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THE ROLE OF TAXATION IN PAKISTAN'S REVIVAL

Edited by
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and **Musharraf Rasool Cyan**

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The Potential of Provincial Taxation

Roy Bahl, Musharraf R. Cyan, and Sally Wallace

The four provinces in Pakistan rely on a number of major and minor taxes. Motor Vehicles Taxes (MV) are the most important source of revenue in the category. Other taxes, such as tax on professions, trades and callings and sales tax on services, have remained underutilized and sources of revenue. After the 18th Constitutional Amendment in 2010, there is renewed interest in levying sales tax on services. Sindh has already established the Sindh Revenue Authority and Punjab is slated to follow suit. In this chapter, a discussion of these taxes is presented as an analysis of the current tax structures and issues in tax policy and administration. The chapter closes with a discussion of reform of provincial taxes with an emphasis on clarifying incentives for provincial revenue mobilization.

1. MOTOR VEHICLE TAXES

Motor Vehicle Taxes (MV) give provincial governments a potentially strong source of revenue. Depending on how the tax is structured, the result can be an income elastic base, a progressive distribution of burdens, and a relatively easy administration. As we show below, much more revenue could be captured if the structure of the taxation of motor vehicles were rationalized, and if the rate were increased. This result would hold in both provinces because the underlying problems and issues are much the same.

Revenue Performance

There are two Motor Vehicle Taxes in the present system: a one-time registration charge and an annual tax, the 'token tax'. In both NWFP (known as KPK since 2010) and the Punjab Province, about two-thirds of motor vehicle revenues are collected from the token tax.[1] In per capita terms, these MV's are equal to only about Rs. 32 in NWFP and Rs. 46 in Punjab in 2005–06, Table 1. They account for about 14 per cent of own source revenues in both provinces, well more than the property tax, but are equivalent to less than one per cent of GDP with the effective rate being about the same in both provinces. ETD officials estimate a compliance rate of about 80 per cent for motor vehicle taxes in Punjab and 70 per cent in NWFP.

Table 1
Revenue Performance of Motor Vehicle Tax

Years	Per capita Nominal Amount (Rupees)[a]		Per capita Real Amount (Rupees)[a,b,c]		% of Own source revenue[a]		% of GDP[d,e]	
	NWFP	Punjab	NWFP	Punjab	NWFP	Punjab	NWFP	Punjab
1999–2000	22.65	20.18	22.65	20.18	15.93	9.65	0.12	0.07
2000–01	23.54	19.60	21.76	18.12	17.12	9.17	0.12	0.07
2001–02	23.22	19.35	20.98	17.48	14.59	9.85	0.11	0.06
2002–03	22.60	22.83	19.55	19.75	14.52	10.20	0.01	0.07
2003–04	24.03	29.93	19.29	24.03	12.93	10.96	0.09	0.08
2004–05	26.44	38.53	19.83	28.91	13.19	11.90	0.09	0.09
2005–06	31.98	45.55	21.97	31.29	14.76	14.05	0.09	0.09

Sources:

Calculations are based on:

a. Provincial revenue time series data provided by the World Bank, Islamabad.
b. NIPS population data.
c. FBS GDP deflator.
d. Punjab Bureau of Statistics, provincial GDP estimates.
e. NWFP GDP estimates from Government of NWFP (2007).

One might expect natural revenue growth from MV taxes. In fact, motor vehicle ownership in Pakistan has been growing faster than the international average for developing nations, see Box 1. The base of both forms of motor vehicle tax used in these provinces is some combination of the number of motor vehicles, their value, and their engine capacity. Different rates are applied to different types of vehicles. Growth in the number of vehicles and increases in the value of vehicles form the *base effect* on the revenue–income elasticity. As may be seen in Table 2, the growth in the number of motor vehicles has far outstripped the growth in population in Punjab. In fact, the growth in vehicles in Punjab is more than five times that in population. So, there is reason to expect some buoyancy in MV tax revenues. There is, also, a *rate effect.* The *ad valorem* rate of the tax on registration of motor vehicles would be conducive to stimulating revenue growth as the value of vehicles increased, as would the shift in consumption toward vehicles with a larger engine capacity.

Table 2

Growth in Motor Vehicles and Population in Punjab

Years	Number of Motor Vehicles[a]	Motor Vehicle Growth Rate	Population Growth Rate
2003	3,031,728	–	–
2004	3,322,974	0.10	0.02
2005	3,836,986	0.15	0.02
2006	4,325,776	0.13	0.02
2007	4,998,026	0.16	0.02

Source: Excise and Taxation Department, Punjab.

Note:

a. Column 1 shows the number of registered vehicles in the province.

The actual revenue growth is shown in Table 1. Both real per capita revenues and revenues as a per cent of GDP increased in Punjab between 2000 and 2007. The increase in real collections is most pronounced for the most recent three years shown. The revenue buoyancy was 1.40, possibly suggesting that the base effect, growth in numbers of vehicles, dominated the rate effect but also reflecting a rate increase in 2003–04. NWFP is a different story. Over this same period, neither real per capita revenues nor revenues as a per cent of GDP increased and the income elasticity was only 0.67. The reasons for this difference in revenue performance lie partly in underlying economic differences. GDP grew at about the same rate in both provinces, but the roadway network in Punjab is much larger, and Punjab is both more developed and more urbanized. The reason, also, lies in the difficulties of NWFP in collecting full liability for motor vehicle taxes. This is due partly to non registration of vehicles in the PATA areas, and partly to a leakage of registrations to Balochistan, as well as partly to widespread exemptions. Some observers have argued that there are other contributing factors: (a) the sale of vehicles on power of attorney and their non-registration; and (b) a high incidence of corruption amongst tax collectors.

Box 1
Growth of Motor Vehicle ownership in Pakistan

Between 1960 and 2002, motor vehicle ownership in Pakistan grew from 1.7 per 1,000 population to 12, an annual growth rate of 4.7%. This compares to a worldwide average, of sampled countries, of 2.8%. For comparison purposes, India's annual growth rate was 6.8% and China's 9.8%. Relative to personal income, the vehicle ownership rate in Pakistan grew by 2.57% over the period, while India's grew by 2.92% and China's by 1.51%. Dargy et al. estimate that between 2002 and 2030, Pakistan's ownership rate will grow from 12 per 1,000 to 29 per 1,000 population, a 3.2% growth rate in ownership.[2] They also estimate that the ownership rate relative to personal income growth will reach 1.48%. For India and China these rates are 1.98 and 2.2, respectively.[3]

The Registration Tax

The registration tax is a relatively simple levy in that it is collected only once, at the time of initial purchase. There are no exemptions, not even for government vehicles. However, Malik reports exemptions for ambulances and school buses in NWFP, and also that a number of government vehicles do not pay taxes 'because of owning department's influence'.[4]

Even if the vehicle is sold, or if its user moves to another province, there is no additional registration tax levied. First-time purchasers are free to pay the registration charge in any province they choose. Once a vehicle is registered, the owner receives a license plate and a registration book that includes space for stamps. If the vehicle is sold, a transfer tax is paid, but there is no additional registration fee. The registration book is transferred with sale. It is required that the owner identification page be replaced through the motor vehicle registration office.

The registration tax rate varies by type and age of vehicle. It is an *ad valorem* sales tax that is assessed according to the value of the motor vehicle and its engine capacity. The rate structure in Punjab is:

Engine Capacity	**Tax Rate**
Up to 1,000 cc	1% of sales value
1000–2,000	2% of sales value
Over 2,000	4% of sales value
Commercial	1% of sales value

The following rates apply for registration in NWFP:

Category of Vehicle	**Tax Rate**
Motor cycle/scooter	1% of sales value
Motor car, jeep up to 1,300 cc engine power	1% of sales value
Motor car, jeep from 1,300 to 2,500 cc	2% of sales value
Motor car, jeep above 2,500 cc	4% of sales value
Trucks, buses, pick-ups	1% of sales value
Tractors	Rs. 1,000

Tax rates have not been changed in 4 years in Punjab and 8 years in NWFP. The tax can be paid in instalments, with a 10 per cent discount for full payment at time of registration.

Assessment and collection are relatively straightforward. The registration fee is collected at the time of purchase of a new motor vehicle. Without payment, there can be no ownership papers. A project is underway in NWFP to expand the computerized data base on motor vehicle registrations. To date however, there are no tax data included in this file. Moreover, the numbering of each record is such that there is no possibility for linking this file to other tax information.

Annual (Token) Tax

The annual tax, the token tax, on automobiles is a fixed rupee amount, depending on the engine capacity. The average car, 1,000–5,000 cc, pays a flat amount of Rs. 1,500 per year. Trucks pay according to axle weight, and buses according to seating capacity. The token tax rate has not been changed since 2000. Vehicles older than 10 years receive a 20 per cent discount. Vehicles used for agricultural purposes are exempt.

The token tax for motor cars can be paid where the vehicle was originally registered or can be paid in another district, if the owner applies for a change of residence. For 'tied' vehicles, which include commercial vehicles, buses and trucks, the tax can only be paid in the office that maintains the registration record. Otherwise, taxes are paid either at the post office or at ETD offices.

Police squads are the major form of enforcement, using random road stops. Enforcement is by a registration card carried in the car. Neither number plates nor windscreen stickers are used in enforcement.

Problems and Issues

The major policy issue to be raised about motor vehicle taxation is whether the structure of the tax matches the government's goals for it. Provincial governments might have multiple goals for the tax on motor vehicles. The most obvious is to raise some target amount of revenue for financing public services. However, there are other goals that the government might have for motor vehicle taxes. It might want to charge road users for the upkeep of the road system, or it may want to impose an extra tax on those who generate congestion and pollution. It may even want to discourage the use of roadways to reduce congestion. All of this needs to be considered in light of the demand for motor vehicle transport, and in light of the economic and political sensitivity of taxes on this sector of the economy.

The present level of tax burden is very low. In 2006, the per capit amount of tax on motor vehicles was only Rs. 32 in NWFP an Rs. 46 in Punjab, well less than one per cent of GDP in bot provinces (Table 1). At a time when the provinces face a shortfal in the quality of public services provided, there would seem to b a premium on revenue mobilization, and motor vehicle taxation would appear to offer some fiscal space. One question to be answered is 'how much revenue should be raised from these taxes?'

