cases).
- The estimates of loss in indirect taxes will be based upon total indirect taxes in FY 23-24 (Rs. 5 trillion, 551 billion) and textile sector's share in it (Rs. 558 billion, mirroring textile sector's estimated share in GDP, i.e., 10 percent, serving as a reasonable proxy in this case since there is no separate estimate of indirect taxes from this sector). The figure was then collated with losses till now to estimate the indirect tax losses if the state of affairs at present continues.
- It is followed by the calculation of losses due to expansion of undocumented economy. Several sources were used for this calculation. At a recent meeting at FBR, cotton growers (backed by APTMA) reported that an estimated 3 million cotton bales are now unreported/undocumented, meaning doubling of the average annual undocumented bales (i.e., 1.5 million bales). It could imply a doubling of undocumented segment compared to previous years. However, we use the historical figure of undocumented sector for this estimation. In aggregate, an estimated 24 percent of the total textile sector is undocumented, which has been applied to the annual tax evasion to calculate losses post-exemption. Other types of evasions include misuse of EFS exemptions by textile exporters, under and over invoicing, non-declaration of bought inputs, smuggling, etc. The same 24 percent rate is used to gauge the expected losses in revenue.

The calculations are as follows:

Estimated loss of income tax= Rs. 10 billion

Estimated loss of indirect tax= Rs. 30 billion

Annual revenue losses (textile sector grey economy, with sales tax exemption) = Rs. 236 billion

iv. ***Loss due to forgone investment in textile sector:*** As demonstrated above, the repercussions for the textile sector include 'sunk investment', investment that cannot be recovered (mainly fixed investment). Besides from this, there are further implications in the form of loss of expected investment. For this calculation, reliance is placed upon the State Bank (SBP) data since the textile sector regularly takes up loans from the SBP (containing the bifurcation between fixed

and variable investment portion of loans), and the information on loans and equity ratio provided by industry sources.

The estimate of expected loss in investment in this sector will be based upon information gleaned from industry sources that have information regarding the inflow of loans and equity to be invested in textiles.

The calculations are as follows:

Investment in the textile sector (in Rs. millions, January 2024-June 2024)= fixed plus variable investment= Rs. 136, 828 + 2,995,463= Rs. 3 billion, 532 million, 565 thousand

Equity investment= Rs. 883,141

Total Investment= Rs. 4,415,706 (Rs 4 billion, 415 million, 706 thousand)

Loss of Investment= Rs 1,225,000 (Rs. 1.23 billion)

6: REFINING THE SCHEME

Why the differential treatment of imported and domestic cotton inputs? Why has the policy not put the same tax on inputs whether local or international? The exporters want to remain out of the GST system because of the problem with refunds. This problem has persisted for many decades. It has created a huge amount of distrust in the system. It is rumored that the FBR likes to delay refunds to meet their targets. It is also said that the refund system is easy to game in connivance with the FBR.

On the other hand, businesses rightly claim that a delay in refund system compromises their cash flow and their business plan. Export orders are hard to meet when cash flow has been compromised by a slowdown in refunds. In this case, credibility and reputation which are extremely important in international markets are compromised.

The effectiveness of a GST system hinges on the seamless integration of all parts of the value chain. In Pakistan, gaps in the GST system allow for fraudulent activities, such as fake invoicing and tax evasion, which hinder the system's efficiency and credibility. Addressing these issues requires a multifaceted approach, combining technological, policy, and enforcement measures tailored to Pakistan's specific challenges. And most important of all it will take time. FBR should not frenetically change rules and rates. Instead, it should rely on steady digitization, develop a trustworthy system of refunds and GST implementation and steadily develop simplicity for the little guy who cannot expend effort and resources on compliance.

6.1: GST Imposition Requires Fixing the Refund System

A level playing field for local production v imports requires imposition of GST on both. The perennial problem with refund—delays and limited payments—imposes an additional tax burden on exports.

Several challenges arise when parts of the value chain remain outside Pakistan's GST system. Completely covering the value chain for a full GST in VAT mode remains challenging. Unregistered or fictitious entities issue fraudulent invoices, enabling undue input tax credits. Businesses outside the GST system create breaks in the tax chain, fostering tax evasion. Non-compliance and lack of traceability lead to inaccurate refund claims and revenue loss. Disconnected segments make it challenging for the Federal Board of Revenue (FBR) to verify claims and trace goods or services through the supply chain.

An innovative approach to address refund delays and fraud involves granting provisional refunds based on period (say monthly or six monthly) averages. Refunds could be disbursed immediately based on historical refund patterns or input-output tax liabilities. At period-end, actual eligibility is reconciled and adjusted. This will improve liquidity for businesses by ensuring timely refunds as well as reduces administrative bottlenecks by shifting verification to post-disbursement reconciliation. However, it will require robust IT systems for real-time processing and reconciliation. There is also a risk of overpayment or fraud if reconciliation is not rigorously enforced. Australia and New Zealand use similar approaches, combining immediate refunds with strict reconciliation mechanisms. FBR could use FASTER system to introduce monthly averaging for export-oriented sectors, ensuring faster refunds while maintaining control through reconciliation.

