

## **Decentralisation of GST Services and Vertical Imbalances in Pakistan**

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### **1. INTRODUCTION**

It is generally believed that the 7th National Finance Commission (NFC) Award and 18th Constitutional Amendment have taken a major step towards much needed fiscal decentralisation. While these two delegate more fiscal autonomy and transfers additional resources towards provinces, it seems difficult that tax decentralisation options provided in these two can practically be implemented. This assertion is based on historical tax decentralisation debate in Pakistan, which has made it a very complex issue in management of public finances.

There are arguments both in favour and against tax decentralisation in Pakistan. Its proponents argue that tax decentralisation is an important principle of governance. They generally propose three advantages of fiscal decentralisation including; preference-matching, efficiency through competition, and increased accountability. In particular, a rational assignment of taxing powers helps providing each level of government, a control over its fiscal destiny by allowing it the choice in the level of spending. It helps assuring taxpayers that they are getting what they paid for and consequently may stimulate participation and improve/increase accountability. According to Bahl (1999), fiscal decentralisation assists in revenue mobilisation, innovation in economic activity, accountability of elected officials and grassroots participation in governance. Given this, it is probable that fiscal decentralisation lead towards improved efficiency in the use of resources as the residents in the sub-national governments can decide about their desired mix of public services and revenues that best suits them.

On the other hand, its opponents counter argue that its implementation seems difficult due to various factors like provincial governments do not have capacity to collect taxes, and the bulk of the taxes in Pakistan are usually paid at the headquarters of the firm that may lead to an unfair allocation of revenues after decentralisation. At the same time, the tax administration in Pakistan desires to move from General Sales Tax (GST) to reformed GST in Value Added Tax (VAT) mode in order to increase the tax-to-GDP ratio. Implementation of this would make the tax decentralisation much more complicated as it is difficult to distinguish the sales tax revenues from goods and services

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as a good producing factory also consume many services including telecommunication. Furthermore, as highlighted by Ahmed (2010) the abject performance of FBR and “trust deficit” among provinces and with the federal government add more complications in the practicality of GST reforms.

Despite these contradictory arguments, attempts were made to analyse the scope of sales tax on services by provincial governments to enhance tax-to-GDP ratio in Pakistan. SPDC (1994) is a systematic attempt which provides a comprehensive framework for sales taxation of services by provincial governments. It analysed the constitutional domain for implementing sales tax on services as per 1973 constitution. It also looked at the incidence of indirect taxes on services and concluded that nominal incidence of federal and provincial taxes on services sector was 2.3 percent of their value added. It also laid down a criterion for provincial resource mobilisation through effective implementation of GST on services. The criterion gave higher weightage to under taxation, extent of incidence on richer households, case for integration with national VAT, level of compliance, ease of collection and so on. It also proposed specific taxation proposals for services sector including banking and insurance, wholesale and retail, telecommunication and others. Regardless of such attempts, in 2000, the provincial governments empowered federal government to implement GST services. Since then GST services is being collected by the Federal Board of Revenue (FBR).

At present, in Pakistan financial status of provincial governments largely hinges on federal transfers to the provinces constituted through NFC award rather than on a rational tax assignment. There is an overriding centralisation of revenue collection as over 90 percent of the revenues are collected at the federal level consequently leaving the provinces with very narrow tax bases. From the perspective of sustainable public service provision, the provincial governments require enough “own” revenues rather than heavily relying on federal transfers and grants. GST on services is an ideal option for decentralisation ensured by the 18th Constitutional Amendment and 7th NFC Award.

In this context, this paper is an attempt to analyse the devolution of GST services and vertical imbalance in Pakistan. It determines the scope of GST services in minimising vertical imbalances, if implemented practically. Since, GST services has been initiated in 2000-01, the paper cover the period 2000-01 to 2009-10.

The paper is organised as follows: Section 2 underlines the constitutional provision of revenue assignment; Section 3 presents the pattern of resource mobilisation in Pakistan; Section 4 reveals the extent of vertical imbalance in Pakistan; Section 5 analyses the devolution of GST services and its impact on vertical imbalance; Section 6 discusses the implementation challenges in collecting GST services; and Section 7 concludes the paper.

