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RETHINKING NFC

Achieving Equity goals

By Kaiser Bengali & Iffat Ara

PRIME POLICY PAPERS

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by

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Inter-personal Equity

Taxes impose a burden on those taxed and the burden can be proportionate or proportionately higher or lower relative to income. The burden is termed as incidence and is designated as progressive if the burden of the tax is higher on the rich and regressive if it is higher on the poor. Generally, direct taxes, i.e. taxes on income, wealth, property, etc., are found to be progressive and indirect taxes, i.e. sales taxes, customs duties, excise duties, etc., are found to be regressive. A tax regime that is progressive is said to be equitable and fair.

In Pakistan's case, about 40 percent of federal tax revenue is accrued from direct taxes and 60 percent from indirect taxes. However, over two-thirds of income tax is collected in advance as withholding tax and is, in effect, indirect in nature. Thus, if the withholding tax component is excluded, the effective share of direct taxes falls to a mere 12 percent, with the effective share of indirect taxes rising to 88 percent (see Table 1). In this respect, attention to the incidence of taxes, particularly indirect taxes, is rendered pertinent.

There have been a number of studies of the incidence of taxes. According to Kazi (1984), rich farmers in agriculture sector are under-taxed. Malik and Saqib (1989) and SPDC (2004) report the entire tax system to be regressive, i.e. a greater proportion of the burden falling on the poor. SPDC (2004) has estimated that the richest 10 percent of the population pays 10 percent of their income in taxes, the same is 16 percent for the poorest 10 percent of the population. GST, in particular, is shown to claim 9 percent of the income of the poorest 10 percent of households, but less than 6 percent of the income of the richest 10 percent. Refaqat's (2008) results are mixed ranging from progressive to proportional, with the incidence of GST on food and clothing shown as regressive.

Table 1: Composition of Federal Divisible Pool (Rs. Bill.)

Tax Head	Current (2014-15)	Share in all taxes (%)	Proposed
Direct Taxes	1,034	39.9	
Income Tax (IT)	1,007	38.9	-
Withholding Tax (WHT)	*691*	*26.7*	691
IT net of WHT	*316*	*12.2*	-
Other Direct Taxes	27	1.0	27
Indirect Taxes	1,556	60.1	1,556
Customs Duty (CD)	306	11.8	306
General Sales Tax (GST)	1,088	42.0	1,088
Federal Excise Duty (FED)	162	6.3	162
FEDERAL DIVISIBLE POOL	**2,590**	**100.0**	**2,274**

Collection of indirect taxes is relatively administratively easy and politically low cost. Resultantly, the federal government has tended to rely rather heavily on indirect taxes for its revenue needs. It even went to the extent of abolishing Wealth Tax on spurious grounds. Post-7th NFC, however, the federal government has to share a larger portion of its tax revenues with the provinces; thereby, narrowing the federal government's revenue base and causing it to call for the provinces to share the federal government's expenditure. Any such move is likely to impinge on the province's social sector commitments. An alternative would be to raise additional revenues from indirect tax sources. Both options would compound the regressivity of the fiscal regime.

Herewith, there appears to be two objectives: raise federal government revenues and render the tax regime equitable – inter-personally and inter-sectorally. The two objectives can be achieved by correcting the currently skewed balance between direct and indirect taxes and between agricultural and non-agricultural income. The attainment of the twin objectives requires that the federal-provincial tax sharing mode provides the federal government with the incentive to prioritize direct tax collection over indirect taxes. This objective can only be realized in the context of the NFC tax distribution formulation.

Composition and distribution of Divisible Pool

The basis for resource distribution between the federation and provinces and between provinces is the Federal Divisible Pool. Over the years since NFC was constituted in 1974, the composition of the Divisible Pool has changed, as shown below in Table 2:

Table 2:

Award	Federal-Provincial Share (%)	Taxes (in Divisible Pool)
1st 1974	20 : 80	Income & Corporate Tax Sales Tax Export duties
4th 1991	20 : 80	As above + CED
6th 1997	63 : 37	As above + Import Duties
Presidential Order 2006	52.5 : 47.5	As above
7th 2010	42.5 : 57.5	As above

As can be seen from the above, the composition of the Divisible Pool has changed on several occasions. The process began with the 1st NFC in 1974 with a 20:80 distribution between the federation and the provinces, with the Divisible Pool including three taxes - Income & Corporate Tax, Sales Tax, and Export duties. The 4th NFC in 1991 enlarged the Divisible Pool by adding Central Excise Duties, but retained the federal-provincial distribution shares at 20:80. The 6th NFC in 1997 further enlarged the Divisible Pool by adding Import Duties, but drastically reversed the federal-provincial distribution share to 63:37.

In other words, the federal share was raised from 20 percent to 63 percent and the provincial share was reduced from 80 percent to 37 percent. The rationale for this shift was explained by the fact that Import Duties then constituted the major revenue source for the federal government – single largest tax revenue source, accounting of one-quarter of tax revenues – and its inclusion raised the size of the Divisible Pool significantly. Resultantly, provincial revenues increased in absolute terms despite the reduction in its share. The composition of the Divisible Pool has since remained the same; however, the federal-provincial distribution was changed to 52.5:47.5 in 2006 and to 42.5:57.5 in 2010.

