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TAX ASSIGNMENT IN SELECTED FEDERATIONS: LESSONS FOR NEPAL

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Abstract

The Constitution of Nepal promulgated on September 20, 2015 has transformed the country from the unitary system of governance to a federal democratic republic. The constitution has provisioned the powers and responsibilities to the federal, state, and local governments under the schedule 5, 6 and 8 respectively. However, it has provisioned the concurrent powers of the federation and State under the schedule 7 and federation, state and local level under the schedule 9. The objective of this article is to review the revenue assignment modality provisioned in the present constitution and to suggest for further amendment based on the international practices and national need. Regarding the issue, the paper suggests that besides the existing provision of constitution, payroll tax should be assigned to the state governments and excise duties (Licence Fee) on alcoholic beverage and tobacco at consumption level should be collected by the sub national governments after their legal and institutional setup and enhancing their capacity of tax administration. This can be helpful in order to reduce vertical fiscal imbalances. Furthermore, Value Added Tax (VAT) should be collected at both the federal and state levels concurrently in future after developing the revenue mobilization capacity of the state governments which also contributes to minimize the vertical fiscal imbalance. In future, the state and local governments should also explore the additional tax bases.

JEL Classification: H21, H22, H23, H24, H25

Keywords

Tax Assignment, Federal Government, State Government, Local Government, Income Tax, VAT, Excise Duty, Custom Duty

1. Introduction

Tax is a major source of government revenue in all countries around the globe- indirect taxes being the major source in developing countries and direct taxes in the developed world. No clear roadmap is available regarding the taxing powers to various levels of government around the world. It is primarily determined by the political, social and economic situation of the country.

The Constitution of Nepal 2015 has divided Nepal into 7 provinces and 753 local bodies including rural municipalities and municipalities. The new constitution has provisioned the tax assignment modality among the central, provincial and local governments. As per the modality, most of the revenue generation power is centralized at federal government. Therefore, the unevenly distributed revenue base under the 240 years of unitary system of governance is supposed to continue under the current federal system of governance. The provincial and local level governments will have to depend again upon the federal transfers in order to perform their expenditure responsibilities assigned by the Constitution.

This paper has analysed the tax assignment model of Nepal presented in the newly promulgated constitution 2015. It has proposed some amendments by analyzing the lessons learned from the selected federations. It is hoped that the recommendations will be useful for the government in establishing the appropriate tax assignment model in Nepal.

The paper is divided into five sections. It begins with a brief introduction. Section two discusses the theoretical perspectives on the tax assignment. Section three discusses the model of tax assignment across the selected federal countries including Australia, Brazil, Canada, Germany, India, Nigeria, Pakistan, South Africa, and Switzerland. The revenue assignment model presented in the Constitution of Nepal 2015 is critically analysed in section four. The last section concludes the paper.

2. Principle of Tax Assignment

The theory of tax assignment simply deals with the following four issues (i) which level of government have to choose the taxes to be imposed at any level, (ii) which level

should define tax bases, (iii) which one should determine the tax rates and finally, (iv) which one should enforce and administer the various tax tools. Many believe that the sub-national governments should be empowered with the sufficient revenue raising rights (Ambrosanio and Bordignon, 2006). Revenue-sharing arrangements can be of two types: those in which multiple levels of government share the tax base and those in which revenue is collected by one level but shared by different levels (Rao, 1997). Federal countries have adopted both separated as well as overlapped assigning tax powers among the levels of governments by constitution. The taxes assigned to the central government are not assigned to the states and vice versa (Boadway and Shah, 2009). However, there is no globally accepted model to deal with these problems.

It is argued that taxes with a nature of relatively immobile bases or taxes on assets and bases with evenly distributed among jurisdictions should be levied by the local governments. It has many merits including (i) prevents tax completion and revenue losses, (ii) prevents the generation of horizontal fiscal imbalances, (iii) yield becomes stable in real terms for expenditure planning. These arguments are put forward in Musgrave's traditional normative and Oates's public choice approach. However, these approaches have many drawbacks comprising (i) it is completely normative approach, (ii) does not reflect the actual situation of the contemporary world, and (iii) weak demarcation of the tax assignments between central and local governments (Prasad, 2016). In this background, user charges, benefit taxes, and taxes on relatively less mobile taxes could be the major sources of revenue generation of the sub-national governments (Musgrave, 1985 and Rao, 1997).

