

# Approaches to sub-national taxation: principles and experience

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# Outline of talk

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- Present some of the new developments in the literature and practice
- Place in the context of the tax reforms in Pakistan
- No recommendations for Pakistan, but suggestions for:
  - research agenda to feed into Finance Commission deliberations
  - as well as tax reforms



# Pakistan: incomplete tax reform agenda

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- Low tax/GDP ratio
- Not related to efficiency, investment climate, distributional considerations, administration
  - Principles of Optimal Tax reform (Ehtisham Ahmad and Nicholas Stern, **Theory and Practice of Tax Reforms**, Cambridge)
- Fractured bases, illogically shared with lower levels
  - unable to support public investment and social spending in a modern market-based economy



# Potential collections: Pakistan ranks low, even in the region

## *VAT Productivity around the globe, 2005*

	Standard rate	Revenue/GDP	Productivity/Consumption	Note
Pakistan	15	3.4	0.3	
Sri Lanka	15	6.7	0.47	
Philippines	12	4.3	0.45	
Turkey	18	7.1	0.48	includes 40% rate on luxury goods
Lebanon	10	5.09	0.5	
Jordan	16	10.1	0.62	includes luxury excises
Korea	10	6.7	0.67	
Singapore	5	1.8	0.63	
New Zealand	12.5	8.9	0.93	

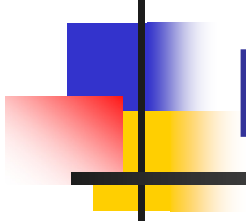


# Pakistan assignments (cont'd)

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- Agriculture: exempted from taxation in Government of India Act 1935
  - Designed to keep “influential classes” loyal to the raj—political economy at play; is it still relevant?
- Capital gains on property part of federal income tax base until 1980s
  - Removed in 1985, reassigned to provinces and exempted
- Political economy and special interest groups?
  - Perceptions of fairness;
  - Incentives and loopholes for unproductive investment (also on share-holdings)

# Traditional/normative versus positive approaches





# Traditional/normative approaches

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- Musgrave, Oates, Tiebout
- Taxes on immobile bases assigned to lower levels;
  - property
- Taxes on mobile bases to center
  - Consumption
  - Income
- Subject to administrative constraints; and
- Supplemented by a system of transfers



# Modern positive approaches

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- Political economy important: Drops assumption of benign politicians and administrators
- Competition matters in generating incentives for efficiency at the sub-national level
  - Both across jurisdictions (horizontal)
  - And among levels (vertical)
- Therefore mobile bases could be appropriate sub-national assignments
  - Income and consumption variants should be examined
- Subject to administrative constraints
- See papers by Breton; Salmon; Lockwood; Wilson; Ambrosiano and Bordignon in Ahmad and Brosio (2006) **Handbook of Fiscal Federalism**





## In both cases....

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- **Control over rate structure is critical** in establishing incentives for hard budget constraints
  - “no bailout” clauses are not implementable without this autonomy
  - But: may have to establish a lower bound to prevent a “race to the bottom”
- **Not necessary to have local administration**
- Increasingly incorporated into policy design, e.g., in EU



# Implementation

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- Federal states
  - Provincial/local legislatures could determine rates/bases
- Unitary states
  - Central parliament/congress legislates bands
  - Provincial/local governments set rate within band
- Central administration consistent with provincial/local autonomy (e.g., Italy)
  - Central tax administration could collect local taxes on common bases (e.g., with VAT and income taxes)
  - Little additional effort for administration or costs on taxpayers
  - Opens up a number of additional options



# Current practice in Pakistan

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- Fractured bases:
  - services a provincial assignment in Pakistan
    - Hard to distinguish between goods and services in a modern economy (software, SIM cards)
    - Headquarters problem
  - Income partly st to federal and partly to provincial tax (capital gains on property, 1985 amendments—not a problem in India)
- No effective assignments to district level (property taxation at the provincial level)
- No incentives to use existing bases (hard to utilize)
- Few incentives for accountability or effective service delivery
- Problems with transfer design (another story, another lecture)



# International practices

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# What does international experience tell us?