FBR could also simplify Compliance for Small Businesses like Malaysia which offers a simplified filing and payment processes to encourage small businesses to register under GST.

India has successfully implemented e-invoicing for businesses, starting with larger entities and gradually expanding to smaller ones, significantly reducing fake invoicing (see Box 4). This is proving to be challenging in Pakistan. FBR is trying to require all transactions in Pakistan to be reported electronically in real time. This will enhance transparency and traceability of transactions as well as reduce the prevalence of fake invoices by validating supplier details in real time and facilitates automated input-output tax matching. The FBR must mandate e-invoicing in stages. For example, first for larger businesses, followed by medium and small enterprises, ensuring scalability and reducing resistance.

Box 4: India's Differential GST Framework for the Export Industry

India's Goods and Services Tax (GST) system incorporates provisions tailored to support the export industry, ensuring that exports remain globally competitive by alleviating domestic tax burdens throughout the value chain.

Key features include:

1. Zero-Rated Supplies: Exports of goods and services are classified as "zero-rated supplies" under the GST framework. This classification implies that exports are taxed at a 0% GST rate while allowing exporters to claim input tax credits (ITC) for taxes paid on inputs used in export production. This prevents the cascading effect of taxes and keeps Indian exports competitive in international markets.

2. Input Tax Credit (ITC) Mechanism: Exporters can claim refunds on GST paid for inputs and input services used in producing export goods or services. This ITC mechanism enhances liquidity and lowers production costs, making Indian goods and services more attractive globally.

3. Integrated GST (IGST) on Imports: When exporters import goods or services, they are subject to Integrated GST (IGST). However, the IGST paid can be claimed as ITC. This credit can either offset GST liabilities on domestic supplies or be refunded in the case of zero-rated export supplies, ensuring a tax-neutral impact on exporters.

4. Exemption for Specific Transactions: Supplies to Special Economic Zones (SEZs) are treated as zero-rated under GST. This allows suppliers to SEZs to claim refunds on input taxes, facilitating a tax-efficient supply chain for export-oriented units operating within these zones.

These differential GST measures aim to eliminate tax-related barriers in the export value chain. By ensuring that Indian exports remain free from domestic tax burdens, the framework promotes greater competitiveness for Indian goods and services in global markets.

There are, thus, several examples of countries that have dealt with the GST issue. The refund system has been under discussion for decades and subject to 1000s of millions of dollars of technical assistance (TA). It is time that this issue was finally settled as in other countries. This would certainly go a long way to fixing the country's tax problems that would develop trust between the government and industry. This would go a long way to increasing both our productivity and exports!

There is no justification for the refund issue to persist. FBR should treat it as an urgent priority to develop its credibility

6.2: Stringent Compliance to EFS Rules to Avoid Frauds

Challenges are faced by authorities in ensuring the proper utilization of export facilitation schemes and underscore the need for stringent monitoring and enforcement to prevent such fraudulent activities. However, the registration requirements for the EFS are rigorous if respected. In our opinion these are not a big reason to tamper with the regime but to fine tune the entry requirements.

On research, a few cases of defrauding the EFS system were found (see Box 4 for examples), and these examples suggest that: a) the magnitude of misuse may not be very large; and b) the audit requirements should be of a shorter duration perhaps a maximum of six months and by

external auditors to be backed by the customs as required. The current period of five years for reconciliation is simply too long to keep the procedures clean, and might as well encourage misuse.

Box 5: Case Studies of Abuse of EFS

Much is made of the possibilities to abuse the EFS scheme. In going through the custom website, we found at least two cases that could very well have been avoided if the EFS rules were strangely followed.

M/s Pro Textile (November 2024): The Collectorate of Customs Exports at Port Muhammad Bin Qasim uncovered a tax evasion of Rs40.16 million by M/s Pro Textile, an Export Oriented Unit in Karachi. The company imported duty-free raw materials under EFS but failed to account for 45.5 metric tons of nylon mesh net fabric worth Rs82.13 million, which were neither recorded in their books nor used in export production. Consequently, customs authorities recovered Rs40.16 million in duties and taxes from the company.

M/s Premium Textile Blanket Industries (February 2024): The Directorate of Post Clearance Audit (North), Islamabad, uncovered a fraud involving M/s Premium Textile Blanket Industries, which misused EFS to the tune of Rs1.4 billion. The company imported fabrics duty-free under EFS but diverted 2,194 metric tons to the local market instead of exporting them, causing substantial revenue loss to the government. A joint investigation is underway to apprehend the culprits.