## **2. REVENUE ASSIGNMENT AS PER CONSTITUTION**

In Pakistan, the constitution and certain statutes designate the revenue assignments between the federal and provincial governments. After the abolishment of concurrent lists in the 18th Amendment, the revenue source assigned to the federal and provincial governments is through an express provision in an article of the constitution or through classification in the federal lists of subjects. In the latter case if the revenue source is mentioned in the Federal List it belongs to the federation only. However, if a revenue source is not mentioned in the Federal List it then belongs to the provinces only.

Federal taxes under the Fourth Schedule, Article 70(4), of the Constitution of Pakistan are given Table 1. It states that among the indirect taxes the federal government has a constitutional right to collect taxes only on the sales and purchases of goods (imported, exported, produced, manufactured or consumed) but not on sales of services. This provides autonomy to the provincial governments to levy sales tax on services.

Table 1

<i>Federal Revenue Assignment as per Constitutional Provision</i>	
Federal Taxes	Federal Legislative List
<b>Direct Taxes</b>	
Personal Income Tax (excl. Agricultural Income)	subject 47
Corporate Income Tax	subject 48
Capital Value Tax (excl. Immovable Property)	subject 50
<b>Indirect Taxes</b>	
Duties of Customs (Including Export Duties)	subject 43
Excise Duty (Except on Alcohol, Narcotics)	subject 44
Taxes on the Sales and Purchases of Goods (Except Sales Tax on Services)	subject 49
Mineral Oil, Minerals, Natural Gas	subject 51
Tax on Production Capacity	subject 52
Terminal Taxes on Goods Transport and Passengers	subject 53

The revenue assignment of provincial governments according to the constitutional scheme is given in Table 2. It is to be mentioned that property tax, capital gains, excise duty, sales tax on services, tax on professions, motor vehicle tax are shared revenues under the NFC clauses of the constitution. The base and rate are set by the federation.

Table 2

<i>Provincial Revenue Assignment as per Constitutional Provision</i>	
Provincial Taxes	Constitutional Scheme
<b>Direct Taxes</b>	
Property Tax	Residuary but there is bar in the Federal List (subject 51)
Capital Gains	Assigned through bar on the federation in the Federal List (subject 50)
Agriculture Income Tax	Through bar on the federation in the Federal List (subject 47)
<b>Indirect Taxes</b>	
Excise Duty on Alcohol/Liquor/Narcotics	Assigned to province by bar on the federation in the Federal List (subject 44)
Sales Tax on Services	Residuary assignment
Tax on Professions	Article 163 of the constitution
Motor Vehicle Tax	Residuary assignment
Stamp Duty	Residuary assignment
Registration Fee	Residuary assignment
Mutation Fee	Residuary assignment
Natural Gas Excise Duty	Article 161 of the constitution
Net Hydro Profits	Article 161 of the constitution
Electricity Duty	Article 157(2) (b) of the constitution

Thus, according to the constitution of Pakistan, federal government is empowered to levy GST only on the sales, purchase and consumption of goods; however GST on services exclusively falls under the domain of provincial governments.

It was for this very reason that provinces levied sales tax on services on 15th July 2000. Later on, in 2000-01, the provincial governments empowered the federal government to collect GST services on their behalf. Since then federal government has been collecting GST services by breaking it into two modes: GST CE mode and GST provincial. The latter has been transferred to provinces (after deducting the collection charges) on the basis of population rather than collection. CE mode was being treated similar to GST goods before the implementation of 7th NFC Award (July 2010).

Though, collection of sales tax on services already remains a constitutional right of provinces, the 7th NFC Award and the 18th Constitutional Amendment further strengthened this. The document of the 18th Amendment states, *in fourth schedule of the constitution, in the federal legislative list, entry 49 after the word "consumed" the comma and words "except sales tax on services" shall be added.* As a result, GST services CE mode is transferred to provincial governments.

### 3. RESOURCE MOBILISATION IN PAKISTAN

Before analysing the impact of tax decentralisation on provincial finances, this section presents the pattern of resource mobilisation (generating the required resources to carry out expenditures for public service delivery) in Pakistan by major revenue source both at the federal and provincial levels.