On the other, the nature of taxes with broad and mobile tax bases need to be assigned to the central government with two main purposes (i) economic stabilization, and (ii) redistribution of income, wealth and resources. In this background, taxes on international trade need to be exclusively levied by the central government.

The political economy approach of tax assignment has been extensively drawn-out in the contemporary world. Therefore, the traditional theory is in shadow now. Under the political economy approach, tax assignment and sharing at the various levels of governments is determined by the negotiation among them. This approach is widely known as 'A Second-Generation Theory of Fiscal Federalism' (Bardhan, 2006 and Oates, 2005). In this juncture, universally accepted principle of tax assignment is not available in the economic literature. Summary of international practice of allocation of taxing power among the various levels of government is given in Table 1.

Table 1: Representative Assignments of Taxing Powers

Type of tax	Determination of Tax Base & Rate		Collection and administration	Comments
	Base	Rate		
Customs	N	N	N, P	International trade taxes
Corporate income	N,U	N, U	N, U	Mobile factor, stabilization tool
Resource tax Resource rent tax (profits, income)	N	N	N	Highly unequally distributed tax bases
Royalties, fees, charges, severance taxes;	S, L	S, L	S, L, P	Benefit taxes/charges for state-local services
Conservation charges	S, L	S, L	S, L, P	To preserve local environment
Personal income	N	N, S, L	N	Redistributive, mobile factor; stabilization tool
Wealth taxes (taxes on capital, wealth, wealth transfers, inheritances, and bequests)	N	N,S	N	Redistributive
Payroll	N,S	N,S	N, S	Benefit charge, e.g., social security coverage
Multistage sales taxes (value-aided tax [VAT])	N	N,S	N, S	Border tax adjustments possible under federal assignment; potential stabilization tool
Single-stage sales taxes (manufacturer, wholesale, retail) Option A Option B	N, S	S,L	S,L N	Higher compliance cost Harmonized, lower compliance cost
"Sin" taxes Exercise on alcohol and tobacco	N,S	N,S	N,S,P	Health care a shared responsibility
Betting, gambling	S,L	S,L	S,L,P	State and local responsibility
Lotteries	S,L	S,L	S,L,P	State and local responsibility
Race tracks	S,L	S,L	S,L,P	State and local responsibility

Taxation of "bads" Carbon	N,U	N,U	N,U	To combat global/national pollution
BTU taxes	N,S,L	N,S,L	N,S,L,P	Pollution impact may be national, regional or local
Motor fuels	N,S,L	N,S,L	N,S,L,P	Tolls on federal/provincial/local roads
Effluent charges	N,S,L	N,S,L	N,S,L,P	To deal with interstate, inter-municipal or local taxes
Congestion tolls	N,S,L	N,S,L	N,S,L,P	Tolls on federal/provincial/local roads
Parking fees	L	L	L,P	To control local congestion
Motor vehicles Registration, transfer taxes, and annual fees	S	S	S	State responsibility
Driver's kitchen and fees	S	S	S	State responsibility
Business taxes	S	S	S	Benefit taxes
Exercises	S,L	S,L	S,L	Residence-based taxes
Property	S	L	L	Completely immobile factor, benefit taxes
Land	S	L	L	Completely immobile factor, benefit taxes
Frontage, betterment	S,L	L	L	Cost recovery
Poll	N, S,L	N,S,L	N,S,L	Payment for services
User Charges	N,S,L	N,S,L	N,S,L,P	Payment for services received

Note: U = supranational agency, N = national/federal, S = state or province, L = municipal or local, and P = private

Source: Shah, A. (ed.) *The Practice of Fiscal Federalism: Comparative Perspectives*, 2007