Arithmetic of proposed changes

Achieving equity goals will also require some corresponding changes in the federal-provincial (vertical) tax sharing formula. The basic proposal is that the federation retains income tax, net of withholding tax, in full and share indirect taxes with the provinces. Full retention of (net) income tax is likely to induce the federal government to expend greater effort in collecting tax from the rich, reducing the relative burden on the poor and, thereby, make the tax structure more progressive. It is also proposed that the federation also collect and retain income tax on agricultural income **in full.**

The proposed arithmetic of change based on the fiscal year 2014-15, depicted in Table 3, is as follows:

The current size of the Divisible Pool is Rs. 2,590 billion, with the federal and provincial shares being Rs. 1,100 billion and Rs. 1,490 billion, respectively. If (net) income tax is removed from the Divisible Pool, its size diminishes to Rs. 2,274 billion, with respective federal and provincial shares out of the (reduced) Divisible Pool declining to Rs. 966 billion and Rs. 1,308 billion. However, if the federal government retains all of (net) income tax, its share rises to Rs. 1,282 billion – a gain of Rs. 181 billion. Correspondingly, the provinces stand to lose Rs. 181 billion.

Understandably, the provinces are unlikely to accept the reduction in their share and a compensating mechanism needs to be found. One option is to give the provinces a share in non-tax revenues, which in 2014-15 stood at Rs. 1,042 billion. Currently, federal 'take home' revenues amount to Rs. 3,632 billion and which includes Rs. 1,100 from the Divisible Pool and Rs. 1,042 from non-tax revenues.

Table 3: Arithmetic of reconfiguring federal-provincial sharing of tax bases

Base Year: 2014-15

1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*
Unit	*FDP Shares (%)*	*Current FDP Size Rs. 2,590*	*Proposed FDP Size Rs. 2,274*	*Add Back Rs. 316*	*Revised FDP Size Rs. 2,590*	*Gain/(Loss) Rs.*	*Undistributed Non-Tax Revenue Rs. 1,042*	*Current FDP+NTR Size Rs. 3,632*	*Distributed Non-Tax Revenue Rs. 1,042*	*Revised FDP + NTR Size Rs. 3,632*
					4+5			3+8		4+5+10
Federal	42.5	1,100	966	316	1,282	+ 181	1,042	2,142	861	2,142
Provincial	57.5	1,490	1,308	-	1,308	- 181	-	1,490	181	1,490
Total	**100.0**	**2,590**	**2,274**		**2,590**		**1,042**	**3,632**	**1,042**	**3,632**
Prov. shares										
Punjab	51.74	771	677	-	677	-94	-	771	94	771
Sindh	24.55	366	321	-	321	-45	-	366	45	366
KP	14.62	218	191	-	191	-27	-	218	27	218
Balochistan	09.09	135	119	-	119	-15	-	135	15	135
Total	**100.00**	**1,490**	**1,308**	-	**1,308**	**-181**	-	**1,490**	**181**	**1,490**

FDP = Federal Divisible Pool; NTR = Non-Tax Revenue; all values are in billion rupees;
Proposed FDP Size of Rs. 2,274 billion excludes Rs 316 billion, which is the amount of income tax net of withholding tax, and which is then added to the federal share.
The Rs. 1 billion difference is due to rounding off error.

Calculations show that allocating 17.5 percent of non-tax revenues to the provinces will compensate for the Rs. 181 billion loss on account of (net) income tax . As columns 9 and 11 of Table 2 shows, the 'take home' amount of the federation and provinces remain the same as of currently. However, the change creates a window of opportunity for the federal government to enhance the share of direct taxes in the total tax portfolio. The proposed re-configuration, perhaps, represents a classic case of pareto optimal welfare maximization.

The 17.5% provincial share of federal non-tax revenues is based on the tax data for 2014-15 to cover the Rs. 181 billion loss to the provinces from the proposed changes in the composition of the Federal Divisible Pool. Incidentally, non-tax revenue receipts are volatile and the federation and provinces are likely to gain or lose depending on the increase or decrease in non-tax collections. A mechanism to account for the volatility will need to be developed.

Inter-sectoral equity

The equity aspect needs to be extended to inter-sectoral distribution of tax burden. Inter-sectorally, the Constitution of Pakistan mandates the federation to collect "taxes on income other than agricultural income". Namely, "taxes on agricultural income" is the domain of provincial governments. The arrangement has created a window for using the agricultural sector as a 'tax shelter'. Namely, profits from non-agricultural sources, which are subject to federal income tax, can be shown to accrue from agriculture and tax on which can be effectively evaded on account of weak provincial institutional procedures in respect of assessment and collection of income tax on agricultural incomes. Provinces have also failed to collect tax on agricultural incomes to its full potential partly on account of the close proximity of the tax collector and tax payer and room for collusion between them. The arrangement constitutes inequity between sectors. This situation can be remedied if collection of

[1]There does appear a Rs. 1 billion difference, which is on account of rounding off.

income tax from agricultural income is shifted from the provincial to federal domain.