#### 3.1. Resource Mobilisation at Federal Level

Table 3 gives the magnitude and growth in different components of FBR tax revenue in Pakistan. In 2009-10, total tax revenue in Pakistan was Rs 1,380 billion. Of this, 39 percent were the direct taxes and 61 percent were indirect taxes. 16 percent of the indirect taxes were originated via excise duties and 20 percent via import duties while the remaining from GST on goods and services.

Table 3

#### Components of Federal Tax Revenue

Year	Total Tax Revenues		Indirect Taxes					
	Total	Direct Taxes	Total	Excise Duties	Import Duties	GST		
						Total	Goods	Services
2000-01	392,277	124,585	267,692	49,080	65,047	153,565	144,981	8,584
2001-02	404,070	142,505	261,565	47,186	47,818	166,561	154,787	11,774
2002-03	460,627	151,898	308,729	44,754	68,836	195,139	180,991	14,148
2003-04	520,843	165,079	355,764	45,552	91,045	219,167	203,713	15,454
2004-05	590,387	183,372	407,015	53,104	115,374	238,537	214,519	24,018
2005-06	713,442	224,988	488,454	55,272	138,384	294,798	263,767	31,031
2006-07	847,236	333,737	513,499	71,804	132,299	309,396	267,531	41,865
2007-08	1,008,091	387,861	620,230	92,137	150,663	377,430	325,752	51,678
2008-09	1,161,150	443,548	717,602	117,455	148,403	451,744	395,154	56,590
2009-10	1,380,000	540,400	839,600	134,400	164,900	540,300	473,474	66,826
<b>Average Annual Growth Rate (%)</b>								
2001-05	11.29	10.21	11.94	-0.53	16.39	15.67	10.39	30.49
2006-10	17.94	25.19	14.65	25.03	4.77	16.56	16.08	21.49
2001-10	14.91	17.45	13.83	10.15	12.10	16.82	14.31	26.35

Source: Federal Board of Revenue, *Yearbook* (Various Issues).

The trend in growth indicates that tax revenue increased at an average rate of 11 percent per annum during 2001-05 and 18 percent during 2006-10; indicating higher growth in federal taxes in the second half on 2000s. In the first half of 2000s, highest growth was observed in GST services while in second half it was in direct taxes. During the entire period, GST services depicted highest growth that could be due to the fact that it started from a zero base.

Table 4 presents the trend in tax to GDP ratio in Pakistan. It shows that total tax revenue remained on average 9.2 percent per annum of GDP during 2001-05 and increased slightly to 9.5 percent during 2006-10. Direct taxes that on average constituted 3 percent per annum of GDP during 2001-05 increased on average by 0.5 percentage points during 2006-10. Alternatively, indirect taxes declined from an average of 6.2 percent per annum of GDP to 5.9 percent of GDP during these two sub-periods. It is noticeable that contribution of GST on goods in GDP remained on average over 3 percent per annum during these sub-periods while that of GST on services stayed at less than 0.5 percent.<sup>1</sup>

Table 4  
*Trend in Tax-to-GDP Ratio*

Year	Total Tax Revenues	Direct Taxes	Indirect Taxes						(Percent)	
			Total	Excise Duties	Import Duties	GST		Goods	Services	
						Total	Goods			
2000-01	9.32	2.96	6.36	1.17	1.55	3.65	3.44	0.20		
2001-02	9.07	3.20	5.87	1.06	1.07	3.74	3.48	0.26		
2002-03	9.45	3.12	6.33	0.92	1.41	4.00	3.71	0.29		
2003-04	9.23	2.93	6.31	0.81	1.61	3.89	3.61	0.27		
2004-05	9.08	2.82	6.26	0.82	1.78	3.67	3.30	0.37		
2005-06	9.36	2.95	6.41	0.73	1.82	3.87	3.46	0.41		
2006-07	9.77	3.85	5.92	0.83	1.53	3.57	3.08	0.48		
2007-08	9.84	3.79	6.06	0.90	1.47	3.68	3.18	0.50		
2008-09	9.11	3.48	5.63	0.92	1.16	3.55	3.10	0.44		
2009-10	9.41	3.68	5.72	0.92	1.12	3.68	3.23	0.46		
			<b>Average Annual Ratios</b>							
2001-05	9.23	3.00	6.23	0.95	1.48	3.79	3.51	0.28		
2006-10	9.50	3.55	5.95	0.86	1.42	3.67	3.21	0.46		
2001-10	9.36	3.28	6.09	0.91	1.45	3.73	3.36	0.37		

Source: Federal Board of Revenue, *Yearbook* (Various Issues).