The revenue targeting issue might be approached by viewing motor vehicle taxes as a kind of benefit charge for using roadways. In 2006, taxes on motor vehicles were equivalent to only about 65 per cent of provincial government expenditures on road maintenance and construction in Punjab, and 53 per cent in NWFP.[5] Note that these percentages relate to actual roadway expenditures, which are below desired, standard, levels and have been for many years. The sector is said to have been squeezed to yield funds for new infrastructure.

In NWFP, the allocation for district level road maintenance declined even further in 2003–04. A significant proportion of the road network is in poor condition primarily due to shortage of maintenance funds. A backlog of Rs.2.5 billion for maintenance needs was estimated in 2004.[6] Punjab road expenditures are in a similar state. From 1990 to 2000, for instance, the road network grew from 26,100 km to 41,000 km but at the beginning of the current decade the road condition was categorized as fair to poor and deteriorating rapidly owing to insufficient maintenance and high volumes of traffic. ADB estimates in 2002 were that given the expansion in the network, Rs.8 billion would be needed annually to maintain the roads in their existing condition.[7] This is almost double the actual 2005–06 level. Given that the ratio of road fatalities to vehicles is 10 times higher in Pakistan compared with other developed countries, the required expenditure to maintain them at an improved level will require road sector expenditures to increase much more.[8] When viewed as a benefit charge, there would seem to be a reasonable argument for a significant increase in the effective rate of tax on motor vehicles. However, the present token and registration taxes do not allocate burdens according to the amount of road use, which makes them an imperfect benefit levy.

Would an increase in motor vehicle taxes above present levels impose an inordinately heavy burden on taxpayers? Some statistics based on the present rate and base structure, and an illustration, might give an idea of effective rates. Suppose an automobile costs Rs. 1.2 million. The annual (token) tax would be Rs. 2,000. The one time registration fee would be 2 per cent of the value of the vehicle (Rs. 24,000). If this registration fee is capitalized over a 10 year life of the car, a combined annual tax of Rs. 4,400 is implied for a new car, rows 1–3. This amount would be equivalent to 9 per cent of average per capita income in Punjab and 13 per cent in NWFP for this type of vehicle.

While this comparison to average income would indicate a very high tax burden, it should be noted that motor vehicle ownership is concentrated in higher income brackets; hence, the effective tax rates on owners will be much lower. Also the effective tax rate for smaller and less expensive vehicles would be lower. From the Pakistan Household Income and Expenditure Survey, we can note that the average level of income in the top two deciles is 135 per cent above the provincial average in Punjab and 134 per cent in NWFP. Further evidence of this concentration of ownership might be drawn from the Pakistan Household Income and Expenditure Survey. The richest 10 per cent of households in Punjab earn 31 per cent of all income in the province and account for 68 per cent of expenditures on motor fuels. The proportions in NWFP are 21 per cent and 75 per cent, respectively. Given the overall low level of taxation at the provincial and central government level in Pakistan, one might argue that this level of taxation does not impose a heavy marginal burden on higher income families. There would appear to be room for an increase.[9]

A second problem is that there are reported, by government officials in both province, to be significant leakages from the tax base. With respect to the registration charge, some owners just do not pay the tax. Some register in other provinces—which is allowed under this tax.[10] Some use fake documents to under-declare taxable value. In addition, significant exemptions are a problem for NWFP. A 2004 study by Malik, sponsored by NWFP, estimated that less than 50 per cent of the vehicle traffic in NWFP was registered in the province. Independent estimates reported in this same study are that Motor Vehicle Tax collections are equal to only about 50 per cent of tax potential.[11] Khan also notes the problem associated with a large number of vehicles brought into the country without payment of custom duty.[12] He estimates about 20,000 such vehicles in FATA/PATA areas in NWFP, of which less than half are registered.

There are other administration problems. The annual token tax for private cars is paid at the post office. Because there is not good coordination between the post office and the excise tax department, record keeping on compliance with motor vehicle taxes is not very good. Commercial vehicles pay at the district ETD offices, where recordkeeping is thought to be better. The MV tax payment records are not computerized. All of this suggests some unfairness in the levy of motor vehicle taxes. Some pay it fully, while some are outside the tax net. This differential taxation erodes taxpayer confidence and further stiffens resistance to tax increases. It also implies a loss of revenues, but there are no good data available to make a reliable estimate.

Reform Options

In considering reform options, the first order of business is for the provinces to think through their rationale for the taxation of motor vehicles. What goals should be accomplished with the motor vehicle tax regime, e.g. should it be a tax levied according to ability to pay, automobile ownership, a tax to cover the cost of roadway use, or a tax to reimburse the general population for the congestion and pollution generated by motor vehicles Then the constraints must be determined. Will reform be limited to a restructuring of the registration and token taxes, or might a tax on motor fuels be considered? Once these basic questions are answered, both the restructuring and the revenue yield issues can be addressed.

Increased emphasis on the taxation of motor vehicles would seem a good reform option for Punjab and NWFP. The base, the number and value of motor vehicles, is growing. A properly structured tax regime for motor vehicles could provide a needed boost to the revenue elasticity of the tax system. Heavier taxes on motor vehicle use can, potentially, address two other needs: (a) to act as a benefit charge on road users that can partially cover the cost of road construction and maintenance; and (b) to compensate society for the external costs of motor vehicle use, i.e. pollution and congestion. The present system does not appear to match up well with any of these goals.

The most difficult question is how to change the revenue structure so as to hit the collection target and achieve the other goals discussed above. One approach is to leave the basic structure in tact but to iron out some of the problems with the component registration and token taxes. The alternative, a comprehensive reform, would change the basic structure of motor vehicle taxes, perhaps including or adding a tax on motor fuels. The view here is that the provincial governments would be best served by moving toward a comprehensive reform of the taxation of motor vehicles. Note, however, that comprehensive reforms always involve more risk. We also present the components of a piecemeal reform

Comprehensive reform of the existing structure. A comprehensive reform of the present registration and token tax could call for adoption of a unified tax on motor vehicles, levied as an annual fee based on vehicle type, a rough proxy for engine capacity. This new, unified tax would replace the present token tax and registration fee. All motor vehicles could be grouped into three classes, and each would be subjected to a specific rate, as shown in Tables 25 and 26. The specific rates were chosen to hit a revenue target equal to the amount required to match the present level of provincial roadway expenditures.[13] This reform proposal is mindful of the objectives of making the system as simple as possible in order to ease the administrative burdens of assessment and collection.[14]

Motor fuel tax. A more far-reaching comprehensive reform would be the adoption of a provincial motor fuel tax. While the token tax is meant to be a user charge for road use, it does not reflect the amount of road use. A tax on motor fuels would better serve this objective and would mobilize significant revenues. Motor fuels are taxed at the central government level in virtually all countries. In the United States, the state governments have autonomy in setting the rate of tax on gasoline. The levy of motor fuel taxes by subnational governments in developing economies is not universally practised, but is certainly not unknown. See Box 2 for a note on the cases of Brazil, India, and Indonesia.

In fact, a motor fuels levy has been proposed and evaluated as a revenue source for provincial governments in Pakistan. One fiscal analysis of Punjab province recommended the adoption of a tax on motor fuels, on grounds of revenue productivity, ease of collection, and the benefit charge aspect.[15] The report cautioned, however, that the tax should be phased in rather than implemented fully in one year, and that it should be proposed as a user charge to protect its legal status.

Though there is much detail to be worked out, a provincial tax on motor fuels would seem to be a workable proposition. The following is a general outline of a proposal for a provincial motor fuels tax, motor fuels charge.

The tax would be levied on an *ad valorem* basis with the rate set at the discretion of the province. This means that fuel prices would vary from province to province.

1. The tax rate also could vary by type of fuel, at the discretion of the provincial government.

2. The tax would be collected by the oil marketing companies based on fuel sold in the province. The federal government would then transfer the revenues to the provincial treasury.

The revenue yield from the tax would depend on the target that the provincial government was trying to hit, and subsequently on the rate that it chose. Revenues actually raised from motor vehicle taxes in 2005–06 could be covered by a specific tax rate of Rs. 0.52 per litre of diesel and Rs. 1.00 per litre of motor fuel in Punjab, and a tax rate of Rs. 0.33 per litre of diesel and Rs. 0.75 per litre of motor fuel in NWFP. The necessary *ad valorem* rates would have been 1.47 per cent in Punjab and 0.93 per cent in NWFP.

Clearly there would be some political opposition to a motor fuels tax from provincial governments, and from the federal government. Some elected officials would be concerned about the political fallout. The impact on gasoline and diesel prices at the pump, and possibly on the price of power, would be unpopular with voters. Some federal government officials might see a provincial motor fuels tax as an encroachment on the federal tax base, and a bothersome influence to be reckoned with in controlling national fuel prices.

Box 2
Subnational Government Taxation of Motor Fuels in Brazil, India, and Indonesia

Three examples of Motor Fuel taxation in developing countries, which might be instructive for Pakistan, are the cases of Brazil, India, and Indonesia.

In Brazil, intrastate sales of fuel are taxed under the state government value added tax. The tax is levied on a destination basis and the revenues are retained by the collecting state. The tax rate is set by each state and may vary significantly. "For gasoline, the average national burden is 46.9 per cent, with variations as low as 41.1 per cent in the state of Mato Grosso and as high as 50.8 per cent in the state of Rio de Janeiro."[16]

Gasoline taxes are not in the State government VAT in India, but states can tax gasoline under a separate sales tax. State governments are free to set the rate above a centrally prescribed minimum of 20 per cent, with the result that the rate varies between 20 and 28 per cent. The tax is collected directly from the gasoline distribution company. In most Indian states the gasoline tax is a major revenue source, sometimes accounting for more than one-half of total revenues.

In Indonesia, the Motor Fuel tax is administered and collected by the province. The tax rate is set by the central government and therefore is uniform across the country. The provincial government is required to allocate 70 per cent of the revenue collections to the districts, local governments, on an equalizing basis.

There is another version of the motor fuel tax proposal that gets around some of the problematic issues. It could be assessed as a federal tax with the revenues distributed among provinces on an origin basis, such as is done in Indonesia. This gets around the problem of non-uniform fuel prices, and, arguably, the challenges to the legality of this charge. However, it does so at a serious cost in that this becomes an intergovernmental transfer instead of a local levy. As such, the reform would not be in step with the goals of fiscal decentralization.