Need for Constitutional amendments

Given that the NFC distribution formula is stated in the Constitution, two amendments would be necessary, one to Article 160 and the other to Item 47 of Fourth Schedule of Federal Legislative List Part I.

Herewith, Article 160 (3) (i) "taxes on income, including corporation tax, but not including taxes on income consisting of remuneration paid out of the Federal Consolidated Fund;" will need to be deleted.
And Article 160(3) (vi) "a proportion of non-tax revenues as specified by the President" will need to be added.

Article 160 reads as follows:

160. National Finance Commission.—(1) Within six months of the commencing day and thereafter at intervals not exceeding five years, the President shall constitute a National Finance Commission consisting of the Minister of Finance of the Federal Government, the Ministers of Finance of the Provincial Governments, and such other persons as may be appointed by the President after consultation with the Governors of the Provinces.

(2) It shall be the duty of the National Finance Commission to make recommendations to the President as to–

(a) the distribution between the Federation and the Provinces of the net proceeds of the taxes mentioned in clause (3);

(b) the making of grants-in-aid by the Federal Government to the Provincial Governments;

(c) the exercise by the Federal Government and the Provincial Governments of the borrowing powers conferred by the Constitution; and

(d) any other matter relating to finance referred to the Commission by the President.

(3) The taxes referred to in paragraph (a) of clause (2) are the following taxes raised under the authority of [Majlis-e-Shoora (Parliament)], namely:–

(i) taxes on income, including corporation tax, but not including taxes on income consisting of remuneration paid out of the Federal Consolidated Fund;

(ii) taxes on the sales and purchases of goods imported, exported, produced, manufactured or consumed;

(iii) export duties on cotton, and such other export duties as may be specified by the President;

(iv) such duties of excise as may be specified by the President; and

(v) such other taxes as may be specified by the President.

The tax component of the Fourth Schedule of Federal Legislative List Part I reads as follows:

43. Duties of customs, including export duties
44. Duties of excise, including duties on salt, but not including duties on alcoholic liquors, opium and other narcotics.
45. deleted
46. deleted
47. Taxes on income other than agricultural income.
48. Taxes on corporations.
49. Taxes on sales and purchases of goods imported, exported, produced, manufactured or consumed [except sales tax on services].
50. Taxes on the capital value of the assets, not including taxes on immovable property.
51. Taxes on mineral oil, natural gas and minerals for use in generation of nuclear energy.
52. Taxes and duties on the production capacity of any plant, machinery, undertaking, establishment or installation in lieu of the taxes and duties specified in entries 44, 47, 48, and 49 or in lieu of any one or more of them.
53. Terminal taxes on goods or passengers carried by railway, sea or air; taxes on their fares and freight.
54. Fees in respect of any of the matter in this Part, but not including fees taken in any court.

Herewith, item 47 “Taxes on income other than agricultural income” will need to read “Taxes on income.” and the words “other than agricultural income” will need to be deleted. The transfer is not likely to substantially raise the quantum of revenues; however, it is likely to realize inter-sectoral equity and shut off the tax shelter avenue.

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The National Finance Commission (NFC) is a constitutional body that has to be constituted every 5 years and which is tasked to determine the respective shares of the federation and provinces of specified federal tax revenues, referred to as the Federal Divisible Pool. The 7th NFC Award, concluded in 2009-10, was historic on three counts. One, it changed the long-standing single criterion – population – formula for fiscal (horizontal) distribution between the provinces to a multiple criteria – population, revenue, backwardness and population density – formula. Two, it devolved GST on Services to the provinces, as stipulated in the Constitution. And three, the change was brought about by consensus, without any province feeling it had been shortchanged.

The primary credit for the success of the 7th NFC belongs to the then Federal Government, as it committed itself to cover any loss, via increase in the provincial share out of the federal share (vertical distribution), that any province would incur as a result of the change from single to multiple criteria. In the event, the provincial share was increased from 47.5% to 57.5% – and Punjab, which was the sole loser on account of the change of the inter-provincial distribution formula, received 113 rupees for every 100 rupees it gave up.

There are expectations with regard to the next NFC on all sides. Provinces expect the federal share to be reduced further and cases for meeting rising provincial expenditures are being built up. To an extent, the federal government is itself responsible for raising provincial expectations by commissioning them to draw up estimates of their future fiscal requirements. Some provinces are also gearing up for a demand to raise the weight of one or the other of the four criteria. Even the federal government has thrown in their claim for more resources, asking for 7% of the gross Divisible Pool for security expenditures and financing federal expenditures in FATA, Gilgit-Baltistan and Azad Jammu & Kashmir. None of these appear to be achievable.

The 7th NFC Award is of great significance as it broke the stalemate in the inter-provincial distribution formula and transferred huge amounts to all the provinces; thereby, strengthening provincial fiscal autonomy. However, the Award is static and is restricted to a debate on 'who can get how much'.It may be necessary to take the debate forward towards making the NFC distribution advance equity goals. And this is proposed to be the agenda of the next NFC.