Almost in all federal countries around the world, custom duties are levied at the central level. On the other hand, taxes on the consumption of goods and services and main direct taxes are levied concurrently on both the central and sub-national levels in most of the federal countries. Switzerland has greater taxing powers with the Cantons which generates around 80 per cent of the total tax revenue of the country. In Canada, the federal government levies value added tax and provinces levy retail sales taxes. Direct taxes are levied by both the federal as well as provincial governments concurrently. In India, excise duties on manufactured products and taxes on the sale and purchase of goods are levied by the central

and state governments respectively. VAT is levied by both the central and state governments concurrently including manufacturing stage VAT by the central government and destination-based VAT up to the retail stage by the states. The central government levies non-agricultural income and wealth and the state governments levy agricultural income and wealth (Schmidheiny, 2017). In Brazil, VAT is levied at both the central and state levels. The sub-national governments in Scandinavian countries and the United States are allowed to levy personal income tax concurrently at both the central and sub-national levels (Boadway and Shah, 2009).

Table 2: Share of Central and Sub-National Taxes: Selected Countries and Years (per cent)

Country and year	Total tax revenues			Taxes on income			Taxes on property			Domestic taxes on goods and services		
	%Central	%State	%Local	%Central	%State	%Local	%Central	%State	%Local	%Central	%State	%Local
*Germany 1998	70.7	22.0	7.3	43.4	36.6	20.0	0.8	48.6	50.6	62.8	37.0	0.2
*Spain 1997	83.0	7.5	9.4	85.7	8.7	5.7	2.8	52.4	44.7	78.5	5.4	16.0
<i>Ukraine 2001</i>	<i>74.3</i>	<i>0.0</i>	<i>25.7</i>	<i>35.6</i>	<i>0.0</i>	<i>64.4</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>80.5</i>	<i>0.0</i>	<i>19.5</i>
*Canada 1999	52.5	38.5	9.0	63.5	36.5	0.0	0.0	21.1	78.9	41.0	59.0	0.1
*Russia 2001	69.7	0.0	30.3	27.6	0.0	72.4	5.2	0.0	94.8	82.7	0.0	17.3
*South Africa 1998	92.8	0.5	6.7	100.0	0.0	0.0	21.7	0.0	78.3	98.6	1.4	0.0
*Switzerland 2000	66.0	20.0	14.0	30.3	39.1	30.7	30.9	42.8	26.3	92.2	7.6	0.2
*Australia 1999	77.4	19.3	3.3	100.0	0.0	0.0	0.0	63.6	36.3	66.2	33.8	0.0
*United States 2001	69.3	19.1	11.6	83.0	15.5	1.5	10.0	8.0	82.0	15.7	67.6	16.8
*Argentina 2001	59.7	40.3	0.0	50.5	49.5	0.0	54.4	45.6	0.0	94.6	5.4	0.0
*India 1999	62.6	37.4	0.0	100.0	0.0	0.0	14.9	85.1	0.0	41.5	58.5	0.0
<i>China 1999</i>	<i>45.0</i>	<i>55.0</i>	<i>0.0</i>	<i>24.4</i>	<i>75.6</i>	<i>0.0</i>	<i>0.0</i>	<i>100.0</i>	<i>0.0</i>	<i>55.7</i>	<i>44.3</i>	<i>0.0</i>
<i>Indonesia 1999</i>	<i>97.1</i>	<i>2.9</i>	<i>0.0</i>	<i>100.0</i>	<i>0.0</i>	<i>0.0</i>	<i>74.9</i>	<i>25.1</i>	<i>0.0</i>	<i>95.9</i>	<i>4.1</i>	<i>0.0</i>

Note: * indicates a federal country. Data for the emerging country group are shown in italics

Source: The World Bank/Richard M. Bird, 2010

In most developing and transitional economies, local governments do not have significant tax collection powers. Richer and larger countries are usually more decentralized in terms of revenue assignments (Table 2).

3. Practice of Tax Assignment in selected Federal Countries

3.1 The Australian Model

Australia is a constitutional monarchy. The queen is the head of state. The queen is represented in Australia by a governor general, who is appointed by the queen on the advice of the prime minister. The Australian federation today comprises the federal government, six states, two internal self-governing territories, and some 720 local bodies. The federation was formed by coming together of six-self-governing British colonies in 1901 (AG, 2017).