### 3.2. Resource Mobilisation at Provincial Level

Table 5 gives the resource mobilisation efforts at provincial level. Compared to Rs 1,380 billion tax collected by the federal government in 2009-10, provincial governments altogether collected only Rs 70 billion. It further indicates that provincial tax revenues increased from a meagre Rs 19.1 billion in 2000-01 to Rs 70 billion in 2009-10. On the other hand, non-tax revenues increased from Rs 19.9 billion to Rs 95 billion during same period.

<sup>1</sup>See Martinez-Vanquez (2006) and Thirk (2008) for analysis of taxation and policies in Pakistan.

Table 5  
*Provincial Revenues*

(Rs Million)			
Year	Tax	Non-Tax	Total
2000-01	19,100	19,900	39,000
2001-02	18,800	21,300	40,100
2002-03	21,800	25,400	47,200
2003-04	28,000	25,000	53,000
2004-05	34,710	22,404	57,114
2005-06	36,800	47,600	84,400
2006-07	36,819	45,408	82,227
2007-08	40,794	77,987	118,781
2008-09	46,084	83,789	129,873
2009-10	70,000	95,000	165,000
<b>Average Annual Growth Rates (%)</b>			
2001-05	13.68	7.59	10.46
2006-10	16.35	40.08	25.21
2000-10	15.01	23.84	17.84

Source: GoP, *Economic Survey*.

Relative to taxes, higher growth in non-tax revenues indicates that provincial revenues are tilted towards non-tax revenue. Further, over the entire period, provincial taxes grew at a pace similar to federal taxes suggesting that capacity of provincial governments in collecting taxes is not as bad as it usually argued.

#### 4. VERTICAL FISCAL IMBALANCE IN PAKISTAN

Vertical fiscal imbalance means the disparity between the revenues of a government and its expenditure responsibilities. An adequate provision of social services is a concurrent function of federal and provincial governments. However, the combination of decentralised spending with centralised financing through grants and tax revenue sharing leads to vertical fiscal imbalance. This situation prevails in Pakistan where the financing and delivery of social services largely lie in the hands of provinces and major sources of revenues in the hand of federal government creating vertical imbalances.

Table 6 shows the total tax and non-tax revenue collected by the federal and provincial governments. Noticeably, the table reveals that the federal government collects 92 percent to 94 percent of the revenue in Pakistan. Only 6 percent to 8 percent of the revenues are collected by the provincial governments. This suggests that provincial governments have a very narrow base of revenue collection.

Table 6

*Revenue Collection of Federal and Provincial Governments*

Year	Total Revenues (Rs Million)			Share in Revenues (%)	
	Federal	Provincial	Total	Federal	Provincial
2000-01	514,000	39,000	553,000	92.9	7.1
2001-02	584,000	40,100	624,100	93.6	6.4
2002-03	673,600	47,200	720,800	93.5	6.5
2003-04	741,000	53,000	794,000	93.3	6.7
2004-05	842,900	57,114	900,014	93.7	6.3
2005-06	992,200	84,400	1,076,600	92.2	7.8
2006-07	1,215,730	82,227	1,297,957	93.7	6.3
2007-08	1,380,599	118,781	1,499,380	92.1	7.9
2008-09	1,721,028	129,873	1,850,901	93.0	7.0
2009-10	1,990,387	165,000	2,155,387	92.3	7.7

Source: GoP, *Economic Survey* (Various Issues).

Table 7 gives only the total tax collection of federal and provincial governments. It further strengthens the point that provinces have limited control in collection of taxes in Pakistan. In most of the years since 2000-01, provincial governments collected only 4 percent of the total taxes in the country.