Finally, there is the question of the equity of a user charge on motor fuels. Suppose the goal is to distribute the burden of this tax on motor vehicle use according to the benefits received. One might say that these benefits are proportional to the amount spent on motor fuel consumption, or alternatively, the benefits could be seen as proportional to the consumption of all transport services. If we use motor fuel consumption as an indicator of benefits received, we can see that the distribution of fuel tax payments is skewed heavily to the higher income brackets. For example, in NWFP the top 20 per cent of households earn 44 per cent of income and account for 87 per cent of expenditures on motor fuels. Roughly the same pattern holds in the case of Punjab. The implication of this pattern is that a motor fuel benefit charge would fall most heavily on higher income households.

The benefits received from roadway expenditures might be seen as accruing to all consumers. In this case, the same progressive distribution of burdens might result. However, the pattern of burdens in this case is less heavily skewed to the higher income families.

2. TAX ON PROFESSIONS, TRADES, AND CALLINGS (PROFESSIONS TAX)

The revenue performance of the 'Professions Tax' (PT) is described in Table 3. In NWFP, the Professions Tax raised Rs. 49 million in 2004–05 and is estimated to raise Rs. 70 million in 2005–06. Due to a rate increase, there has been an uptick in revenues since 2004. In both provinces, the tax accounts for only a minimal share of the budget: 1.6 per cent of own source revenues in NWFP and 0.80 per cent in Punjab. Real per capita collections have risen slightly in NWFP over this study period, but collections in Punjab have stagnated. The tax raised Rs. 97 million in Punjab in 2004–05 and a revenue target for 2005–06 was set at Rs. 225.

Professions Tax Overview

The Professions Tax has its roots in a central government levy on 'every person engaged in import and export trade and who held a license.'[17] At that time, the tax was levied on the *value* of goods imported or exported. In both provinces, the current version of the 'Professions Tax' is a flat charge, specific tax, for designated 'professions.' In 1973, the tax was assigned to the provincial governments.

Table 3
Revenue Performance of the Professions, Trade and Callings Tax

Years	Per capita Nominal Amount (Rupees)[a]		Per capita Real Amount (Rupees)[a,b,c]		% of Own Source Revenue[a]		% of GDP[d,e]	
	NWFP	Punjab	NWFP	Punjab	NWFP	Punjab	NWFP	Punjab
1999–2000	1.12	2.36	1.12	2.36	0.79	1.13	0.006	0.009
2000–01	1.33	2.27	1.23	2.10	0.97	1.06	0.007	0.008
2001–02	2.12	2.10	1.92	1.90	1.33	1.07	0.010	0.007
2002–03	2.26	2.02	1.96	1.75	1.45	0.90	0.010	0.006
2003–04	1.93	2.20	1.55	1.76	1.04	0.80	1.037	0.006
2004–05	2.37	2.21	1.78	1.66	1.18	0.68	1.182	0.005
2005–06	3.54	2.47	2.43	1.69	1.63	0.77	0.010	0.005

Sources:

Calculations are based on:

a. Provincial revenue time series data, provided by the World Bank, Islamabad.
b. NIPS population data.
c. FBS GDP deflator.
d. Punjab Bureau of Statistics, provincial GDP estimates.
e. NWFP GDP estimates from Government of NWFP (2007).

The tax is levied as a flat amount but this 'rate' varies by type of profession. There is a rather loose definition of the term 'profession' and each province has the authority to develop its own detailed list of professions. However, the list of professions is very similar between NWFP and Punjab. As noted below, there is little correspondence between the flat tax amount that is applied and the potential income received by various professionals, i.e. higher paid professions are not systematically taxed at higher effective tax rates, although there are differences in statutory rates.

The 'professions tax' has more the feel of a user charge on businesses, corporate and unincorporated, than an income tax. The Punjab Resource Management Programme report views the 'professions tax' as a user fee, but Malik analyses it as an income tax in NWFP.[18] Both studies report dismally low levels of collection and compliance. There are reports that the local governments insist on collecting the tax, increasing confusion about the collection procedure.[19] A large proportion of the tax is paid by salaried government workers.[20] Many observers see administrative difficulties that may be impossible to overcome in the short or medium term unless the structure of the tax is changed.

Indian states have similar experiences with the 'Professions Tax'. Orissa State imposes a tax on professions, trades, and callings that is effectively levied as a payroll tax on wage earners, and is withheld by employers. In the state of West Bengal, the tax is also levied via employers as a withheld tax or directly on the self-employed.[21] Employers obtain a 'Certificate of Registration' and self-employed obtain a 'Certificate of Enrolment' as a condition of compliance with the tax. In Maharashtra State, low levels of compliance led to a tax amnesty in 2007. In most examples, we could identify in India, the level of revenue collection is small. For example, in West Bengal, the tax on professions, trades, and callings generates approximately 1.5 per cent of the total tax revenue for the state, Rs. 30 per capita in 2004–05. The city of Dhaka also levies a 'professions tax', with similar results.

Tax Structure

In Punjab, there are six general categories of 'profession', with a fixed amount of tax assessed to each category. Each category has multiple subcategories so that in total, 47 'professions' are taxed. NWFP lists 11 main categories. As seen in Table 4, the specific rates range from Rs. 200 to Rs. 100,000 in Punjab and from Rs. 100 to Rs. 50,000 in NWFP. The tax rates were last changed in 2002–03 in both provinces. Most taxpayers, who are subject to the 'Professions Tax', are, also, subject to the federal income tax.

Table 4
Taxes on Professions and Callings

Category	Rate NWFP	Rate Punjab
1. Companies registered under Companies Ordinance 1984	Rates range from Rs. 1,000 to Rs. 50,000 based on amount of paid up capital	Rates range from Rs. 5,000 to Rs. 100,000 based on amount of paid up capital
2. Persons other than companies owning factories and commercial establishments	Rs. 750, companies with 10 or more employees	Rs. 1,000 to Rs. 5,000 based on the number of employees
3. Persons other than companies owning commercial establishments having more than 10 employees		Rs. 3,000 within metro and municipal corporation limits Rs. 2,000 all others Rs. 1,000 all other commercial establishments other than wholesalers and retailers
4. Persons engaged in import or export	Rs. 1,000 to Rs. 1,500 based on value of imports or exports	Rs. 2,000 to Rs. 5,000 based on value of imports or exports
5. Persons engaged in profession, trade, calling, or employment who were assessed to pay income tax		Rs. 200
6. Contractors, builders, and property developers	Rs. 1,000 to Rs. 5,000 based on the amount of sales	Rs. 500 to Rs. 10,000 based on the amount of sales
7. Persons engaged in other professions and callings	Rs. 100 to Rs. 200 based on monthly income	Rs. 500 to Rs. 10,000 based on profession
8. Customs and clearing house agents	Rs. 1,000	
9. Travel agents	Rs. 2,000 to Rs. 5,000	
10. Restaurants and marriage halls	Rs. 5,000	
11. Advertising agencies	Rs. 1,000	
12. Doctors and labs	Rs. 300 to Rs. 5,000 based on type of profession	

The tax is structured so that it may fall on the corporate entity, 'companies registered', on self-employed professionals, doctors, lawyers, marriage hall entrepreneurs, etc. and on employees, presumably in the formal sector. The latter category is taxed at a very low rate. This definition of the base gives the 'professions tax' some characteristics of a business license fee for companies and self-employed, and an additional wage tax for individuals employed in these sectors, Categories 7 and 9 in Table 4. If one accepts that the tax is a fee levied on business for services provided by the provincial government, it is not at all obvious that there should be an additional fee levied on individuals employed in these businesses. Instead of having an additional category of taxpayers and an additional tax administration, it might be preferable to roll the tax on workers in the formal sector into the amount that is levied directly on the business.

It is no easy task to determine the revenue potential of the 'professions tax' in either province. To do this, one would have to know the number employed in each taxed category. The Pakistan Labour Force Survey offers some detail on the level of employment by occupation, but it is difficult from that survey to determine who is self-employed versus who is employed by a company, and it is difficult to determine the level of sales/exports for the companies and self-employed businesses, etc.[22] We make an estimate of the revenue potential for the following occupational categories: professionals, technicians and associate professionals, legislators, senior officials, and managers. For the tax rate, we use a very rough (and conservative) average of Rs. 500 per employed person. Excluding any tax on companies, this analysis demonstrates the revenue potential of the tax, Rs. 1.3 billion in NWFP and Rs. 6.3 billion in Punjab. In both cases, the analysis suggests that current collections are less than 4 per cent of revenue potential.[23]

An analysis of Lahore data can give some indication of the relative importance of the different categories of profession in current revenue collection. Based on data from the Punjab Excise and Taxation Department for Lahore District, 2006–07, most of the revenue from the tax, 49.2 per cent, comes from category 5 in Table 4, persons engaged in a profession, trade, calling or other employment, who are subject to the income tax. The next largest revenue producers for Lahore are: companies with paid up capital exceeding Rs. 200 million, 10.9 per cent, real estate agents within metro and municipal limits, 7.3 per cent, companies with paid up capital exceeding Rs. 50 million, 6.9 per cent, and companies with paid up capital exceeding Rs. 5 million, 4.1 per cent. This analysis demonstrates that nearly 80 per cent of the revenue take is from employed individuals, some of whom are employed by 'paying' companies, and directly from companies.

Administration

Administration of the tax is very weak in both provinces. Provincial officials confirm our belief that there is much higher revenue potential than is currently exploited. The excise tax departments in both provinces build their tax rolls by using income tax statistics, limited company directories, professional association lists, etc. In Punjab, officials attempt to obtain information to identify professionals from the chamber of commerce and from professional associations. In Punjab, about 35 lower level officers are working on assessment and collection of this tax (but they also work on other taxes). In Lahore district alone, there are over 250,000 taxpayers on the tax rolls. However there are no designated 'professions tax' officers. Assessments and demand notices are carried out by the excise tax department. The process is very labour intensive. This imbalance between officers and clients suggests the root of the administrative problem and exacerbates the compliance problem.

In NWFP, an initial demand notice, 'notification bill', is sent to individuals and it contains their 'professions tax' liability. According to officials in NWFP, if the notice is ignored, the penalty is a doubling of the tax. Still, the reported collection rate is very low. It is estimated by officials to be on the order of 30 to 40 per cent. There is little manpower designated for administering the tax in NWFP. For example, in Peshawar district there are only 7 inspectors assigned to cover the tax on professions. Khan notes that Peshawar's population is about 1.5 million, and that there are over 50,000 shops and 3,000 doctors.[24] But he reports that the relevant records on 'professions tax' shows that only a fraction of these 'potentials' are in the base. His calculation is that each inspector has the impossible task of supervising about 10,000 tax units.

