BUSINESS RECORDER
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**03rd May, 2019**

## Significance of Fifth Schedule of Customs Act

News reports have indicated that the Government was considering removing the Fifth Schedule of the Customs Act. This would be a major step that could potentially disturb the balance in customs law. To appreciate this, it is necessary to understand how the said schedule was introduced in the customs law.

In June 2013, during negotiations for an IMF programme, talks were nearly stalled as the Mission was not satisfied with the richness of tax reforms on the table. As a rear-guard action, two reforms were offered: (a) to broaden the tax net through the issuances of tax notices to 300,000 potential taxpayers whose data was available in FBR based on the information from withholding tax payments; and, (b) elimination of all statutory revision orders (SROs) and exclusion of this instrument in future tax administration. The Mission Chief was jubilant and an agreement was reached.

The above reforms were diligently implemented during the programme. It is the rationalization of SROs reform that would be discussed here. Let us explain the nature of this reform within the context of the Customs Act, 1969, while we would say a few words on the Sales Tax side also toward the closing. An SRO is a concessionary order that allows charging of duties at lower rates than those specified in the statutory customs manual. The proliferation of SROs virtually neutralized the statutory regime. Out of some 7000 tariff lines, nearly 90% were subject to rates specified in the SROs. More significantly, SROs were routinely amended giving rise to uncertainty about the stability of the tax regime.

At the outset, the use of SROs for altering tax rates was curtailed and subsequently, through an amendment in the law the power of the Federal Government to issue SROs was withdrawn except under certain exceptional circumstances such as national emergency and high volatility in prices of essential commodities. A phased programme of elimination of all SROs, spready over three years, was formulated and subsequently implemented.

Every year, before a phase would be implemented, stakeholders" meetings were organized by an inter-ministerial committee headed by the Finance Minister, which would share the planned removal of SROs and its impact on the beneficiaries. The exercise entailed revision of duties to the nearest statutory rate, upward or downward depending on the economic significance of a given PCT Heading. In many cases, particularly where duties were to rise, a path of adjustment toward the final rate was agreed.The exercise invariably resulted in enhanced revenues for the Government.

After implementation of each phase in the respective Finance Act, the IMF would make a very careful assessment of each entry and ensure that it was implemented as per the understanding reached under the programme. This was an annoying process but was inevitable for completion of Review and release of tranche.

It is also important to underline another reform that was running concurrently with the SROs rationalization exercise. This is the reduction in duty slabs. At the start of the programme, there were seven duty-slabs and it was required to be reduced to only four with a maximum tariff of 20%, down from 25% at the start of the programme. Making a choice within these four duty rates was not any easy exercise. All numbers were tried between 1-5 as the minimum and finally it was set at 3. Yet not everything could have been subjected to 3% and hence the search for an instrument that could resolve these challenges.

At every stage of phasing exercise, it was felt that a significant number of items could not be placed in the tight framework of Schedule 1, which contained the statutory tariffs. It was therefore found necessary that a category be created that would protect such items, and where the government would retain the necessary

freedom to design policy not constrained by the limitations of First Schedule. A new sub-section(1A) was added to Section 18 of the Customs Act, 1969 which stated: (1A) Notwithstanding anything contained in sub-section (1), customs duties shall be levied at such rates on import of goods or class of goods as are prescribed in the Fifth Schedule, subject to such conditions, limitations and restrictions as prescribed therein.

This was the genesis of the Fifth Schedule in the context of SROs reforms. An understanding of the characteristics of Fifth Schedule would enable us to appreciate its significance. First, the Fifth Schedule was an agreed departure from the primary regime evolved in the First Schedule, which is based on statutory tariffs. However, the Fifth Schedule is also subject to Parliamentary oversight. Second, it allowed more duty-slabs beyond the agreed four, within the maximum rate of 20%, found in the First Schedule. Third, and most importantly, it allowed the return of the zero rate that was critical to protecting such major imports as are directly consumed by the consumers, such as vegetables frequently imported from across the border and medicines and its raw materials. Fourth, the protection needed to domestic industry as well as incentives for import substitution and promotion of export oriented industries, are also built in the Fifth Schedule.

Finally, let us see what kind of items have been included in the Fifth Schedule.The items allowed under the Fifth Schedule are of three types: consumer products (food, petroleum products, LNG), plant and machinery (pharmaceuticals, textiles, agriculture and food chain machinery, renewable energy and other power plants), raw materials for industry (active pharmaceutical ingredients, drugs, textiles, poultry, automotive industry etc.) and someother products (for domestic protection and export industries).

The inclusion of items in the Schedule is subject to a number of conditions, limitations and restrictions. For the purpose of completeness of the regime, the First Schedule comprehensively states statutory tariffs for all items. But, with the fulfillment of specific conditions and limitations, certain items can be imported under Fifth Schedule. For instance, many raw materials for import substitution or export oriented industries could be allowed under the Fifth Schedule provided they are not manufactured locally. In sum, significant operational details have to be passed through before the concessions available under the Fifth Schedule can be enjoyed.

A similar exercise was done in the case of Sales Tax Act and two schedules, namely Sixth and Eighth, were crafted that allowed charging of lower than the statutory rate of sales tax or allowed exemptions to such items as food and medicine.

Viewed in the above perspective, these schedules need protection as their elimination would lead to a significant disruption for trade, industry and common consumers. Undoubtedly, marginal changes, wherever felt expedient can be made, and should be made, but their fundamental nature has to be preserved so that in the most critical application of tax policy the requisite freedom needed by the Government is not impaired.

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