Table 7

*Tax Collection of Federal and Provincial Governments*

Year	Total Taxes (Rs Million)			Share in Taxes (%)	
	Federal	Provincial	Total	Federal	Provincial
1999-00	386,800	18,800	405,600	95.4	4.6
2000-01	422,500	19,100	441,600	95.7	4.3
2001-02	459,300	18,800	478,100	96.1	3.9
2002-03	534,000	21,800	555,800	96.1	3.9
2003-04	583,000	28,000	611,000	95.4	4.6
2004-05	624,700	34,710	659,410	94.7	5.3
2005-06	766,900	36,800	803,700	95.4	4.6
2006-07	852,866	36,819	889,685	95.9	4.1
2007-08	1,009,902	40,794	1,050,696	96.1	3.9
2008-09	1,158,586	46,084	1,204,670	96.2	3.8
2009-10	1,523,497	70,000	1,593,497	95.6	4.4

Source: GoP, *Economic Survey* (Various Issues).

On the other hand, the current expenditures of the federal and provincial government given in Table 8 indicate that the share of provinces in total current expenditure is far high. Provinces spend 23 percent to 29 percent of the total current expenditure in Pakistan. It needs to mention that the share of provinces would go up if these expenditures include the amount of development expenditures.

Table 8

*Current Expenditures of Federal and Provincial Governments*

Year	Total Current Expenditure (Rs Million)			Share (%)	
	Federal	Provincial	Total	Federal	Provincial
1999-00	477,900	148,500	626,400	76.3	23.7
2000-01	479,000	166,700	645,700	74.2	25.8
2001-02	524,600	175,600	700,200	74.9	25.1
2002-03	599,800	191,900	791,700	75.8	24.2
2003-04	557,000	218,000	775,000	71.9	28.1
2004-05	664,200	200,300	864,500	76.8	23.2
2005-06	789,100	245,600	1,034,700	76.3	23.7
2006-07	973,130	402,215	1,375,345	70.8	29.2
2007-08	1,416,015	437,132	1,853,147	76.4	23.6
2008-09	1,495,873	545,697	2,041,570	73.3	26.7
2009-10	1,670,963	590,000	2,260,963	73.9	26.1

Source: GoP, *Economic Survey* (Various Issues).

Thus, while provincial share in tax revenue on average is less than 5 percent during the 2000s their share in expenditure is over 25 percent indicating the extent of vertical imbalance in Pakistan. This builds the argument that provinces to a large extent depend on the resources or transfers from the federal government to meet their expenditures demand. Accordingly, in Pakistan, 88 percent of the provincial government's resources depend on intergovernmental transfers. In contrast, in other developing countries, like India and Malaysia, 35 percent of the provincial government's resources come from intergovernmental transfers.

##### 5. DEVOLUTION OF GST SERVICES AND VERTICAL IMBALANCE

Having developed that there are significant vertical imbalances in Pakistan, it is important to analyse whether or not devolution of GST services will make any sizeable impact. As Khan (2009) highlights that services sector constitutes more than half of the value added of the economy, but it is fetching only 34 percent of the federal tax receipts. While mentioning the difficulties in taxing services, he points out that many services are rendered at the distribution process or at the stage of production, which sometime have informal characteristics, hence making it difficult to collect taxes from them. Given the narrow base of services and difficulties attached to collecting taxes from them, this section first highlights the contribution of GST in overall FBR taxes and then looks whether GST services has sizeable tax base. As per scope of the study, it excludes other taxation on services sector such as Federal Excise Duty (FED), income tax and the like. It also compares effective tax rate of GST services with other taxes to highlight the tax potential in GST services. Afterwards, it compares the vertical imbalances in revenue transfer to the provincial governments with or without GST services.

### 5.1. Contribution of GST Services in FBR Taxes

Table 9 gives the contribution of GST on services in comparison with GST on goods under different tax heads. For instance, in total GST, services contributed on average only 7.4 percent per annum during 2001-05, which increases to 12.6 percent during 2005-10. GST services contributed on average 4.5 percent per annum in total indirect taxes and 3 percent per annum in total tax revenue during 2001-05. These shares increased to 7.7 percent and 4.8 percent respectively during 2006-10. While in comparison with GST goods these shares are still very low, they showed relatively higher growth.

