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Strengthening Provincial Finances

A TAX REFORM AGENDA FOR THE MEDIUM TERM

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Introduction

- Should revenue assignments be revisited?
- Current solution for provinces—the GST agreement
- Some options for the next NFC

Should revenue assignments be revisited?

Current context

- Additional spending devolved to provinces under the 18th Amendment
- Financed by larger share of divisible pool
  - Contingent on raising the dismal tax/GDP ratio (9 to 12%)
  - Larger GST revenues—efficiency of GST
    - Pakistan C-efficiency of GST fell to .27
    - Philippines and Sri Lanka around .45
    - Integrated approach to GST has been advocated
- Major achievement on partially integrated administration
  - Provincial administration possible for some sectors
  - However, this reinforces the split bases
- But should the debate be on the assignment itself?
  - Administration a red-herring?

Existing provincial assignments

- Relics of Government of India Act 1935
  - Provincial taxes
    - Taxation of agricultural income
    - Property and land taxes
    - Sales taxes, but which (on goods) went to Federation after independence
- 1973 Constitution assigned sales taxes on services to provinces
  - At the time, this was largely a final point tax on tangible services
  - Much before the advent of the GST
    - proposed for Pakistan by Ahmad and Stern in the early 1980s
    - partial endorsement by Qamar-ul Islam Tax Reform Commission 1983

Design of the 1973 Constitution

- Overlapping spending assignments
- Financed by
  - Share of divisible pool
  - Split revenue bases
- 18th Amendment has focused on unbundling spending responsibilities
  - Did not address the revenue assignments
  - Fissures clear in the tussle over administration of the GST on services

Why broad-based own-source revenues?

- Accountability of provincial and local governments
  - Clarity in spending responsibilities
    - Addressed in the 18th Amendment
  - Should be accompanied by access to broad-based own-source revenues
    - Defined as control over revenue base at the margin, setting of rates
- Is the GST on services an own-source revenue base?
  - Very hard to implement with split administration
  - Variation in rates would make provincial administrations on services a very complex matter
  - Potential loss in overall revenue-productivity
    - Could result in lower overall pie, without own-source benefits