Australia has a highly centralized tax system. There is very little sharing of tax bases across the tiers of government. More than 82 per cent of national revenue is collected by the centre through controlling major revenue bases such as income tax on individuals and companies, excise duties and levies, and taxes on international trade and VAT. The remaining 18 per cent is collected by the state and the local governments. The states raise their revenue from the tax bases such as pay roll tax and stamp duties, land use and natural resource tax, motor vehicle tax, gambling tax, and royalty from resource extraction. The local governments collect from the tax bases such as property tax, and parking fees and charges (Agegnehu and Behaylu, 2015). The state governments are free to impose tax rates on all tax bases that are not reserved to other tiers of government by the Constitution or by subsequent legislative or judicial decisions.

Australian federation is characterized by a high level of vertical fiscal imbalance between the federal and sub-national governments. Sub-national governments are highly dependent on federal transfers. State and local governments require some 40 per cent of total public sector expenditure to meet their obligations but raise only about 18 per cent of total public sector revenue. A number of stakeholders are questioning this model and making criticism (Agegnehu and Behaylu, 2015).

3.2 The Brazilian Model

Brazil is a federal democratic republic under a presidential system. The President is both the head of state and the head of government administered by the cabinet of ministers. The country is a three-tier federation which includes 26 states, over 5,500 municipalities and a federal district. According to the 1988 Constitution, states and municipalities are independent units of the Brazilian federation (BG, 2017).

The Brazilian taxation system is based on the 1988 Constitution. States and municipalities have independent taxing powers in Brazil. The federal government is solely

responsible for imposing taxes on both individual and corporate income taxes, foreign trade, and rural property and payroll. The federal government has also the residual powers to intervene in the economic sphere and any other potential tax source not clearly assigned to the state or local governments by the constitution (Fernando, 2007).

Goods and service taxes are concurrently levied by the federal and state governments in Brazil. The federal government is authorised to tax on manufacturing goods and the social contributions. VAT, property tax and motor vehicle tax are levied by the state governments. The local governments collect sales tax of urban property and user charges. In this perspective, Brazil is characterized by a high degree of revenue decentralization at the state level in comparison to many federal countries around the world (Fernando, 2007).

3.4 The Canadian Model

Canada is a constitutional monarchy in which the monarch is the British Queen or the King. Federal governor general and provincial lieutenant-governors are appointed by the relevant governments to be the Monarch's representative in Canada. Canada federation composed of 10 provinces, 3 territories, and about 3,700 municipal governments (GoC, 2017). The federal government in Canada has the constitutional right to raise tax revenue by any mode of taxation. However, both levels of government enjoy a very broad based and shared taxes jurisdiction. The federal government raises major share of its revenue from three broad-based tax sources-personal income taxation, sales taxation, and payroll taxation.

The Canadian provinces have full discretionary power regarding the choice of their tax systems. They enjoy an independent legislation and administration of taxes within their jurisdiction. Provinces can levy VAT, both personal and corporate income taxes, excise taxes, resources tax within their jurisdictions. Property tax is the main source of the local governments. Unlike Australia and Germany, the Canadian tax system is more decentralized. The provinces are provided adequate autonomy both in terms of determining tax bases, rates and generate own revenue (Boadway and Shah, 2009).

3.5 The German Model

Germany is a democratic federal parliamentary republic. Germany comprises 16 states (Landers), 22 government districts, and 403 districts on municipal level consisting of 301 rural districts and 102 urban districts (FGoG, 2017).

The central government in Germany has an exclusive authority over the major taxes including customs duties, both personal and corporate income taxes, turn over tax, insurance tax and VAT. Taxes are generally collected by the central (federal) government and then shared to the sub national governments (states and the local governments) on approved percentages based on the constitutional provisions.

Unlike Canada, the German tax system is more centralized. The states and local governments lack discretionary power over determining tax bases and rates within their jurisdiction. The taxes exclusively assigned to the states and local governments are: property tax, motor vehicle tax, inheritance tax, lottery tax, tax on beer and tax on local business, fishery and hunting tax, and entertainment tax. The states and local government tax base is insignificant to finance their expenditure needs (Feld and Hagen, 2007).