Table 9

#### *Contribution of GST on Goods and Services*

Year	GST on Goods as Proportion of Total			GST on Services as Proportion of Total		
	GST	Indirect Tax	Tax Revenue	GST	Indirect Tax	Tax Revenue
2000-01	94.41	54.16	36.96	5.59	3.21	2.19
2001-02	92.93	59.18	38.31	7.07	4.50	2.91
2002-03	92.75	58.62	39.29	7.25	4.58	3.07
2003-04	92.95	57.26	39.11	7.05	4.34	2.97
2004-05	89.93	52.71	36.34	10.07	5.90	4.07
2005-06	89.47	54.00	36.97	10.53	6.35	4.35
2006-07	86.47	52.10	31.58	13.53	8.15	4.94
2007-08	86.31	52.52	32.31	13.69	8.33	5.13
2008-09	87.47	55.07	34.03	12.53	7.89	4.87
2009-10	87.63	56.39	34.31	12.37	7.96	4.84
Average Annual Shares						
2001-05	92.59	56.39	38.00	7.41	4.51	3.04
2006-10	87.47	54.02	33.84	12.53	7.74	4.83

Source: Federal Board of Revenue, *Yearbook* (Various Issues).

### 5.2. Tax Base of GST Services

Table 10 shows the ratios of GST goods and GST services base to GDP. While base-to-GDP ratio of GST goods substantially increased, base-to-GST ratio of services hovered around over 20 percent during the two sub-periods. This happened because FBR focused only on the efficiency of GST services collection till 2008-09, without broadening its tax base. However in 2009-10, new services like banking insurances and other were also added to broaden its base.

Table 10  
*GST Base-to-GDP Ratio*

Year	Total GST	GST Goods	(Percent)
			GST Services
2000-01	48.41	27.81	20.60
2001-02	47.56	26.47	21.08
2002-03	48.27	26.96	21.31
2003-04	50.95	30.58	20.37
2004-05	54.35	34.18	20.17
2005-06	57.78	37.29	20.49
2006-07	56.84	36.41	20.44
2007-08	59.53	39.12	20.41
2008-09	56.03	33.59	22.44
2009-10	54.45	31.56	22.89
<b>Average Annual Ratio</b>			
2001-05	49.9	29.2	20.7
2006-10	56.9	35.6	21.3

### 5.3. Effective Tax Rates

Table 11 portrays the effective tax rate of different components of tax revenues in Pakistan. It indicates that effective tax rate of GST services hanged on average only about 1.4 percent and 2 percent per annum respectively during the two sub-periods. GST on goods though declined from an average of 12 percent per annum during 2001-05 to nearly 9 percent during 2006-10 but remained far above than that of GST on services. GST services have lowest rates because of lower efficiency of tax collection and tax exemptions. This lowest effective tax rate indicates greater potential of GST in services sector.

Table 11  
*Effective Tax Rate*

Year	Direct Taxes	Indirect Taxes			
		Excise Duty	Imports Duty	GST	
				Goods	Services
2000-01	4.18	4.72	17.77	12.38	0.99
2001-02	4.48	4.25	11.95	13.13	1.25
2002-03	4.37	3.62	14.83	13.77	1.36
2003-04	4.04	3.11	14.25	11.81	1.35
2004-05	3.81	2.93	13.30	9.65	1.83
2005-06	3.95	2.43	12.05	9.28	1.99
2006-07	5.10	2.75	10.49	8.47	2.36
2007-08	4.91	2.90	9.92	8.13	2.47
2008-09	4.68	3.13	8.89	9.23	1.98
2009-10	4.99	3.15	9.57	10.23	1.99
<b>Average Annual Rate</b>					
2001-05	4.18	3.73	14.42	12.15	1.36
2006-10	4.72	2.87	10.19	9.07	2.16

Though, it is apparent there exist potential of taxation in the services sector but the idea here is to observe how far the vertical imbalance be reduced once the provinces are empowered to collect GST services.

#### 5.4. Share of Provincial Revenues with or without GST Services

Table 12 displays the share of provincial tax revenues in total taxes with and without GST services. It indicates that had the GST services been devolved in 2000-01 and had it acquired the same efficiency then provincial share of taxes would have increased from 4.3 percent to 6.3 percent in 2000-01. And, with the passage of time this share would have further increased to 8.6 percent in 2009-10. Thus, with full provincial share of GST services, provincial share in taxes would have more than doubled during 2006-10.

