Research and Policy Brief

An Agenda for Devolved Tax Collection

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Pakistan's tax system has undergone significant reforms over the last three decades, leading to modernization of direct and indirect taxes. Some major reforms in direct taxes include the introduction of withholding taxes, rationalization of income and corporate tax rates, and introduction of self-assessment for filing income taxes. The developments in indirect taxation include rationalization of the customs tariff structure with a reduction of tariff bands and maximum rates, introduction of a tax on services, and efforts to introduce a value-added tax (VAT). Despite these reforms, Pakistan stands among the bottom 10 percent countries in terms of tax-to-GDP ratio. A comparison of Pakistan's tax-to-GDP ratio with India reveals under taxation of at least 3 percent of the GDP. It can be inferred that these reforms had limited success in achieving desired results.

At present the taxation system is inequitable and relies heavily on indirect taxes. The system is also inefficient and unable to capitalize true potential. Apart from governance issues related to corruption and mismanagement, inefficiencies in the system are structural and can be associated with the federal structure of the country where the same tax bases are divided between both tiers of the government. For instance, the two major taxes i.e. income tax and sales tax have divided tax bases; while income taxes fall under the federal domain, agricultural income tax falls under the provincial domain. Similar tax base sharing is reflected in sales tax that divides the tax base into goods and services. This situation demands for revisiting tax assignment or at least tax collection mechanisms for removing loopholes in the system.

Revenue Assignment as per Constitution

The 1973 Constitution designates revenue assignments between the federal and provincial governments. After the abolishment of concurrent lists through the 18th Constitutional Amendment (2010), revenue sources are assigned through classifications in the federal lists of subjects. A revenue source will belong to the federation only if it is mentioned in the federal list; otherwise, it will be treated as a provincial revenue source.

Federal taxes are mentioned under the Fourth Schedule, Article 70(4), of the Constitution. The federal government has a constitutional right to collect taxes on corporations, income other than agriculture income, and capital value of assets, excluding taxes on the immovable property. Among indirect taxes, the federal government has a constitutional right to collect taxes on the sales and purchases of goods (imported, exported, produced, manufactured or consumed), but not on the sales of services. The other major federal indirect tax includes taxes on international trade i.e. export and import duties and excise duties.

The revenue assignment of provincial governments includes direct taxes on property, agriculture income, and professions. Among the indirect taxes, major provincial taxes include sales tax on services, excise duty on alcohol/liquor/narcotics, motor vehicle tax and stamp duty. It is worth a mention that most provincial taxes are assigned through a bar in the federal list, which implies that part of the tax base falls under the federal domain, whereas, the remaining tax base is in the provincial domain.

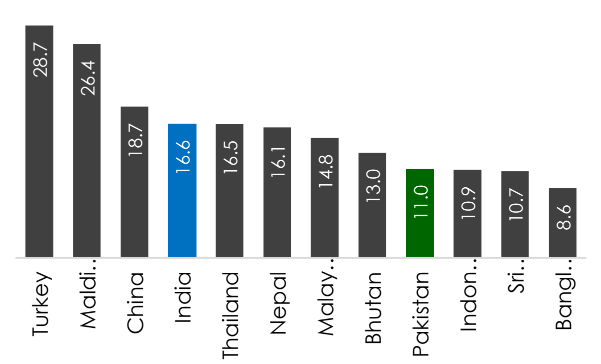
Why Tax Assignment Matters

Second generation theory of fiscal federalism places greater emphasis on the importance of revenue generation by sub-national governments. Sub-national governments that finance a substantial portion of their own expenditures through their own revenues tend to be more accountable to citizens, are more likely to provide the services desired by people, to provide market-enhancing public goods, and to be less corrupt compared to sub-national governments that are heavily dependent on fiscal transfers.

Pakistan's Comparative Position in Tax-to-GDP Ratio

Pakistan is the fifth most populous country in the world. Its economy is the 25th largest in the world, in terms of purchasing power parity (PPP), and 42nd largest in terms of nominal GDP. It ranks 157 out of 179 countries in terms of tax-to-GDP ratio, which is much lower as compared to its economic ranking. Chart 1 presents a comparison of the tax-to-GDP ratio of selected developing countries, indicating that Pakistan is positioned among the lowest tax-to-GDP ratios. A comparison of Pakistan's Tax-to GDP ratio with India and Malaysia reveals a difference of at least 3 percent of the GDP.

Chart 1: Tax-to-GDP Ratio in 2017 – A Comparison

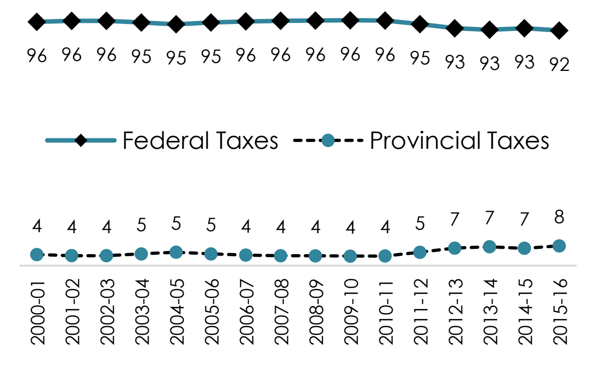


Source: Heritage Foundation (2017)