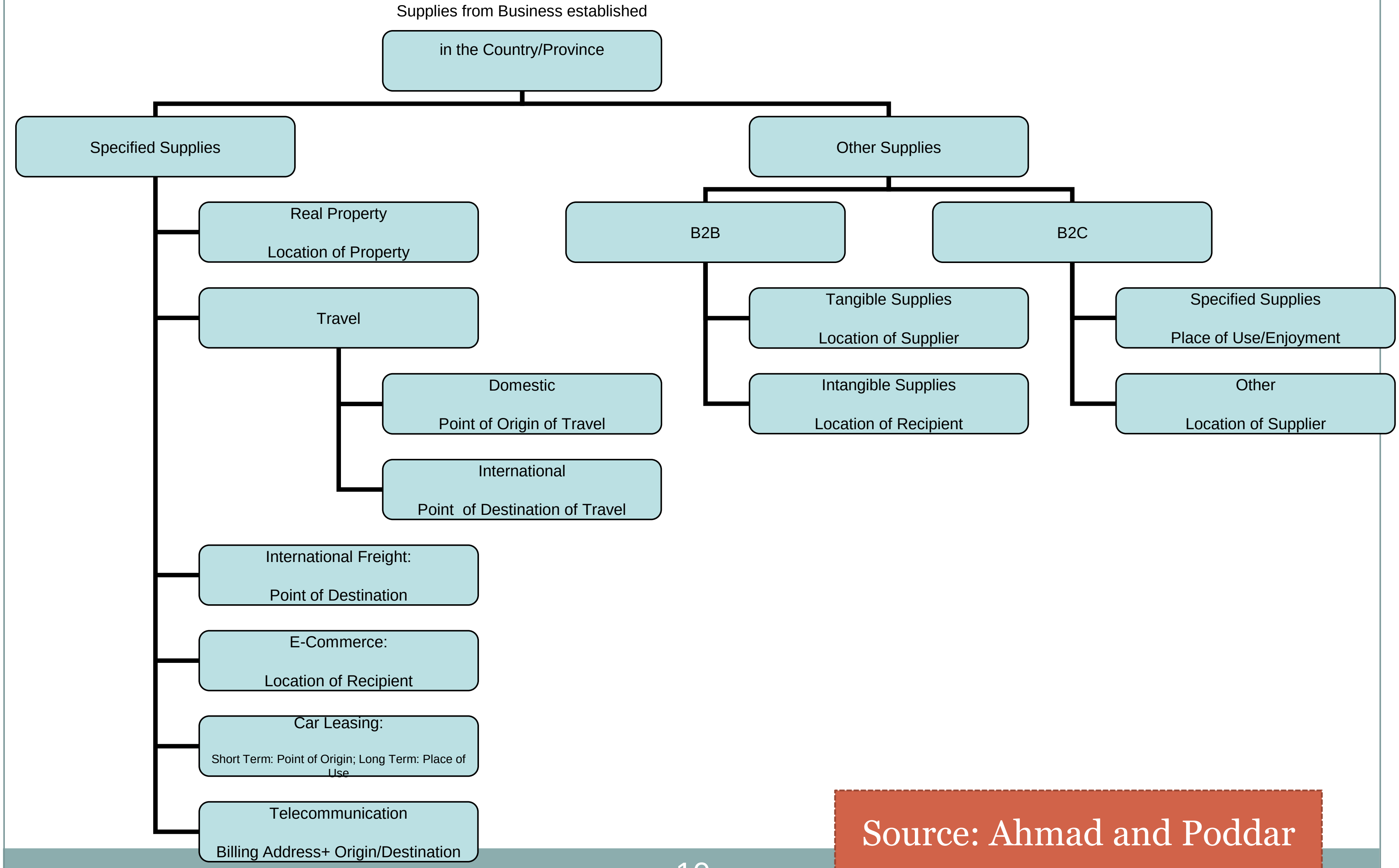
The current solution for the GST

UNIQUE AND VERY HARD TO ACHIEVE

Design of reformed GST laws

- Modern treatment
  - Accounts for tangible and intangible and joint supplies
  - Goods easy to define
  - Services defined as all supplies other than goods
- Pakistan context—unique solution proposed (June 7, 2010)—recognizing political realities:
  - To permit provinces to begin to administer the GST on services:
    1. Final point sales tax for "final" services; peel off from GST on services
    2. Federal administration for items requiring input crediting/refunds; permits modern approach to definition of services under reformed GST
    3. Special treatment for telecommunications (80% of revenues on services)—involving effective federal administration, although with a political caveat

Place of Supply: Services other than goods



Source: Ahmad and Poddar

Case: Stand-alone "final services"

- Stand-alone ("final") services
  - Without major credits to other sectors, or significant input credits from others
- Could be taken out of the GST and administered as a stand alone final point sales tax
  - No crediting or refunds—sector effectively "exempt" or "input taxed" as far as GST is concerned
  - Administered by given provinces, if they so choose
  - List may vary across provinces/over time (best to place as a Schedule in Provincial GST bill)

Stand-alone services: Initial List

- 9801 Hotels, restaurants, marriage halls, clubs and caterers
- 9805 Service providers
- 9807 Property developers and promoters
- 9809 Contractual execution or furnishing suppliers
- 9810 Beauty parlours, slimming clinics
- 9811 Laundries and dry cleaners
- 9814 Architects, town planners, property and interior decorators
- 9815 Medical, legal, accounting and other consultants
- 9816 Pathological laboratories
- 9817 Medical labs and diagnostic services
- 9818 Specialized agencies, except credit ratings, market research
- 9819 Specialized businesses, except stockbrokers, underwriters, indenters and commission agents
- 98.20 Specialized workshops and undertakings
- 9821 Specified fields, including baby care and massage
- 9822 Specified services—fumigation, maintenance, janitors

Should be looked at carefully, as some distortions remain—see below.