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- Political economy is important
- While India is interesting, given common starting point
  - No need to take on their burdens
- Look to China, OECD experiences for best practice
- Work out what suits Pakistan's context
  - No need to replicate others precisely



# Illustrations from China

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- Traditionally upward revenue sharing—Moghul style
  - No longer appropriate after moving to a market based system with modern taxation
  - Political tussle with the provinces
- Major tax reform in 1994—moving China towards a modern tax system: recentralization of tax powers
  - Central tax administration established for the first time, to administer shared VAT and other central taxes
  - Investment VAT established as “shared tax” (75: 25)
- Supplemented by “equalization transfer framework”
  - Power of Shanghai and coastal provinces recognized
  - Ahmad, Keping Li, Richardson and Singh (2002)



# Policy agenda for China

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- Additional reforms for Central Tax agenda
  - VAT on consumption basis and extended to services
    - What happens to the local business tax?
  - Income tax further consolidation
- Sub-national taxation options
  - Scope for some local control over rates, but which level of government should get this?
  - Links with accountable responsibilities—how many levels?
    - 2 lower “responsible” tiers: Provinces and districts/municipalities?
    - Can provincial studies shed some light on this?
  - What’s appropriate for each level?
  - New tax assignments?



# India: Central CST, State VATs

- Genesis of GOI Act 1935: tussle between center and states/ unable to change structure given entrenched political interests: excises on production vs sales to consumers
- Slow moves towards an overlapping VAT system
- Not all states have VATs (origin based), sales tax
- Central CST (evolution from the central excise/MODVAT)
- Inter-state sales
  - Registered dealers: CST@lesser of 4% and state sales tax rate
  - Others: CST@greater of 10% and state sales tax
- CST additional to state sales tax in destination state
- Interstate branch transfers: no tax in origin state; diverse rules for input tax rebates
- Imports: not subject to state VATs
- Services: exempt from state VAT, no reverse charge rules for inter-state purchases or imports of inputs





# India: problems

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- Inter-state checkpoints to monitor movement of goods
  - Inefficient and unworkable
  - Complex arrangements for goods passing through one state destined for another
- Little coordination or information sharing among states or between states and Center
- Interstate trade subject to massive evasion
  - Avoidance of CST through branch transfers
  - Evasion through undeclared interstate sales (both origin and destination states)



# OECD practice

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- Moves to give more control over tax rates to sub-national governments
  - Canada: overlapping occupation of tax bases—including for the VAT/sales/income taxes
  - Spain and Italy recent reforms; piggy backing and IRAP (see below)
  - In Germany, Länder have no control over rates but control tax administration
    - Adverse incentives
    - Focus of current reforms

## OECD Tax autonomy of sub-central governments

**2002**

		As share of sub-central tax revenues				
Sub-central tax revenue as % of total tax revenues		Discretion on rates and reliefs	Discretion on rates			
			Full	restricted	Revenue split set with SCG consent	Revenue split set by CG, pluriannual
<b>Australia</b>	<b>31.4</b>					
States	28.4	100.0	-	-	-	-
Local	3.0	100.0	-	-	-	-
<b>Canada</b>	<b>44.1</b>					
Provinces	35.5	93.3	-	-	6.7	-
Local	8.6					
Local (Québec)		0.6	96.0	-	-	-
<b>France</b>	<b>10.0</b>					
Local	10.0	72.1	-	8.5	-	-
<b>Germany</b>	<b>28.7</b>					
Länder	21.8	-	-	2.4	86.3	-
Local	7.0	17.6	-	33.6	47.6	-
<b>Italy</b>	<b>16.4</b>					
Regional	11.3	-	-	58.8	23.7	17.6
Local	5.2	27.1	-	50.4	-	13.1
<b>Spain</b>	<b>65.4</b>					
Regions	38.8	34.8	-	-	37.5	-
Local	26.6	0.6	-	13.3	-	-
<b>Switzerland</b>	<b>43.1</b>					
States	27.0	90.4	-	-	9.6	-
Local	16.2	2.9	-	97.1	-	-

Source: National sources and OECD, Revenue Statistics 1965-2004, 2005 Edition.