In some cases payment of the tax may be made by a principal on behalf of a group of taxpayers, e.g. unions on behalf of particular groups of traders, or employers on behalf of employees. Malik reports that confusion between the provincial government and local governments regarding collection authority may decrease compliance. According to Malik, local governments 'insist on collecting this tax' even though it is not a local government tax.[25]

Problems and Issues

The 'professions tax' is an attempt to reach a part of the personal income base in the province. However, the tax is levied at such low rates that it would likely fail on the revenue raising objective. even if administration were efficient. To give an idea of how low effective tax rates can be, it was noted, by ETD officials, that a physician can make Rs. 20,000 per day, but pay only Rs. 1,000 per year in 'professions tax'. In such a case, the tax is little more than a nuisance.

Another problem is the uncertain justification for levying this tax. The Professions Tax might be justified on the basis of benefits received from provincial government services, i.e. it is a tax paid by a business, employee, or self-employed person for the privilege of doing business in the province. Or, it might be an attempt to tax higher paid professions at higher rates. However, the variable rate of tax across professions suggests neither a benefits rationale nor an ability to pay element. A benefits tax approach would suggest transforming the Professions Tax into a business levy, or a piggyback on the federal corporate income tax. As a general income tax, the Professions Tax might be replaced by a more transparent income tax.

Other features of the tax structure are just unclear. For example, some professionals are taxed twice, once through an official employer and then again as a professional employee. This practice is suggestive of a general benefits tax such as an income tax. In short, it is not easy to infer the objectives of the tax from its structure.

As a stand-alone tax, the Professions Tax would be hard to collect in the best of circumstances. Professionals not tied to an incorporated business are notoriously difficult to find for purposes of tax administration. The sheer number of professionals, 2.7 million in NWFP and 12.5 million in Punjab, would make efficient administration of the tax a very costly proposition. Many states in India require a registration process for the tax on professions. This process may be effective if the registration is required for other important business transactions or tax payments. These might include contracting with the federal government, customs procedures, workers welfare and workers profit participation funds, these would be applicable to companies only, motor vehicle registration, etc. The crux of the problem is the identification of eligible taxpayers, and it is no easy task to identify all potential taxpayers. Khan, in his analysis of tax administration in NWFP, calls for a detailed survey to identify businesses and individuals liable for the tax on professions.[26] An integrated data base that captures professional registration, motor vehicle registration, government contracting, and other activities would go a long way toward resolving the administration problems of the Professions Tax.

Most would point to weak revenue performance as the major failure of this tax. As was discussed above, collections under the current system are estimated at less than 10 per cent of what they would be if the collection rate was 100 per cent.

Reform Options

In Punjab ETD officers believe that the tax, even as currently structured, could raise up to three times more in revenue if there was more focus on its collection. This seems a feasible if not conservative target. Khan has the same view for NWFP, and argues that the tax could be significantly more productive.[27]

There are several ways to improve the practice of taxing professionals at the provincial level. We would suggest five reform options. One is to take the view that the Professions Tax is more a nuisance than a productive levy, so it should be abolished as a provincial tax. It would be better to invest the administrative resources used in potentially more productive areas of revenue mobilization. Under this scenario, the Professions Tax might be turned over to the TMAs or union councils and perhaps be treated as a kind of general charge for the privilege of doing business in the local area. However, this transfers the difficulties in collection to a lower level of government, if the data base and administrative capacity for collection are not enhanced.

The second route is to take the view that there is need for a more broad-based provincial tax to reach the growing fiscal capacity, particularly in urban areas. The Professions Tax could be converted into a piggyback levy on the federal income tax, on individuals and/or corporations, with collection by the federal government. Provincial governments could choose a piggyback rate within a prescribed range and the federal government could collect the income tax as it does now.[28] For example, a 3 per cent piggyback on collections for individuals and self employed in Punjab could yield Rs. 487 million per year and Rs. 83 million in NWFP, both substantially more than current collections.[29]

Objections to this option are that it could be struck down as a 'double tax' particularly on workers in complaint enterprises, and unconstitutional. Also, increasing the overall income tax rate, even by this small amount, might reduce compliance. Another objection would be that under this scheme the self-employed would escape the local tax net altogether since they often evade the federal income tax. This is a valid objection because the self-employed are notoriously hard to tax. To deal with this, the piggyback income tax might be supplemented by a presumptive income tax administered by the province. Even if the presumptive tax on the self-employed was not effective, it would be no worse than the present Professions Tax administration where 80 per cent of collections come from those already in the income tax base. This option is included in the policy matrix, and it is the opinion of the authors that this option has the most potential given the current state of administrative resources.

Alternatively, the tax could be piggybacked on the gross receipts of companies and self-employed. A gross-receipts tax or gross turnover would be simpler. Gross-receipts taxes, however, can be very distorting in nature and could increase the tax burden of compliant start-up businesses by a substantial amount and possibly lead to cascading in output prices. A number of transition countries have chosen this route with limited success. Examples are Albania, Azerbaijan, Kazakhstan, Kyrgyzstan, Ukraine, and Serbia.[30]

A third reform route would convert the current 'professions tax' into a sales tax on services. Many professionals provide some type of service although not all are covered under the current tax on services. If option 2, piggyback on the income tax, is not a viable option, replacing the professional tax with an expanded provincial sales tax on selected services is an alternative. A drawback with this option is that services delivered by a firm or an individual whose headquarters office was in a different province than the where the service was delivered would raise some controversy about where the tax should be credited. Unfortunately, we cannot make a revenue estimate for this option with data that are currently available. Services are difficult to tax, but because of the existing federal sales tax infrastructure, the collection rate of a sales tax on services probably would be higher than that for the current Professions Tax.

A fourth option would retain the tax, but adjust the specific rates to be higher and more in line with expected levels of income for the various professionals, and to eliminate the tax on salaried individuals who are employed in companies. Without a significant improvement in administration, such reform options are unlikely to yield much in additional revenues. The necessary first step here is a survey to enumerate all of those professions liable for the tax, and an automation of this data base. Because such a data base does not presently exist, we cannot make an estimate of the revenue impacts of increasing the nominal rates. While this option has its merits, it is an income-based tax that has its roots in the current Professions Tax, the provincial authorities would have to commit increased resources to administer the tax. Changes would need to encompass training, performance evaluation, and database development in addition to other considerations.

A fifth option would be to restructure the tax as a benefits charge for services provided by the provincial government, e.g. road infrastructure, certain utilities. In this case, the tax might be levied on businesses and not necessarily on employees of taxpaying entities, although there may be a similar benefits argument for individuals. A provincial level business registration fee, flat fee, or progressive fee based on type or size of business could be assessed annually as a presumptive tax. Here again there are difficulties of compliance, record keeping, and administration that may dampen revenue significantly.

3. SALES TAX ON SERVICES

The Constitution of Pakistan reserves certain tax bases for the federal government. All other residual tax bases can be claimed by provincial governments. The constitution provides for federal taxation in the case of 'taxes on the sales and purchases of goods imported, exported, produced, manufactured, or consumed'. This leaves open the possibility for provincial governments to levy a sales tax on services. All four provincial governments tax some services.

Tax Base and Rate

In theory, the constitution is permissive in allowing each province to define its own sales tax base, i.e. to determine which services it will tax. In practice, the laws for each province were written by the federal government and were adopted, as ordinances, by the four provinces. These ordinances include a more or less uniform list of services to be taxed. The base is the gross amount of sales, and the tax rate is set by the federal government at the national rate of 15 per cent. Service providers are entitled to claim input tax credit for the tax paid on taxable purchases, inputs, and utilities.

Tax Administration

Tax assessment and collection is the responsibility of the sales tax collectorate of the federal government. A collection fee of 2 per cent is retained.

Revenue Performance

The revenue performance is described in Table 5. The sales tax on services yields 9.15 per cent of own revenues in NWFP and 7.52 per cent in Punjab, which makes it a considerably more important revenue source than the property tax, but a considerably less important source than either taxes on property transfers or Motor Vehicle Taxes. Still, revenues amount to only about 0.05 per cent of GDP.

Table 5
Revenue Performance of the Sales Tax on Services (2005–2006)

Province	Per capita Collection (Rupees)[a]	% of Own Source Revenue[b]	% of GDP
NWFP	19.83	9.15	0.06
Punjab	24.38	7.52	0.05

Sources:

Calculated from

a. Provincial revenue time series data provided by the World Bank, Islamabad, and the NIPS population estimates.

b. Provincial revenue time series data provided by the World Bank, Islamabad.

The composition of sales tax revenues is described in Table 6. The pattern shown is one where 98 per cent of total national collections is made in Punjab and Sindh. Note that revenue collections are concentrated on four services: hotels and restaurants, travel and shipping agents, advertisements and courier services.

Problems and Issues

There are four issues to be addressed in evaluating the sales tax on services as a provincial government revenue source: (a) whether it has a significant revenue potential for provinces; (b) administrative concerns; (c) the matter of encroachment on this tax base by the federal government; and (d) economic disincentives.

Revenue Potential. In theory, the sales tax on services could be a lucrative revenue source for provincial governments. The base of the tax is potentially large. We can note from the national accounts in Punjab that 10 per cent of provincial GDP is classified as 'other services'. This sector is defined in the provincial accounts to exclude transport, storage, and communications. If this rough estimate of the broad version of the base for the sales tax on services is indicative, we can say that the effective tax rate at present is well less than 1 per cent.