Stand-alone:
If no effect on other provinces; but requiring crediting

- Care needed if include services using inputs of goods or services
- Such as hotel chains/ architectural / accountancy firms (Province 1)
  - Will need to apportion input refunds due (other provinces) and treat Province 1 Sales as exempt sales
  - Purchases of hotel stays in Province 1 hotels/ architectural/accounting firms will not be allowed as credits to other goods/service
    - Minimal effects on other provinces
    - Some distortions for Province 1
    - But can be handled with modified forms

Stand alone: affecting other provinces

- Some "stand alone" services which affect other provinces
- Such as final point sales taxes on trade related services
  - Collected at port without input credits or refunds
  - Become a provincial import duty, with higher prices passed on to other provinces, but revenues retained by importing province
    - Generate conflict and retaliation
    - Potential tax wars

Case: Services with input credits/refunds

- Input credits/refunds cannot be handled by provincial administration
- Include intangibles and services with significant input crediting and invoicing across provinces
  - Zero rating for exports
- Suggest that FBR administer on behalf of provinces
  - Pay into "escrow" account managed by all provinces (roughly Rs 10 billion guesstimate)
  - Approximate integrated operation of the GST
  - Avoid potential conflict and tax wars

Special case: Telecommunications

- Relatively small number of sophisticated companies with good information
- Breaking the administration chain:
  - Returns, audit, refunds, crediting operated by the FBR
  - Payment of the gross tax by company directly to the concerned province on the pre-determined base (calls made, received or composite)
- Although gross tax paid approximates an origin basis,
  - the crediting and refunds returns it to an effective destination base
  - Relatively easy administratively for telecommunications
- Should not be applied to any other services—would become impossible to administer
  - Flying invoices could multiply—given the break in the administration chain

Special Case : Telecommunications

- Using international practice across countries: could use lines/bills/ calls made as proxies
- One return to FBR (need to be modified); one audit
- Firms apply input credits, determine total amounts to be paid to each province (based on criteria)
- Make payment directly to concerned province
- Refunds (B2B) (approx Rs. 3 billion in 2008/9) apportioned and charged by FBR to each province using same proportion
- Figures available suggest that calls made close correlation with aggregate consumption by province

PROVINCIAL SHARE IN CONSUMPTION OF SERVICES BY HOUSEHOLDS 2007-08

	Number of Households	Monthly Expenditure on Services per household	Annual Expenditure	Provincial Share	Population Share
	(000)	(Rs)	(Billion Rs)	(%)	(%)
Punjab	14589	3535	618.9	**60.39**	**57.36**
Sindh	5872	3454	243.4	**23.74**	**23.71**
K-P	2916	3825	133.8	**13.05**	**13.82**
Balochistan	1062	2260	28.8	**2.82**	**5.11**
Total	**24439**		**1024.9**	**100.00**	**100.00**

Source: Dr. Aisha Ghaus Pasha for the Revenue Advisory Committee, using National Household Survey Data

What are the net effects?

- **Additional revenues predicated on integrated administration**
- Impossible to have control over rates at margin—hence does not qualify as own-source revenues
- Unlikely that the net distribution will be very different from share in consumption
  - So where is the benefit in terms of greater accountability?
  - Higher revenues?
- Provincial demands indemnified by federation—but is this sustainable?
  - Would come out of divisible pool
  - Hence would affect the net allocation of resources to provinces

Central government indemnities

- May be needed in marginal terms, to get political agreement (compensate losers)
- But if the revenue shares exceed amounts collected (say 135%)
  - Would distort the effective shares going to provinces—would clearly see it as x/135 rather than x/100
  - Who would it convince?
  - Untenable for the federation; especially in the context of reduced federal revenue shares