Federal and Provincial Shares in Taxes

Chart 2 shows the share of federal and the provincial governments in total tax revenues. Noticeably, the federal government collects more than 90 percent of total taxes in Pakistan. Prior to the 7th NFC Award, the provincial share was around 4 percent which increased to 8 percent in 2015-16. This suggests that provincial governments have a very narrow base of taxes and over-reliance on federal transfers. Buoyant sources of revenues, like sales tax on goods, income and corporate taxes are still under the domain of the federal government. From the perspective of sustainable public service provision, provincial governments require enough "own" revenues in order to not be heavily reliant on federal transfers and grants. The gradual increase in provincial shares in taxes is an outcome of devolution of the sales tax on services. Initially, the government of Sindh took the initiative to collect the sales tax on services by establishing the Sindh Revenue Board (SRB). Afterwards, government of Punjab and Khyber Pakhtunkhwa established their respective revenue authorities to collect this tax. Recently, the Government of Balochistan has also established a revenue authority to collect sales tax on services. So far, the provincial revenue board and authority have performed much better in collecting sales tax on services. This provincial tax machinery also helps the federal government in the collection of withholding taxes, particularly those on motor vehicles.

Chart 2: Distribution of Total Taxes (%)



Source: Pakistan Fiscal Operation (Various Years)

Issues

The taxation structure in Pakistan is skewed in favour of top tiers. At the time of independence, sales tax on goods was a provincial tax. However, after a couple of years the federal government took sales tax on goods temporarily under its domain and it still remains a federal tax. The 1973 constitution endorsed sales tax on goods as federal tax. Federal and provincial tax assignments have remained unchanged since 1973. Even the 18th Constitutional Amendment (2010) did not modify federal and provincial tax assignments and was limited to explicitly endorsing sales tax on services such as provincial tax - which was already a provincial tax since its inception in 2000 but was collected by the federal government on behalf of the provinces. This kind of division generally creates complications that hinder progress in tax reforms and resulted in revenue losses.

The experience of other countries indicates that VAT is a relatively efficient tax if properly implemented. Despite strong support from the international community including IMF, VAT is not fully introduced in Pakistan mainly due to this bifurcation. For collection purposes, federal government treated sales tax on goods as an excise duty. In reality, both taxes are different in nature. While excise duty is a production tax and collected from manufacturers and producers, sales tax on goods is a consumption tax collected from final consumers. However, in

VAT mode sales tax is collected during different stages of production and from sales that include producers, importers, wholesalers and retailers. Due to its complex nature, despite introducing sales tax reforms in the 1990s and having full control over both sales taxes on goods and services, the federal government has been unable to fully introduced VAT to collect sales tax. The major lacking is to implement the wholesale and retail tax. As a result, a significant amount of revenues is lost largely due to incomplete coverage of the value chain that likely encourages manufacturers, producers and importers to under-report quantity or price or both.

In contrast, provincial governments are to collect sales tax on services dealing largely with service providers including beauty parlours, marriage halls, hotels, restaurants and the like. They have an interest in wholesale and retail taxes. They have a relatively small geographical area to deal with. If they start collecting both sales taxes on goods and services, they will be likely to cover entire value chain. This will enhance the efficiency of the sales tax collection, as single tax institution will collect both sales taxes on goods and on services.

Similar to sales tax, income tax also has a loophole that provides incentives to individuals and businesses to evade income tax by showing income from other sources as agriculture income. Provincial governments collect very small amount under agriculture income tax but federal government losses large potential amount due to this anomaly. If both taxes, income tax and agriculture income tax, were to be collected by the federal government the scope for evasion would be eliminated through this channel.

Recommendations

A low tax-to-GDP ratio in Pakistan can be attributed to the divided tax collection powers between the federation and federating units, thereby, generating inefficiencies. Therefore, it is suggested that all income taxes should be collected by the federal government. It is to be noted that this recommendation is aimed to reduce anomalies in tax collection, which do not require amendments to the constitution. The federal government should transfer agricultural income tax to the respective provinces, after deducting collection charges.

Similarly, sales tax on goods is a federal tax, while sales tax on services is a provincial tax. These divided collection powers are also generating inefficiencies in tax collection. Given the performance of provincial revenue authorities and boards in collecting sales tax on services, provincial governments should collect both sales taxes on goods and services. This will help reform sales tax in a truly VAT mode as provincial governments can tap wholesale and retail sales taxes and reconcile them with sales tax collected from factories and import stages. The provincial government should transfer sales tax on goods to the federal government that can be distributed afterwards, as per the spirit of the NFC award.

A common misperception is that such a kind of tax collection restructuring will generate a tax war among provinces, lead to tax exporting and a race to the bottom, and financially deprive federal government. It should be noted that devolving collection powers does not mean devolution of sales tax. The federal government in consultation with the provincial government will set sales tax rates and targets. The provincial government will transfer all collected sales tax on goods to the federal government. This also eliminates the scope for tax exporting. Provincial governments are constitutionally entitled to retaining sales tax on wholesale and retail tax.

Research and Policy Brief prepared by Muhammad Sabir