Table 6
Sales Tax Collection from Services (Provincial)
(rupees in millions)

Item Name	Punjab	Sindh	NWFP	Balochistan	Total
1. Hotels/restaurants/ fast food/catering (services)	1343.25	514.13	54.60	17.27	1929.25
2. Services provided by travel agents/ stevedores/shipping agents/ship chandlers	240.51	648.20	4.44	2.45	895.59
3. Advertisements on TV/radio	48.98	667.79	0.21	0.05	717.03
4. Courier services	42.78	608.17	0.04	0.01	651.00
5. Caterers, suppliers of food/drinks	2.57	18.37	0.00	0.00	20.94
6. Services provided for inland carriage of goods	10.22	0.00	0.00	0.00	10.22
7. Clubs (services)	3.76	0.26	0.00	0.00	4.02
8. Marriage halls and lawns	1.91	0.00	0.00	0.29	2.20
9. Cable TV operator and others	0.19	0.00	0.30	0.00	0.49
10. Beauty parlours/ clinics/sliming clinics	0.16	0.24	0.00	0.00	0.41
11. Service rendered by foreign exchange	0.03	0.16	0.00	0.00	0.19
12. Services (Aachitects, town planners, and contr.)	0.04	0.02	0.00	0.00	0.06
13. Laundries/dry cleaners	0.05	0.00	0.00	0.00	0.05
Total	**1694.43**	**2457.34**	**59.59**	**20.08**	**4231.44**
Percentage Share	**40.04**	**58.07**	**1.41**	**0.47**	

Source: Federal Board of Revenue, Sales Tax Wing.

However, there are some significant challenges in taxing this base and ratcheting up revenues. First, the provincial government would need to be willing to expand its presently taxed base to include additional services. As noted above for other provincial taxes, a combination of the growing NFC Awards and political opposition to provincial tax increases lead to a situation where there is little incentive for the political leadership to increase tax effort. Second, the service sector is notoriously hard to tax because it is composed of many small firms that are difficult to identify and their recordkeeping often is problematic. Third, there is a 'headquarters' problem, i.e. the tax may be paid at the headquarter location rather than at the point of consumption. Note, for example, that Punjab accounts for 57.2 per cent of Pakistan's GDP but only 40 per cent of total provincial sales tax collections on services. Sindh, where many headquarters are located, accounts for 29.8 per cent of national GDP but 58 per cent of provincial collections of the sales tax on services.[31]

Tax Administration. Administration may pose a constraint to a more revenue productive sales tax. On the one hand, the federal sales tax administration may be neutral in its collection of the provincial tax on services vs collection of a national sales tax. On the other, why should the central government aggressively pursue collections against a broader services base, when 98 per cent of the revenues accrue to the provincial governments? The deeper the province decides to go into the services base, the harder to assess will be the base, and the more costly to the central government will be the administrative effort required. In fact, the government of Punjab proposed an expansion of the tax base to include marriage halls and beauty parlours, but according to provincial officials, the central government sales tax administration department was unwilling to collect from these sectors. Administrative complication was cited as the reason. Punjab province also has proposed an expansion of the base to 44 additional categories of service but no action has yet been taken.

This highlights a significant problem. The split between administrative responsibility and rate/base determination is not likely to work effectively unless there is significant revenue sharing. The levying government, province, will accept the political risk only if the revenue rewards are great enough. And the collecting government, federal, will not allocate the resources necessary to administer the tax properly, if the revenue benefits do not justify taking on the additional costs. While the correct split of revenues to accomplish the goal of 'adequate' revenues for the province and the federal governments has not been worked out, it seems clear that the present 98 per cent/2 per cent division is not the answer.

There is another dimension to the administration problem. The provinces complain, rightly, that they do not receive regular reports from the federal sales tax administration department concerning the details of collections. If the provincial governments are to be expected to move forward with base expansion, and to use their comparative advantage of 'familiarity' to identify new firms for inclusion in the net, there must be full sharing of information about tax assessment and collection. However, it is not clear whether the underlying problem is that the central government is unwilling to supply this information, or whether their statistical data base is so weak that the data are not available.

Encroachment. Third, there is the issue of 'encroachment'. The Constitution does not reserve the right to tax services for the federal government. Presumably this leaves the provinces free to levy a sales tax on services. In fact, however, the federal government also levies a sales tax on services, in the form of excise taxes.

While the federal government sees this as a matter of national interest, the provincial governments see it as encroachment. The ten services now taxed by the federal government as excises are listed in Table 7. The total yield on these is Rs. 28.2 billion vs Rs. 4.2 billion in collections under the provincial ordinances.[32] Most of the federal revenue, 95 per cent, is collected from telecommunications services. Paradoxically, the provinces would be better off in revenue terms if the sales tax on services was a federal tax with revenues included in the NFC sharing pool.

Table 7
Sales Tax/Excise Duty (in VAT mode) in Services in Pakistan

• In Pakistan, six services are chargeable to sales tax @ 15% through Provincial Sales Tax Ordinances promulgated in year 2000. These are: (i) Services provided by hotels, marriage halls, clubs and caterers (ii) Advertisements on TV and Radio (iii) Custom agents (iv) Ship chandlers (v) Stevedores (vi) Courier services * Services provided by beauty parlours and dry cleaners are exempted.
• Four services are chargeable to federal excise duty @ 15% (in VAT mode): (i) Telecommunication services (ii) Advertisements on CCTV/cable TV (iii) Inland carriage of goods by air (iv) Domestic air travel
• Six services are chargeable to federal excise duty at specific rates: (i) International air travel (ii) Shipping agents (iii) Insurance except life insurance (iv) Non-fund services of banks (v) Franchise services

Source: Federal Board of Revenue, Sales Tax Wing.

Economic Incentives. Finally, there is a question about whether a 15 per cent tax on services would damage the economy and perhaps force some firms out of the market. For example, some hotels and places of entertainment might see the tax as significantly cutting into their profit margin. Another outcome is that consumers might find their consumption of services more expensive, to the extent the tax can be shifted to them. These are possible, even probable outcomes according to some observers. But should this cause a rethinking of the proposal to extend the sales tax on services?

The answer here is that it should not. Services should be taxed, just as other consumption is taxed. Why should the sales tax treat the purchase of clothing or an appliance any differently than an expenditure on a restaurant meal or a visit to a beauty parlour? Services have enjoyed a preferential tax treatment in Pakistan for many years, and the proposal here is to remove that preference. While some service sector activities will be negatively impacted, and there might be an employment effect, the more level playing field would allow producers of goods to expand their output as consumer choices shift.

Reform Options

The most obvious reform option is for the provincial government to selectively expand its base by bringing more services into tax. This expansion should begin by including those services that could most easily be reached under current administrative practice.[33] This proposal would need to be accompanied by an incentive package that would stimulate an increase in revenue effort on the part of the provinces, i.e. to reward provincial governments for taking this politically unpopular step. We further discuss the incentive issue below. It is likely that if the incentive strategy was successful, this option would lead to disproportionately heavy revenue collection in Punjab and Sindh where the service sector is more developed.

There is no easy way to identify the 'best' candidates for inclusion in the tax base for the sales tax on services. One might imagine the following steps.

1. Charge the federal government with the responsibility for compiling a comprehensive list of services, perhaps by reference to the categories listed in the standard industrial classification.
2. Charge the provinces with responsibility for identifying those services to be brought into tax and assisting the federal sales tax department in building the tax roll. Provinces might start this process by determining whether a useful establishment survey exists or could be carried out. Other files that can be useful in identifying firms for inclusion in the sales tax are UIPT records, electricity duty payments, and professional registries. An issue to be resolved is whether all provinces would need to tax the same set of services. Under a provincial administration, each province would be able to choose its own base from among the list of eligible services. Under a federal administration, there might be more pressure for uniformity.
3. Each province should work with the federal sales tax administration to identify a size threshold for inclusion in the services tax net, and then estimate revenue yield.
4. The federal sales tax department in each province should develop comprehensive reports on assessment and collection detail, and delinquency lists. These reports should be shared with the provincial governments.
5. It is likely that new provincial ordinances will be required.

An important consideration that underlies all of the reform options proposed here is that the tax base will become more complicated as additional services are added. As noted above, there is question about the willingness of the central government to expand its administrative efforts so as to reach those smaller firms and self-employed individuals who provide services. This problem might be erased in either of two ways. The first is to transfer administrative responsibility for the services tax to the provincial government. If this were done, the provinces would need to gain expertise in sales tax administration, a comparative advantage which the central government now has. In the long run, provincial administration of provincial taxes could be the right direction for reform in a federal country such as Pakistan. It would however, be difficult to protect revenues during what might be a long transition period. If provincial governments were not up to the task of efficiently collecting the tax on, services and many analysts share this concern, the reform would bring little revenue gain. Moreover, it should be considered that a federal sales tax administration avoids duplication of efforts between the two levels of government, and likely is a lower cost administrative option.

The other solution is to hold to the federal administration but to give a collection incentive to the federal government by converting the sales tax on services to some form of shared tax. An example of how this might be done is discussed below. If federal revenue retention from collections was high enough, a more aggressive administrative effort might be drawn out. It is doubtful that a 2 per cent collection fee is the answer.

The issue of federal encroachment on the provincial sales tax base is also difficult. In fact, 'encroachment' is a pejorative that may not properly describe the issue. The two levels of government are in competition for the same revenue base. The provincial level feels that it has a constitutional right to the tax base, and would like to have the federal government give it an exclusive on taxing services. The federal government sees its right to tax services when in the national interest, and when the headquarters problem makes provincial taxation infeasible. The middle ground is a shared tax, where each side has a claim on this tax base.

Revenue sharing does not resolve the interprovincial competition issue that surrounds the headquarters problem. There is no one best resolution to the headquarters problem. Countries have tried various approaches. One step that might be taken is to allocate all final sales for a company across provinces. If this can be done, the proration can be used to deal with the headquarters problem. However, this is administratively difficult, involves a good deal of subjectivity in establishing an allocation formula, and increases the compliance costs on companies. This approach is used, for example, in the allocation of the state government corporate income tax base across states in the US. Second, each company could be asked to report its taxable sales by province, but this could significantly increase compliance costs and administrative costs. Third, those components of the service tax base where the headquarters problem is particularly serious could be assigned to the federal tax base, and a revenue sharing scheme could be worked out. A fourth approach is to introduce a tax effort component into the NFC Award, but to eliminate 'headquarters taxes' from the tax effort computation. In this case, the federal government would be responsible for identifying 'headquarters taxes', i.e. provincial taxes whose burdens are largely exported. None of these proposals could be implemented without a great deal of arbitrariness.

Depending on the goals that the federal and provincial governments have set for the sales tax on services, consideration might be given to three reform options.