Table 12

#### *Provincial Revenues With or Without GST Services*

Year	(Percent)					
	Provincial Share in Revenues			Provincial Share in Taxes		
	Without GST Services	With GST Services	Difference	Without GST Services	With GST Services	Difference
2000-01	7.1	8.6	1.6	4.3	6.3	1.9
2001-02	6.4	8.3	1.9	3.9	6.4	2.5
2002-03	6.5	8.5	2.0	3.9	6.5	2.5
2003-04	6.7	8.6	1.9	4.6	7.1	2.5
2004-05	6.3	9.0	2.7	5.3	8.9	3.6
2005-06	7.8	10.7	2.9	4.6	8.4	3.9
2006-07	6.3	9.6	3.2	4.1	8.8	4.7
2007-08	7.9	11.4	3.4	3.9	8.8	4.9
2008-09	7.0	10.1	3.1	3.8	8.5	4.7
2009-10	7.7	10.8	3.1	4.4	8.6	4.2
<b>Average Annual Shares</b>						
2001-05	6.6	8.6	2.0	4.4	7.0	2.6
2006-10	7.3	10.5	3.1	4.2	8.6	4.5

Source: Authors' estimates based on *FBR Yearbook*.

#### 5.5. Role of GST Services in Minimising Vertical Imbalances

Table 13 shows vertical imbalances in Pakistan with or without devolving GST services during 2006-07 to 2009-10. It indicates that if GST services were successfully devolved then vertical imbalance would have been reduced. For instance, in 2006-07 vertical imbalance would have been reduced from 27.2 percent to 23.9 percent due to decentralisation of GST services. Similarly in 2009-10, vertical imbalance would have been reduced from 24.3 percent to 21.2 percent due to decentralisation of GST services.

Table 13  
Vertical Imbalances in Pakistan

Year	Without GST Services			With GST Services		
	Revenue Share	Expenditure Share	Surplus / Deficit	Revenue Share	Expenditure Share	Surplus / Deficit
<b>2006-07</b>						
Federal	93.7	66.5	27.2	90.4	66.5	23.9
Provincial	6.3	33.5	-27.2	9.6	33.5	-23.9
<b>2007-08</b>						
Federal	92.1	73.6	18.4	88.6	73.6	15.0
Provincial	7.9	26.4	-18.4	11.4	26.4	-15.0
<b>2008-09</b>						
Federal	93.0	70.4	22.6	89.9	70.4	19.6
Provincial	7.0	29.6	-22.6	10.1	29.6	-19.6
<b>2009-10</b>						
Federal	92.3	68.0	24.3	89.2	68.0	21.2
Provincial	7.7	32.0	-24.3	10.8	32.0	-21.2

Source: Authors' estimates based on *FBR Yearbook*.

## 6. IMPLEMENTATION CHALLENGES

Despite the fact that devolving GST service has constitutional provision and it also reduces the vertical imbalances, this has not yet been put into practice. There are certain challenges that often come in its implementation debate. These can be sum-up in following three arguments.

- Provincial governments do not have the capacity to collect GST on services.
- Under VAT regime, collection of goods and services cannot be separated.
- Bulk of the taxes in Pakistan are paid at the headquarters of the firm that may lead to an unfair allocation of revenues after decentralisation.

This section systematically discusses the validity of these arguments by analysing the structure of GST services. Table 14 presents the GST collected on services by sectors in 2009-10. The statistics reveal that GST on services is largely collected from telecommunication sector, which contributed more than 70 percent of total GST on services. Historically, the share of telecommunication in GST services was more than 90 percent. The other major tax spinners are banking and insurance (tax collected under federal excise duty), community and social services, and transport and communication services.

Table 14

*General Sales Tax on Services—2009-10*

Sector	Tax Collection (Rs Million)	Share (%)
Telecommunications	44,852.5	70.4
Banking and Insurance	5,969.8	9.4
Community and Social Services	5,368.9	8.4
Transport and Communication	4,453.2	7.0
Hotels, Recreation and Entertainment	2,347.7	3.7
Wholesale and Retail Trade	468.8	0.7
Other	222.6	0.3
Total	63,683.5	100.0

Source: Federal Board of Revenue.

Note: Banking and Insurance largely includes federal excise duty.

### 6.1. Devolution of GST on Telecommunications

There are several apprehensions regarding the devolution of GST on telecommunication services. For example, does it require lots of capacity that provincial government do not have at present? Will it lead to an unfair allocation among provinces? Is it impossible under VAT regime?