# OECD: Share of sub-central taxation

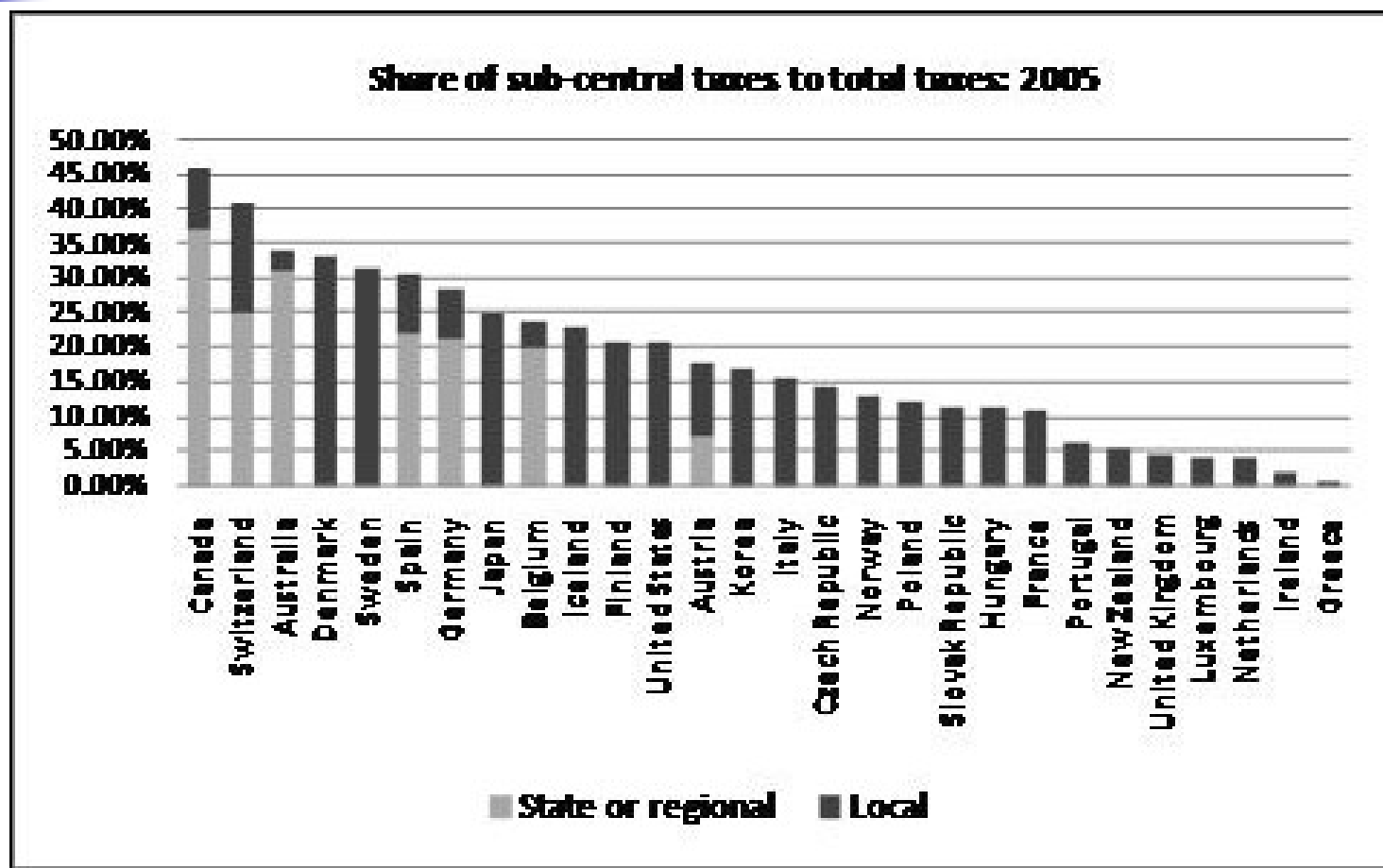


Table 2. Assignment of taxes in Latin America

	Argentina	Brazil	Mexico	Bolivia	Chile	Colombia	Peru
Corporate income	N	N	N	N	N	N	N
Personal Income		I	I (payroll)	IDH: N. I N	N	N	N
Gross Assets of Firms and Individuals	N	N	N	Transfer: N	N		N
Sales	VAT: N Turnover I	VAT (ICMS): I	VAT: N	VAT:N	VAT: N	VAT: N	VAT:N
Other indirect	Energy and fuel: N	IPI: N		Turnover :N Excises: N	Turnover :N Excises: N	Gasoline: N/ Alcohol and cigarettes: I Surtax on gasoline	
From Rents on Natural resources	Royalties: I			Royalties: N, I,		Royalties: N,I, M	Royalties: shared
Taxes on vehicles	Ownership : I	Ownership : I	Ownership and use: I	Ownership	Use: M	Registration and use: I	Registration :I
Real property	Property: I	Land : N Urban Inheritance I Transfer: M	Transfer: I Property: M	Property : M	Urban property: M(s)	Transfer: I Property: M	Property: M
Business taxes		On Services: M	Industry and commerce: M	Local business tax (Patentes)	Local business tax (Patentes)	Local business tax (Patentes)	

Sources: Finot, (2004), Jimenez, (2006), reproduced in Ahmad and Brosio (2008).