Option 1: One course of action is to fold the sales tax on services into the federal value added tax, i.e. eliminate the excise tax approach. Since federal collections on goods are part of the NFC revenue sharing pool, then over 40 per cent of sales tax collections on services would accrue to the provinces.[34] By comparison with the present system, the province would do better in terms of revenues. Why not leave it at that? There are several reasons. One is that the service sector may remain untaxed while goods are taxed at 15 per cent under the VAT. This would continue the unwanted distortion in the national sales tax system.[35]

A second drawback with this option is that continuing with the present system does not address the disconnection between who administers the tax and who gets the revenue; hence, the absence of an incentive for aggressive administration will remain in place. A more focused collection effort, as a provincial sales tax on services might give, could lead to an increased revenue take on the service sector. Finally, this system does not allow a province to easily ratchet up collections if it should choose to do so. Revenue growth will likely be modest under this option.

Option 2: The ten services that are presently taxed by the federal government could be transferred to the provinces. This would increase provincial revenues from the service tax by a factor of more than seven.[36] Another version of this option would be to limit the transfer to those services that are not collected in the VAT mode, but the revenue take would be small in that case. This transfer of base could establish the sales tax on services as a provincial tax. Sales tax administration would also be transferred to the provinces.

The next step would be for the provinces to begin expanding their tax base selectively by bringing the easier to reach services into tax.

The disadvantage to this approach is that the 'easier-to-tax' services with a broad base are likely to come away with a much heavier tax burden than other services. This would continue a pattern of taxing those sectors where administration is manageable, while allowing the tax burden on the 'hard-to-tax' services to remain low. There is also the problem of the difficulty that provinces would have in administering this tax. The proper accounting for cross-province sales of inputs would be particularly difficult for the province tax authorities given their limited experience with the sales tax. Finally, there is the shortcoming that the federal government would almost certainly resist surrendering this taxing power.

The revenue yield from this option depends not only on how quickly the provinces learn sales tax administration, but on which services are brought into the tax net. This involves a detailed analysis, service by service, of the potential taxable base. Short this preparatory work, we can only suggest revenue targets that might be feasible. But even these kinds of calculations are convincing of the very significant revenue potential. For example, at present, the GST on services in Punjab is equivalent to about 0.05 per cent of GDP originating in the 'other services' sector. If the goal is to double this effective rate, to only 0.1 per cent of provincial GDP in this sector, the increase in revenue would be Rs. 2.2 billion in Punjab. If we assume that the GDP share of 'other services' is the same in NWFP as in Punjab, doubling of the present tax effort on services would yield an additional Rs. 420 million in revenue. This kind of revenue potential would seem high enough that each province would want to undertake an effort to identify those services that could be brought into the base. Reformers would do well to remember, however, that gaining access to the service tax base is only part of the challenge. The provincial governments would then have to develop the wherewithal to assess and collect the sales tax on services.

Option 3: A third reform option is to convert the sales tax on services to a shared tax with the federal level. The federal and provincial governments would tax the same services, with assessment and collection carried out by the federal government. There would be a separate federal and provincial government tax rate, not to exceed 15 per cent. The services to be taxed would have to be the same under such a regime, and the federal rate would be the same in all provinces. The provincial tax rate could vary according to the decision of the provincial government. This autonomy in provincial rate setting would preserve an important fiscal decentralization feature, even though it could introduce some administrative complication. There might be restrictions here, e.g. the federal rate might be set at 7.5 per cent and the provincial rate would be limited to 7.5 per cent.

Because revenues would be shared between the two levels of government, there would be more incentive for aggressive tax administration by the federal government. The revenue increase under the shared tax could be, potentially, quite significant. This approach combines the rate setting discretion of provincial governments with the superior administration capacity of the federal government.

One disadvantage of this approach, from the point of view of provinces, is a giving up of the formal, exclusive, claim on this base by provinces. Another disadvantage is that the headquarters problem would remain. Particularly Sindh could follow a strategy of taxing services heavily and exporting its tax burden to other provinces.

Tax Burdens. Would revenue increases from the sales tax on services be feasible in terms of the burden it would impose on taxpayers in the provinces? To try and answer this question, we estimate of the distribution of the burden of the sales tax on services using HIES data on the consumption of personal and professional services by households at various income levels.[37] In Tables 8 and 9, we compare the distribution of income across population deciles with the distribution of consumption of personal services. For example, the top 10 per cent of the households in NWFP account for about 44 per cent of all household income, but only about 36 per cent of consumption of personal services. The distribution presented in this table shows that the lower income groups allocate a greater share of their budgets to services. This suggests that the GST on services is a mildly regressive tax. A repeat of this analysis for Punjab gives almost exactly the same result.

Table 8

Revenue Performance of Taxes as Per cent of Total Revenues[a]

Punjab

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Urban Property Tax	0.22	0.49	0.03	0.87	0.80	1.05	0.66
Agriculture Income Tax	1.40	0.69	0.56	0.55	0.65	0.39	0.38
Registration Fee	0.28	0.23	0.24	0.30	0.45	1.40	1.23
Land Revenue (includes mutation fee)	2.69	2.56	2.23	2.91	3.37	3.29	1.97
Taxes on Professions, Trades & Callings	0.21	0.19	0.18	0.15	0.16	0.13	0.13
Motor Vehicles Tax	1.84	1.64	1.63	1.71	2.22	2.20	2.41

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Table 8

Revenue Performance of Taxes as Per cent of Total Revenues[a]

GST on Services	0.00	0.96	1.11	1.09	1.20	1.03	1.29
Stamp Suties	5.07	3.31	3.50	3.77	5.56	4.05	3.41
Entertainment Tax	0.27	0.21	0.12	0.11	0.09	0.02	0.01
Electricity Duties	0.09	1.59	0.16	0.15	0.17	0.42	0.74
Hotel Tax	0.11	0.08	0.09	0.08	0.12	0.10	0.14
Provincial Excises	0.54	0.50	0.53	0.49	0.62	0.49	0.49
Cotton Cess	0.32	0.00	0.36	0.30	0.28	0.32	0.26
Other	0.84	2.50	0.93	0.01	0.01	-0.59	0.09
All Taxes	13.88	14.95	11.67	12.48	15.69	14.33	13.21

Source: Calculations are based on provincial revenue time series data provided by the World Bank, Islamabad.

Note: Total revenue includes all intergovernmental transfers.

Table 9

Revenue Performance of Taxes as Per cent of Total Revenues

NWFP

	1999/ 00	2000/ 01	2001/ 02	2002/ 03	2003/ 04	2004/ 05	2005/ 06
Urban Property Tax	0.35	0.64	0.73	0.60	0.79	0.60	0.76
Agriculture Income Tax	0.37	0.11	0.22	0.17	0.21	0.13	0.18
Registration Fee	0.06	0.04	0.05	0.22	0.13	0.12	0.11
Land Revenue (includes mutation fee)	0.91	0.84	0.91	0.98	1.06	1.07	0.83
Taxes on Orofessions, Trades and Callings	0.11	0.12	0.19	0.18	0.14	0.14	0.19
Motor Vehicle Tax	2.20	2.11	2.05	1.75	1.77	1.56	1.71
GST on Services	0.00	1.04	1.17	1.16	1.24	1.11	1.06
Stamp Duties	0.75	0.66	0.70	0.69	0.96	0.95	0.76
Entertainment Tax	0.12	0.04	0.04	0.03	0.03	0.01	0.03
Electricity Duties	1.39	1.04	2.02	1.27	0.50	0.52	0.68
Hotel Tax	0.09	0.00	0.00	0.02	0.04	0.04	0.07
Provincial Excises	0.08	0.07	0.10	0.09	0.08	0.06	0.08

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Table 9
Revenue Performance of Taxes as Per cent of Total Revenues

Education Cess	0.13	0.00	0.00	0.21	0.42	0.63	0.14
Other	0.21	0.25	0.26	0.01	0.00	0.01	0.38
All taxes	6.76	6.98	8.42	7.37	7.38	6.95	6.98

Source: Calculations are based on provincial revenue time series data provided by the World Bank, Islamabad.

Note: Total revenue includes all intergovernmental transfers.

4. OTHER MINOR TAXES

The revenue performance of all other taxes in the province is reported in Table 8. Both provinces levy more or less the same set of 'smaller' taxes. In a few cases, the tax base calls for some differentiation, e.g. tobacco in NWFP and cotton in Punjab. In total these smaller taxes add to administrative costs and do not generate significant revenue. Notwithstanding, that these are minor levies their potential is not being fully exploited. Even the present narrow revenue bases are only partially captured because of weak administrative efforts.

Entertainment Tax

The Entertainment Tax (ET) duty is a minor levy on various types of entertainment events, cinemas, circuses, stage plays, and casual entertainment. The tax rates have been lowered in recent years. Administration is by inspectors, and the management of an event is responsible for collections. In both provinces, there is a notional determination of the tax liability. It is set at a fixed per cent of the announced admission price, but with an assumption that only 20 per cent of the seating capacity of the theatre will be occupied. Entertainment duty accounts for less than 0.1 per cent of provincial government revenues in both Punjab and NWFP.

The entertainment duty is beset by a number of problems. The base has been narrowed by exemptions, so that some entertainment events are not taxable.[38] This imposes a revenue cost and it introduces some unfairness. Exemptions may be given by local government officials and so the coverage of the tax may vary greatly from district to district. Another problem is that the tax rate, 65 per cent, is high enough to encourage evasion. This is an especially important problem because of the difficulty of collecting the tax under present administration arrangements. Collection rates are unknown. Finally, because cinemas have been closing, this tax is losing its revenue raising capacity. Many in the ET department in Punjab think it should be eliminated.

Excise Duty

Excise tax revenue is collected mostly from the sale of licenses to produce alcohol products used for industrial purposes, e.g. denatured alcohol. There also is a duty levied at a specific rate on the production of all spirits. In total these duties account for a very small amount of revenue (Table 8).

Cotton and Tobacco Levies

There is a levy of 8 paisa per kg on the receipt of cotton at the mill. The tax is collected directly from the ginning factories in Punjab province. The revenue yield is very small.

The tobacco development cess is levied as a specific tax on the amount of tobacco production in NWFP. The tax rate is Rs. 2 per kilogram of tobacco. Assessment and collection are relatively straightforward. The Pakistan Tobacco Board sets an annual target of production based on their information about the demand for tobacco by the two major cigarette manufacturing companies. The tax is levied on the target and is easily administered. Most of the tobacco grown in the Province is purchased by two companies which simplifies collections.

The main tobacco manufacturing plants are in Karachi. Tobacco sales have expanded beyond these two companies, so the department now uses, since 2004, a private contractor to collect the tax on open market transactions. This has resulted in an increase in collections. Still, revenue collections are very low.