Medium-term options for the next NFC

AN AGENDA FOR FURTHER WORK

Arguments concerning tax assignments

- Traditional intergovernmental theory
  - Assign immobile tax bases to lower levels
  - More mobile to center, reinforce the administration constraints
- Modern political economy approaches
  - Mobile tax bases accentuate sub-national discipline, hence attractive from political economy perspective
  - Variation in rates critical in establishing provincial accountability

Options

- Single Administration working on agency basis for all levels of government; unified base, rate determined in consultation:
  - Australia (closest to Pakistan legal context—done by agreement to get around constitutional constraints)
  - Revenues collected revert to the Provinces
- Single Administration working on agency basis for all levels of government; unified base, some rate variation
  - Italian IRAP
  - Surcharge
  - US Income tax—collected by IRS for all levels
- Separate administrations; variations in rates (Brazil)
  - Avoid , if possible

Tax reforms: gainers and losers

- Assignments of broad based revenues to provinces may accentuate disparities
- May need to be introduced together with an explicit equalization framework
  - China and Australia: based on revenue capacities and spending needs
  - Possible to indemnify "losers"—Chinese "absolute revenue guarantees", and phase in reforms over time

GST and Integrated Income Tax alternatives

- Centralized administration is easiest,
  - With various revenue-sharing arrangements
  - No accountability however, as rates cannot be amended with revenue sharing
  - But alternatives are possible with better control over the base and rates at the margin—so administration is not the issue
- Local administration is problematic
  - Options discussed below
  - Experiences, Brazil and India show difficulties; make take years to develop
  - Easier alternatives

Dual GSTs

- Nationally determined base, covering both goods and services
- Central administration on an agency basis
- Provincial governments impose provincial GST on the standard base, within a bracket to prevent harmful competition
  - All producing/selling units registered taxpayers, avoid difficulties with multi-province firms
  - Constraint can be lifted if tax administration has full information to ensure apportionment.

Dual GSTs

- Broadening of the base, increases the revenue potential for provincial governments
- Subnational control over rates makes it more attractive as a source of local own-revenues
- Less unequal distribution than other dual option (for income taxes)
- Adjustments needed to deal with the headquarters problem

The IRAP—business tax on GST format

- Linked to income generation rather than consumption
- Creates a linkage between taxes and benefits provided to businesses, and provides a significant basis for provincial/regional revenues
- Very hard to avoid

Italian IRAP

- Base: difference between sales and sum of material purchases and depreciation
  - Equivalent to income-type origin-based VAT
- Statutory rate is 4.5 percent
  - Regions permitted to raise or lower by up to 1 %
  - All public bodies are subject to the tax
  - Revenues are substantial: 2.5 percent of GDP—or a third of all VAT collections; two thirds of CIT

Italian IRAP

- Collections more equally distributed than PIT or GST because of the public sector component
- Central administration, using the same procedures for the GST
- Modest additional record keeping requirements for the taxpayers
- For multi-regional firms, apportionment is on the basis of wages
- Easier to administer than provincial GST on consumption basis—substantial revenue potential

A medium-term strategy

AGENDA FOR THE FINANCE COMMISSION

Financing sub-national spending

- Unbundling of the concurrent responsibilities
- Sequenced approach needed
- Critical elements:
  - "Own-source" revenues at the margin
  - Redesign transfers—within a consistent "equalization" framework (nested between provinces and within provinces)
  - Could use spending needs and revenue capacity factors
  - Limited earmarked transfers
- Move debate from "administration" to effective decisions on the utilization of assigned bases

Agenda for next NFC

- Agency basis for FBR serving all levels for the major taxes
  - Under the Council of Common Interest?
- Consolidation of revenue bases: both Consumption and Income
  - More efficient administration of GST; and income taxes (including from capital gains and agriculture)
- Dual income tax as well as dual GST would provide larger own-source revenues to the provinces
  - Control over rates at the margin more important than "administration"
- Property taxes then could be reassigned to the local level
  - Provincial cadastres/land records