Notes: N represents national level; I the intermediate level, and M the municipal or local level; IHD: profit tax on hydrocarbons in Bolivia; ICMS: tax on goods and services: IPI: Industrial Products Tax, (both Brazil); M(s) collections of property tax are shared among municipalities (Chile).



# Latin American examples

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- Focus has been on consolidating central VAT/ Argentina, Mexico, and in the unitary states, Chile, Peru and Colombia (Ahmad and Brosio, 2008)
- Brazil: complex system with overlapping VATs—undergoing simplification and reforms
  - Linked to transfer reforms
- In most unitary states, inadequate assignments with little or no subnational control over rates (especially at intermediate level)
- Chile: quite centralized in both policy and administration
  - Although, municipalities collect property tax based on central design



# An agenda for reforms

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# Importance of accountable governments

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- Decide which levels of government will be held accountable for major service delivery
  - Tendency is for two main sub-national levels:
    - Provinces/states
    - Districts/municipalities
- Flow of information, spending responsibilities and transfer design equally important
- Assign appropriate tax handles
  - Control over rate structures
  - Achieved by a band legislated by central congress
  - Rate setting established by relevant government/council





# Completion of federal/central tax reforms

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- VAT/GST reforms:
  - Extend coverage to services, retail and eliminate special sectoral regimes
    - Adjust revenue-sharing
    - Compensate through transfer system (Australian model)
    - New tax instruments for provinces (see below: e.g., IRAP-type arrangement; dual VATs; specific revenue-sharing—outside the consolidated pool?)
  - Income tax: fast growing revenue source; consolidate definition and bases: plug holes and avoidance/evasion
    - Integrated (Haig-Simons) definition of income (consumption plus change in wealth)
    - Nordic dual model (separate taxation of capital at fixed rate and earned income at progressive rates)
    - Piggy-back options for provinces



# Sharing options

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- Sharing of VAT, income taxes
  - Good for political economy purposes
  - Closes vertical imbalances
- But
  - Does not equalize
  - Or provide adequate “own-source” revenue handles



# Piggy-backing or sharing bases

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- Surcharges or “piggy-backing” on the Income taxes or GST
  - Could be within a maximum to minimum band to prevent “excessive game-play”
  - Provide adequate discretion
  - But as bases may be very unevenly distributed:
- May have to be supplemented by an “equalization transfer system”
- Sharing bases: full autonomy, as in Canada



# Dual VATs?

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- Sharing tax revenues does not give control over rates
- Dual VATs
  - Origin or destination basis?
  - Treatment of cross-border trade
  - Central and state VATs (Brazil—India incomplete agenda)
  - Canada: HST, or Quebec VAT



# IRAP/business taxes

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- IRAP
- Could be used as a substitute for the business tax
- Origin-based VAT, administered by the central tax administration,
  - Rate band specified by the central government
  - Specific rate chosen by the state/regional government



## Italy's Experience with the IRAP

IRAP (*Imposta Regionale sulle Attività Produttive*) was introduced in 1998.

- on the difference between their sales and the sum of their material purchases and depreciation, i.e., an origin-based income-type VAT, whose payment is determined by the subtraction method. Basically, its tax base is the sum of wages, profits, and interests.
- The statutory central rate is 4.25 percent, but regions can vary this, in either direction, by 1 percentage point. General government is also subject to IRAP, with a tax base that is limited to wages and salaries paid and with a tax rate of 8.5.
- Even with its present relatively low tax rates, revenue from the IRAP is substantial, in the order of almost 2.5 percent of GDP. It represents broadly more than one-third of VAT collections, one-fourth of PIT collections, and more than two-thirds of CIT collections.
- These collections are more equally distributed across regions than VAT or CIT, because government (which is relatively more important in Southern Italy) also pays.
- IRAP has some attractive features on the administration side. Its taxpayers are those already subject to VAT, while additional record-keeping requirements are relatively small.