Hotel Tax

The Hotel Tax is levied at an *ad valorem* rate on room rentals. In Punjab, the rate is 8 per cent, except in hill stations, where the rate is 4 per cent. In NWFP, the rate is 5 per cent. There is provision for self-assessment, but in practice the tax liability is assessed by ETD in both provinces. The assessment formula used is the same. Gross receipts are estimated as the product of the rate per bed and the number of beds. The tax rate of 5 per cent is applied to the estimated revenue base that assumes 50 per cent occupancy. This notional determination of tax liability frees the ETD from having to monitor the self-assessed base and keep track of actual occupancy rates.

There are a number of problems with the Hotel Tax. Some hotels object to the use of a notional 50 per cent occupancy rate for beds versus an actual occupancy calculation. A case is pending in the court. In NWFP, the Hotel Tax is not levied in the PATA districts. Many resorts that operate in these districts, with a large number of beds, are outside the tax net. Another problem is overlap with the General Sales Tax on services, whose revenues also accrue to the provinces. Services provided by hotels are already listed as a possible base for the sales tax on services.

Electricity Duty

In 1964, Punjab levied an electricity duty through its Finance Act.[39] The duty is levied on consumption of electricity. The consumers under various categories are liable for its payment. All federal, provincial, and local government official facilities are exempt. In addition, places of worship and street lights are exempt. The duty is collected by the licensee, mostly WAPDA, on behalf of the provincial government when selling electricity to consumers. The rates vary across classes of consumers. The rates were revised in June 2007,[40] replacing the rates that had applied since 1980. Under the Finance Act 2007, the following rates apply:

Table 10
Electricity Duty

A	**In case of energy supplied by a licensee to consumers of any of the following categories:**	**Electricity Duty on the amount of the variable charges or the supply charges worked out according to electricity tariff (%)**
1	Domestic	1.5
2	Commercial	1.5
3	Industrial undertakings	1
4	Tube wells for irrigation and agricultural machinery	1
5	Premises where the supply of energy by a licensee is un-metered	1.5
B	**In case of energy not supplied by a licensee to consumers of any of the following categories**	**Electricity duty per unit**
1	Domestic	5.5 paisa
2	Industrial undertakings	1.5 paisa

The tax is collected by WAPDA as part of the electricity bills and pays it to the provincial government. The provinces have harmonized rates and laws, through consultations in IPCC. The duty is therefore structured similarly in NWFP and Punjab. Collections from this duty are a small amount of provincial revenue. In Punjab, it was 0.74 per cent of total revenues in 2005–06. In NWFP, electricity duty revenues were 0.68 per cent of total provincial revenues in the same year.

Problems and Reform Options

The 'other taxes' levied by the provinces do not generate much revenue. The sum of Hotel Tax, entertainment tax, excises, and tobacco and cotton levies and other agricultural cesses, yielded an amount equivalent to only 1 per cent of total revenues in Punjab and about 1.5 per cent in NWFP. The administrative costs of efficiently collecting these taxes would be high. In the case of entertainment tax and hotel tax, the assessment is notional and exemptions have compromised fairness.

One reform route is to abolish the Hotel Tax in favour of including it in the sales tax on services. This could lead to a revenue gain, even if the smaller hotels are subjected only to a flat charge. The electricity duty might also be moved to the sales tax on services. The entertainment tax could be passed down to the local governments, since they are in a better position to administer the tax efficiently. Khan's conclusion about the entertainment tax in NWFP is that 'there is not much potential in this tax, hence no reason to continue with it.'[41] The excise duties also might be abolished on grounds that revenue yields does not justify the administrative effort.

The agricultural cesses and excises should be folded into the agricultural income tax. This could increase fairness and revenue flow, if the agricultural income tax is reformed in terms of its assessment. In the case of tobacco in NWFP, another option might be considered. The tobacco cess could be abolished in favour of a surcharge on the federal excise duty on tobacco products. The additional revenue could be returned to the province. This approach could eliminate unnecessary administrative expenditure on collections of provincial cess.

This reform package would free up administrative resources at the province level, to be devoted to taxes where the yield potential is greater. The net revenue losses would be small.

5. HYDEL PROFITS: NWFP

According to a constitutional provision, Article 162-(2), the provinces are entitled to the net profits from the generation and sale of electricity at power stations located in their area, when these stations are owned and operated by federally owned utilities. The biggest power station in NWFP is located at Tarbela. The dam and its power house were commissioned in 1974. The construction was financed by the federal government. Despite the constitutional provision, NWFP did not get the net profits for many years after the Tarbela facilities went into operation. The matter has been challenged by the province on a continual basis and remains unresolved even today.

Currently, the province receives a partial payment of its claims against revenues from electricity sales. Even at this level, the net profits from hydroelectric sales in 2007–08 are 7 per cent of total provincial current revenues and 96 per cent of provincial own source revenue.

In 1991, an initial agreement was reached when the Council of Common Interests (CCI), a constitutional body for resolution of intergovernmental disputes, ruled that net profits along with arrears should be paid by WAPDA to NWFP on an annual basis.

At this stage the CCI also laid out a methodology for calculation of net profits. For the year 1991–92, the net profits were calculated to be Rs. 6 billion.[42] NWFP has been paid an annual amount of Rs. 6 billion ever since. This implies erosion in real value by more than 60 per cent between 1992 and 2005.[43] The province disputes this payment as being too low, and in addition it asks for payment of Rs. 596 billion in arrears. According to the Government of NWFP, the electricity tariff has been increasing ever since this 1991 calculation, but the determination of profits has been kept constant.

This issue was raised by the NWFP during the 6th NFC discussions. As a result it was decided between the federal government, the controlling authority of WAPDA, and NWFP that the matter will be referred to an independent arbitration tribunal. Following this decision, WAPDA and NWFP presented their claims and supporting arguments to the arbitration tribunal in 2005. WAPDA, contesting the NWFP claim of unpaid arrears, presented a counter claim that an overpayment of Rs. 11 billion had been made to the province between 1991 and 2005 and that this should be adjusted against the future payments. WAPDA's claim is based on the argument that some of the surcharges do not form part of the revenue entitlement of the province.

In October 2006, the tribunal decided in favour of the NWFP claim and concluded that an amount of Rs. 110 billion was payable to the province, and that this amount should be paid in five instalments. After the tribunal's decision, NWFP requested payment from WAPDA and its guarantor, the federal government. WAPDA in turn has filed a civil suit challenging the tribunal's decision. The Government of NWFP has approached the Supreme Court to get the tribunal's decision implemented. The payment of profits in the meanwhile remains constant at Rs. 6 billion per year.

CONCLUSIONS

There are good opportunities for reforming the system of provincial level taxation and fiscal decentralization in Pakistan, but the job will not be an easy one. A comprehensive reform will require both federal and provincial government involvement. The leadership in programme design for this activity might come from FBR, but any reform of the intergovernmental system must leave significant room for provincial level discretion.

A properly designed reform must at once allow the federal government to satisfy its objective of increasing provincial level taxes in a framework of good tax policy, and the provincial government to satisfy its objective of enhancing both public service levels and fiscal autonomy. In keeping with the spirit of fiscal decentralization one would not expect all provinces to choose exactly the same reform programme. It is imperative, then, that the federal government be clear on what is inside and what is outside the legal boundaries for provincial revenue mobilization.

The design of the tax reform might centre on four elements. The first is to determine appropriate targets for provincial tax revenues, i.e. by how much should revenues be increased? The second is to identify structural reforms that would make the provincial tax system operate in a more efficient way, would hit these revenue targets, and would further the decentralization goals that the government has adopted. The third is to put appropriate incentives in place to encourage provinces to implement tax reforms that will generate increased revenues. The fourth is to lay out the elements of a feasible implementation programme for these structural reforms. We cover all four of these elements in the discussion below, and in a final note we add a discussion of actions that the federal and provincial governments might take to begin moving toward implementation.

Perhaps most important of all considerations about the proper reform package is its political acceptability. The reform programme laid out above is more fair than the present system in that it moves toward treating all taxpayers in the same way by removing tax preferences from many households and businesses. Special treatments are rarely given up without a fight, however, and the more influential are those who have enjoyed the preference, the tougher will be the fight. In addition, the reform package includes a net revenue increase of significant amount. Taxpayers usually are resistant to tax increases, even when account is taken of the possible improvement in public services. Tax reform coupled with tax increase will require a strong political will on the part of the leadership in both provinces.

Revenue Targets

The most conservative of politicians will favour low risk options for revenue targets, usually a tinkering with the present system. But tinkering will not raise much money. We see the basic goal of this reform to be a significant increase in revenue mobilization by provincial governments. This calls for a more far-reaching set of reforms, and much higher revenue targets. This is perhaps the first matter for policy makers to sort out.

Estimating a tax revenue target for Pakistan's provinces is at best a subjective exercise. For example, the federal government has called for an increase in provincial taxes to reach a level equivalent to one per cent of GDP.[44] Achieving this target would require a doubling of the present level of revenues in both provinces. There is no documentation available on how this central government target was determined, nor are there proposals for how it might be reached.