7: FINAL RECOMMENDATIONS

Pakistan remains a cotton economy and cotton products remain the mainstay of our exports. The value chain is moving slowly to higher value-added goods but the traditional sectors from raw cotton to spinning while losing share in the value chain are still a valuable part of the system. The important point to note is that the value chain is transitioning naturally to develop higher value products and integrated suppliers.

This study shows several important points that should be important for policy. The top ten being:

1. The imposition of an 18% sales tax on local inputs, coupled with persistent delays in refund processing, has created a stark imbalance between domestic and imported inputs, adversely affecting local cotton producers and spinning units. **This policy not only threatens the viability of the formal textile sector but also incentivizes the informal sector, which escapes the tax net. Consequently, Pakistan's textile industry has experienced significant closures, job losses, and a decline in competitiveness, with ripple effects on the broader economy, including agriculture and services.**
2. The one-sided imposition of the GST on domestic inputs will force adjustments in the local value chain that our findings suggest could be costly in the short run. The value

chain is adjusting at its pace. **Our estimates suggest that forced changes through making local inputs more expensive will impose excessive costs as large as 2% of GDP (over 1.7 trillion rupees).** The recent gains from exports may be at risk then. The losses incurred, both economic and socio-economic, are staggering. The erosion of trust between industry stakeholders and tax authorities further complicates efforts to implement reforms. **Addressing these challenges requires a holistic approach that balances the needs of exporters, supports local industries, and ensures compliance through robust monitoring and reconciliation mechanisms.**

3. The high valued added producers will not be affected by the extension of GST on domestic products as imports are free of tax. The upstream producers will of course have to compete against GST free imports which are also not subject to any tariffs. **In economic terms, the upstream sectors are experiencing an erosion of their terms of trade because of this change.** Those using imported inputs will move away from these domestic inputs. Our consultations show that the costs of adjustment could be significant and at least in the short run place pressure on exports as well.
4. The Export Facilitation Scheme and the broader fiscal policies affecting Pakistan's textile industry illustrate a complex interplay of incentives and inefficiencies that significantly impact the sector's performance. While the EFS aims to promote exports by enabling duty-free access to imported inputs, its misuse, including diversion of inputs to local markets and the inclusion of non-exporting entities, has undermined its effectiveness. **Our brief investigation shows that the abuse of the regime is not excessive and could be controlled by some simple tweaks to the system.** This includes:
 - i. ***Ensure that the eligibility conditions are rigorously applied,*** and malfeasance is punished harshly.
 - ii. ***The 5-year audit/reconciliation period needs to be shortened*** and strengthen to be 6 months with substantial online monitoring of transaction and algorithmic checks of inputs and exports of participants.
5. Economic theory suggests that the value chain must continue to evolve without policy intervention. This is the basis of the GST/VAT system. The solution to this problem then is immediately obvious:
 - i. ***Withdraw this imposition of the GST on the local inputs.*** Of course, this is the first best solution as it requires no adjustment and lets business go on as before. Unfortunately, this may not be the preferred position from the point of the GST system and policy. It will mean a broken chain in the system.

- ii. ***From a GST point of view, the preferred solution would be to impose the GST on import as well.*** In this case the system will be neutral to the imposition of the tax. However, there is a catch. As argued above the refund system has not been fixed as required. It continues to create frictions creating critical cash flow issues for producers. Surprisingly, this issue has not yet been resolved after decades.
6. Producers continue to complain about delays in refunds as well as incomplete refunds. **For its own credibility and efficient expansion of the GST system, urgent action must be taken to ensure a rapid refund of GST system.** Several country examples are available and FBR has ample consultants working on the problem. We are sure there is a recognition of the need for a good refund system. With this system in place, the hesitation of the producers to move to a full GST will be reduced. Indeed, this may be an important step to extend the base of the GST.
7. Since this is not a study on the GST, we will not go into detail on how to fix the refund system, but there is a huge consensus on digitization being the solution. **Here we would only like to point to perhaps using algorithms to reconcile inputs and outputs and following the practice in some markets allow instant refunds on select transactions to qualified people with the proviso to periodically reconcile the difference.** This could provide much needed liquidity while ensuring tax collection. Algorithms can allow this to happen, and malfeasance identified relatively quickly.
8. Data also shows that exports as a percent of GDP are on a shallow declining trend which is very disturbing. Simulation exercises also show that policy instability specifically change in tariffs and taxes tends to adversely impact exports. ***Haque Tax Commission*** report also showed that tax policy stability is very important for investment and growth. **Volatile policy has been an important impediment that the policymaker must bear in mind before changing past policies especially taxes.**
9. Econometric results also show that **maintaining a realistic exchange rate is important for exports.** The elasticity is not only statistically significant but also quite substantial.
10. **Low tariffs and openness can help the Pakistani value chain to be better embedded in the global value chain.**

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