# Reforming Pakistan's GST: How to handle provincial issues?

## ■ Option 1: Make GST a federal subject, collections by FBR

- What's in it for provinces? Alternatives:
  - Surcharge or “piggy-back” band on entire GST base: 3-4 percentage points to provinces?
  - Origin based provincial VAT/IRAP for provinces, also collected by FBR
  - Straightforward sharing of revenues collected on derivation basis
- Option 2: Return of the “services” component to respective provinces
- Some control over rate structure important in achieving greater provincial responsibilities and hard budget constraints
  - Ambrosiano and Bordignon in Ahmad and Brosio (**Handbook of Fiscal Federalism, 2006**)



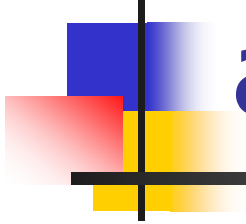
# Pakistan: Income taxes

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- Best to consolidate bases in Pakistan
- Consolidate CIT—single rate 30%; eliminate small business distinctions
- PIT: increase exemption limit, reduce bands, coordinate top rate with CIT
- Introduce “piggy backs” or bands
- Give more revenues and accountability to provinces



# Some taxes with mixed assignments





# Excises

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- Useful tax bases for provincial governments (or even large municipal areas)
  - Avoid cross-border leakages
  - Tax consumption of “bads” (cigarettes, fizzy drinks, alcohol)
- Assess revenue, distributional consequences in deciding (Ahmad and Stern, 1991)



# Excises

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- Several useful excise bases, particularly at the provincial/state levels
  - Tobacco
  - Alcohol
  - Petroleum products
  - Electricity
- Consumption or production base



# Natural resource taxes

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- Local assignments problematic
- Off-shore/on-shore distinction led to problems in Indonesia
  - Case of Aceh
- May not solve political economy tensions
- Extremely disequalizing
- Could vary significantly from year to year depending on price fluctuations
- Alternative: assign different taxes



# Natural resources: continued

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- For provincial level
  - Surcharge on central natural resource income tax/royalties ( as with other income taxes)
- For municipal/district level
  - Environmental excises to offset damage (based on production or pipelines)
  - Linked to physical production/pipelines
  - Does not vary with price and directly linked to physical transport
- Political economy: determine extent of sharing



# Taxation of agriculture: presumptive taxation

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- Net incomes above a high threshold could be subjected to the federal/central income tax
- Overlapping arrangements possible:
  - Presumptive land tax could be imposed above a certain landholding (for equity purposes)—accruing to local government—extension of property principle
  - Crediting against the income tax a possibility



# Lower-tier governments

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District/Municipal governments



# Property taxation

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- Most appropriate for lower level of administration
- Bands for establishing rates in unitary states;
  - Could be set by center or intermediate levels of government
- Valuation key issue—use of updates; “self assessment” subject to minima
- Cadastre should be kept at the center or provincial levels





# Fees and charges

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- Replace or eliminate:
  - Nuisance fees and charges, particularly that impose barriers to trade, or impinge on the poor
- But some fees for use of services could be justified on the benefit principle
  - Vehicle licenses
  - Environmental/betterment levies
  - Water rates (municipalities or groups of municipalities; private concessions)
  - Betterment levies
  - Advertising fees



# Concluding remarks

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# Options for subnational tax-handles

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- Need for overall increases in tax revenues—reassign tax bases
  - Consolidate national tax bases; FBR administration
  - Political economy important: additional revenues for provinces
- Provinces: need access to own-revenues at margin for accountability
  - Surcharges on income taxes
  - Minimum IRAP/dual VATs
  - Agricultural land taxes, crediting towards income tax?
- Natural resources (only non-variable revenues to lower levels—e.g., production excises)



# Sub-national tax reforms

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- Municipalities/districts
  - Property taxation
    - Strengthen cadastre, federal TA, national campaign
    - Allow municipalities to set rates within band
    - Valuation market based subject to minimum assessment
  - Environmental excise
  - Congestion charges
- Sub-national tax autonomy should be seen as part of package including spending and transfer reforms
  - to create incentives for sub-national governments to utilize their tax powers and manage spending efficiently