There are systematic approaches to fixing on provincial revenue targets, and arguably this is where the formation of an intergovernmental fiscal reform programme should begin. Probably the best approach is to start with expenditure targets that reflect minimum acceptable service levels (ME).

$$ME - Tr = OSR$$

where

Tr = transfers

OSR = own source revenues

ME = minimum expenditure needs

From the identity we can develop a revenue target for provincial governments. After accounting for financing from intergovernmental transfers, the remainder of the cost of providing minimum service levels would be covered by own source revenues. This normative service level approach to determining the minimum needed level of tax effort is what each provincial government should do, i.e. revenue needs should be based on an expenditure plan.[45] However, the major difficulty with this approach is that 'minimum service level' is itself a subjective concept. Determining minimum service levels, and costing them out, becomes a balancing act between affordability and what a province considers to be its most pressing needs for upgrading services.[46]

Sometimes the balancing act is driven more by affordability, and political, considerations than by service upgrading. This would seem to be the case in Pakistan. Politics often has driven higher investments in the expansion of service delivery networks. In the 1990's, costly CDL's were used to carry on infrastructure development programmes despite revenue shortfalls. The provinces recognize that the services they provide are greatly inadequate, but they have not been willing to increase taxes to cover this gap. In fact, it is more likely that expenditure levels are driven primarily by the amount of transfers, and loans, received from the centre.[47] The solutions to this problem are either (a) to leave it to local voters to push elected officials for increases in service levels that would lead to tax increases; or (b) to put in place a system of incentives/penalties for higher/lower rates of provincial revenue mobilization. Either of these solutions is consistent with the fiscal decentralization approach to governance. However, it does not appear that any of Pakistan's provinces have established minimum spending or service levels. Under the ADB's Punjab Devolved Social Services Programme, minimum service delivery standards have been developed but they have not been adopted.[48] Nor does the federal government target for provincial taxes appear to be driven by this concept. Expenditure benchmarks were established in the Poverty Reduction Strategy Paper in 2004.[49]

A second approach is to set the provincial revenue target as the amount necessary to eliminate the structural budget deficit for each province. Based on the analysis presented above, we can argue that the shortfall in Punjab is equivalent to 137 per cent of total provincial taxes in 2006–07. The analogous number for NWFP is about 300 per cent of total provincial taxes. This calculation suggests quite large target increase in provincial taxes for both provinces. Note however that this 'fiscal discipline' approach to setting budget targets is driven more by goals of budget balance than by public service needs. While it is a good thing that provincial governments are financially solvent, the reasons for this solvency can be as much due to low spending and low taxes as to fiscal prudence. A companion reform to upgrade provincial services would call for an even higher tax target.

The revenue target might also be set by using international comparisons. The average level of subnational government taxes in developing countries is equivalent to about 10 per cent of total taxes raised by central and subnational governments.[50] Thus, each province might take the target of raising its ratio of taxes to GDP to a level that is equivalent to 10 per cent of the central government's tax to GDP ratio. Using this approach, we can estimate that Punjab's target would require an increase of 111 per cent in taxes and NWFP's would require a 179 per cent increase in taxes. The fault with the international standards target is that it is calculated without reference to expenditure needs or to expenditure responsibilities assigned to the provincial and local governments, it is based on uncertain (IMF) data, and it is arbitrary. The illustrative targets for property taxation, discussed above, were set in this manner.

Structural Reforms

Some will argue that these targets are too ambitious. On the other hand, these targets may be viewed in the context of the very low current level of taxation, the many preferential treatments that have been given, and lax administration. The whole idea of this reform option is to significantly increase the participation of provincial governments in revenue mobilization, so it follows that the targets should be high. If the provincial political leadership feels uneasy with the target levels of revenue mobilization, it is probably a sign that the reform programme suggested has met its objectives. Also, there is the question of the timing required to reach these targets, i.e. a one year tripling of a tax might be politically infeasible, but a four year time horizon might make the same reform palatable.

As demonstrated in some detail above, this range of revenue targets can be reached with what many would see as 'reasonable' structural reforms. Moreover, the reforms outlined here have other beneficial properties in terms of improving the equity of the system, reducing the administrative cost, and rationalizing the choice of tax instruments. It should be said early, and often, that these policy changes and revenue enhancements cannot be realized without a significant upgrading of the tax assessment and collection efforts of the provincial governments.

INCENTIVES

Provincial governments must be willing to enact and implement these reform measures if revenue gains are to be realized. As discussed above, there has not been much interest in revenue mobilization on the part of the provincial governments in the past. There are three ways in which this reluctance might be overcome enough to reform the tax system. The first is to convince taxpayers that a result of the reform will be improved public services. The second is to convince taxpayers that a comprehensive reform will bring about a more fair tax system in which similarly situated household and businesses will be treated the same. It also can be argued that such a tax system will be friendly to economic development because of its fairness and because the higher rate of revenue mobilization could lead to infrastructure improvements. The third is to offer an incentive that is lucrative enough to help provincial governments overcome their reluctance to increase taxes. The discussion below focuses on the incentive route.

Punjab finances only 9 per cent of its expenditures from its own taxes, and NWFP finances only 3 per cent. The remainder of revenues come from intergovernmental transfers and from loans. This state of affairs raises two problems. First, it weakens the link between the expenditure benefits enjoyed by local residents and the burden associated with paying for those expenditures. The result is a weak accountability of provincial/local officials to their voting constituency. Second, provincial and local governments have a comparative advantage in raising certain types of revenue. Their failure to aggressively collect these revenues imposes a 'cost' in terms of an overall lower level of revenue mobilization in the country. The consequence is a lower level of public services than otherwise would be the case.

The question arises as to why provincial government taxes are not higher. In Punjab and NWFP, the standard answers to this question are weak taxable capacity, inadequate tax sources, deficient tax administration, and voter resistance. All of these arguments are open to some debate, but as we have shown above, the provincial tax share of GDP has remained low during this decade.

A possible explanation of the failure of provincial governments to mobilize more revenue is that they have too little incentive to do so. The central government provides significant and growing revenue through transfers and loan funds, so why incur the wrath of voters and take on the local elite by raising taxes? Arguably, political leaders in provincial governments would rather be accountable for the present levels of public services than spend their political capital. A related issue is that provincial governments are not very good at spending for public services. In fact, provincial spending patterns are characterized by unfilled positions and delays in capital project disbursements. If provinces cannot spend what they have available now, why raise more in taxes? This is yet another dimension to the provincial tax effort issue.

Finally, there are difficult legal and political hurdles to overcome in building an incentive component into the NFC Awards. On the legal side, is there a way to circumvent the requirement that all provinces must agree to the formula structure of the NFC Award? Can this formula adjustment be done by federal government mandate? So long as consensus is a binding constraint on the NFC distribution formula, it seems unlikely that an incentive plan will be acceptable. The possible opening is that the incentive grant might be structured out of the federal share; and under Clause-(b) of Article 160 or Sub-Article (7) of Article 160 of the Constitution. On the political side, provinces have already shown themselves to be unwilling to increase taxes, even in the face of poor public service levels. This does not bode well for the prospects of provinces accepting a reward/penalty programme based on their tax effort choices.

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Notes

1. The Punjab estimate is calculated from Government of Punjab, 2007a, 38. The NWFP estimate is based on ETD assessment.
2. Dargy et al., 2007.
3. Source Dargy, Gately and Sommer (2007).
4. Malik, 2004, 31.
5. We define road expenditures as sum of:
   a. Provincial road sector current expenditure;
   b. Provincial current capital expenditure on roads;
   c. Districts road sector expenditure is calculated using an approximate ratio of 7% of the total grant to the district government as road sector expenditure at the local level. The percentage was obtained from the revised estimates of City District Government Faisalabad 2005–2006, using road sector expenditure to total budget ratio. It does not include estimates of road expenditures by TMAs, because the consolidated TMA accounts are not available.
6. ADB, 2004a.
7. ADB 2004b.
8. ADB, 2004a.
9. We have also calculated the tax burden for the purchase of a used vehicle (shown in Tables 23 and 24), using the same method. The results under the present tax regime show the tax burden to be Rs. 3,000 vs. Rs. 4,400 owing to the lower registration tax.
10. It is reported that many commercial vehicles are registered in Balochistan where the tax rate is lower, but operate primarily in NWFP.
11. Malik, 2004.
12. Khan, 2004.
13. Many other rate structures would satisfy this objective.
14. The coverage of each rate class will be determined by each province, and probably will be based mostly on distributional considerations. The rate classes likely will differ from province to province. Our proposed rate structure, shown in Tables 25 and 26, is meant only to be illustrative.
15. Government of Punjab, 2007a.
16. Soares de Silva, 2006, 293.
17. Malik, 2004, 37.
18. Government of Punjab, 2007a and Malik, 2004.
19. The World Bank, 2005.

20. Provincial officials report that 80 per cent or more of the tax is paid by government employees. We do not have data to verify this claim.
21. State of West Bengal, 2008.
22. Federal Bureau of Statistics, 2005 and 2006.
23. Malik (2004) finds similar results.
24. Khan, 2004.
25. Malik, 2004, 38.
26. Khan, 2004.
27. Khan, 2004.
28. For purposes of illustration, this piggyback is for individuals and self-employed only. A similar change could be done for companies.
29. We used data on federal income tax collections to develop this estimate. We have company income tax collections by province but we do not have individual salaried or non-salaried collections by province. We calculated the share of company receipts to total receipts by province, and assumed that the same share would hold for salaried and non-salaried individual collections. For NWFP this share is 3.7% and in Punjab it is 21.5%.
30. Engelschalk, 2004.
31. Sindh GDP is estimated based on Provincial Finance Department statistics.
32. The Rs. 28.2 billion refers only to collections made in 'the VAT mode', i.e. under the value added tax administration.
33. Malik (2004, 46) carried out such an analysis for NWFP and identified 25 services for inclusion in the sales tax base. Pasha (1995), in an earlier study, carried out a similar exercise for all provinces.
34. The GST on goods is collected by the federal government. After deducting a collection fee (5%), one-sixth of the revenues from the pool for the pass-through grant to local governments. The interprovincial distribution of this pool is on the basis of octroi collections in 1998–99. The remaining five-sixths of the revenue becomes part of the general divisible pool and is distributed between the federal government and the provinces (vertical sharing) and among the provinces horizontally according to the NFC formula.
35. VAT administrations in most low income countries concentrate efforts on the import and manufacturing stages, and are less successful in taxing services.
36. We do not have data to break out the division of this revenue by province, but estimate that the variations are quite wide.

37. We assume full forward shifting of the tax to consumers. For a f discussion of the method used, see Wallace (2008).
38. Cinemas in cantonment areas are exempt.
39. Government of Punjab 1964, Section 13 and Fifth and Sixth Schedule
40. Government of Punjab 2007c, Section 3.
41. Khan, 2004.
42. Government of NWFP, 2007a.
43. The World Bank, 2005a.
44. This target was presented in the *Economic Survey* (Government of Pakist 2007), 65.
45. The revenue target for motor vehicles taxes, discussed above, was set reference to roadway expenditures. This is an example of expenditure ne driving a revenue target.
46. South Africa uses such an approach by allocating a portion of its 'equita shares' grant to local governments on a basis of expenditure needs. T approach is to provide each local government with a block grant tha equal to the estimated cost of providing 'basic services' to poor househo (Reschovsky, 2003).
47. This too is subject to a hard budget constraint and therefore implies a r for the NFC in Provincial finance reform.
48. ADB, 2007.
49. Government of Pakistan 2004, Table 71, 110.
50. Bahl and Wallace, 2005.