As per our understanding, the answer to all these questions is in negative. Firstly, there are fewer telecommunication companies to deal with. They have computerised record and have complete information about usage of their services, charging of bills and payment of taxes. As a result, devolution of telecommunication taxes does not require much capacity and provincial governments can easily collect tax with these fewer computerised telecommunication companies. Their computerised records also help minimising the scope of unfair allocation among the provinces. However, devolution of GST on telecommunication under VAT mode is relatively a difficult task. Attempts have been made at the federal and provincial (Sindh) government level to resolve this issue. Their technical teams concluded, “while VAT regime requires ‘input-output adjustment’ to be centralised, collection can be decentralised.” For instance, as per 2009-10 estimate provinces can collect Rs 45 billion in GST from telecommunications services. Since bulk of this tax is collected from end users with limited scope for input output adjustment, however, companies seeking refunds submit consolidated (goods and services) account/claim to FBR. As per FBR estimates these refunds hardly reached to Rs 3.5 billion. After receiving and verifying these refund claims FBR can provide refunds (Rs 3.5 billion) to companies and provinces can reimburse FBR the amount equivalent to refund claims i.e. Rs 3.5 billion.

### 6.2. Devolution of GST on Banking and Insurance

Banking and insurance sector is the second biggest contributor in services tax. At present, the services of this sector are taxed under FED mode and not under GST. Nevertheless, after the 7th NFC Award, it is likely that this collection can be treated as GST. This sector also has smaller number of banking and insurance companies, mostly in

formal sector, having computerised records. Given this, the provincial governments do not require much capacity and can easily deal with them. Moreover, complete computerised transaction details also minimise the scope of unfair allocations of GST among the provinces. Similar to telecommunication sector, the input output adjustment can be dealt by federal government; however, the collection can be devolved.

### **6.3. Devolution of GST on Other Sectors**

In contrast to telecommunication and banking and insurance, other sectors have large number of tax payers. The provincial governments need to build capacity in order to collect GST from them. In this regard, recently an attempt has been made by the government of Sindh where it established a board named Sindh Revenue Services (SRS). It has an independent board of directors and separate collection mechanism. Currently, the progress of SRS working is slow as the decision to devolved GST services is in pending.

Certain confusions also prevail regarding the collection of GST services. For example, there is confusion that if more than one person was involved in consuming a service like telecommunication then who will pay the tax. And if they live in different provinces then which province would receive the revenue from GST services. Theoretically, this argument seems very difficult but in reality this can be addressed very easily. For example, every telecommunication company charges a fee on its services. While two persons are consuming same service the bill is generally paid by one person. Since GST service is a proportional tax on billing amount, it would be collected by the province whose consumer bears the charges of bill and hence that province will receive the revenue. The same logic can be followed if more than one consumer pays the billing amount and taxes, whether in a pre- or post-paid manner.

Another confusion is whether or not GST service is a part of divisible pool. Prior to the 7th NFC Award, GST on services CE mode was part of the divisible pool and GST provincial tax was treated as straight transfers. After the 7th NFC Award, both GST provincial and CE mode would be treated as straight transfers and hence GST services would no more be part of divisible pool.

## **7. CONCLUSION**

In Pakistan, confinement of major sources of revenues with the federal government and a sizeable expenditures assignment at provincial level creates vertical fiscal imbalances. While these vertical imbalances are generally addressed through intergovernmental transfers, there is still a need to devolve taxes at provincial levels. The 7th NFC Award and 18th Constitutional Amendment ensure that a GST services is a provincial tax. In this context, this paper analyses the scope of GST services in minimising the vertical fiscal imbalances in Pakistan. The analysis indicates that devolution of GST services will help doubling the share of provincial tax revenues in total taxes thus facilitate reducing vertical imbalances in Pakistan. Moreover, the telecommunication sector, which pays bulk of the GST services, requires limited provincial capacities for collection of GST as there are fewer telecommunication companies in Pakistan and all have computerised database.

Though, the devolution of GST services will reduce the vertical imbalance but it will not eliminate it completely. Future NFCs would therefore be needed to address the issues of remaining vertical and horizontal imbalances.

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