3.6 The Indian Model

India is a democratic republican federal country. The country has a three-tier federal structure with 29 states and 7 centrally administered territories -2 of which have legislatures. Below the state governments, in urban areas there are 96 municipal corporations, 1,494 municipalities, and 2,092 smaller municipalities. There are 247,033 rural local bodies, of which 515 are at the district level, 5,930 at the block level, and 240,588 at the village level (GoI, 2017).

In India, the central government has the power to levy the major broad-based and mobile tax bases including taxes on non-agricultural incomes and wealth, corporate income taxes, customs duties, and excise duties on manufactured products for reasons of stabilization and redistribution. All residual powers related to taxes which are not mentioned in any of the lists automatically fall into the domain of central government.

The major tax powers assigned to the states are taxes on agricultural income and wealth, stamp duties and registration fees on the transfer of property, motor vehicles taxes, sales tax on goods, taxes on the transportation of goods and passengers, entertainment tax, excises on alcoholic beverages, property tax, taxes on professions, trades, callings and employment, and taxes on the entry of goods into a local area for consumption, use or sale (octroi).

Recently, India has introduced goods and service tax (GST) collected at different levels of the government. Central GST is collected by the central government, state GST by the state government, and integrated GST by the central government on inter-state supply of goods and services. Service tax, the central excise duty, additional customs duty commonly known as

countervailing duty, additional excise duty and special additional duty of customs are replaced by the central GST and the central sales tax (levied by the centre and collected by the states), state value added tax/sales tax, entertainment tax (other than the tax levied by the local bodies), octroi, entry tax, luxury tax and purchase tax, are replaced by the state GST. Integrated GST is collected on interstate transfer of goods and services and levied by central government (CBEC, 2017).

3.7 The Nigerian Model

Nigeria is a federal republican country and it has three layers of government- i) federal ii) state and iii) local. The executive power exercised by the president. The country is comprised of 36 states and 744 local government areas (FRoN, 2017).

The major revenue sources like import duties, excise duties, VAT, corporate income tax, mining rents and royalties, petroleum profit tax, and personal income tax fall under the jurisdiction of the federal government. The administration and collection is conducted by the states (Ekpo, 2007).

3.8 The Pakistani Model

Pakistan is a democratic republican federal country. The country is constitutionally called the Islamic Republic of Pakistan. The country is composed of 4 provinces, and 149 districts which include approximately 596 Tehsils and more than 6,000 union councils (GoP, 2017).

In Pakistan, major revenue sources including income taxes both personal and corporate, VAT and excise are assigned to the central government. Property tax, vehicle tax, and charges and fees are assigned to the provincial and local government (FBR GoP, 2014).

3.9 The South African Model

South Africa is a democratic republican country with three-layer system of government. The President is the executive authority. The President is elected by the Parliament. The country is composed of- i) 9 provinces, ii) 8 metropolitan municipalities iii) 44 district municipalities and iv) 226 local municipalities (SAG, 2017).

There are very limited revenue sources under the jurisdiction of the sub-national governments. They have lower fiscal autonomy. The provincial governments are unable to increase and collection of revenue and to do the efficient administration due to the narrow-based tax collection rights which remains a significant problem in South Africa.

All major tax sources including personal income, corporate income and consumption taxes are assigned to the federal government. The minor tax powers such as licence fee on motor vehicle, hospital user fees and gambling taxes are under the jurisdiction of provincial governments. Municipalities are assigned to levy property taxes, turnover and utility user charges (Khumalo and Mokate, 2007).

3.10 The Swiss Model

Switzerland is a democratic federal republic. The country comprises 26 cantons and around 2,889 municipalities. Cantons are highly independence and they have permanent constitutional status. All cantons are equal in status but they are different in terms population and area. They have own constitution, parliament, government and court (FC, 2017).

Every canton has adequate fiscal autonomy and hence they are free to levy on any type of tax that fall within their jurisdiction. Their autonomy extends to the extent of having their own tax legislation, they can choose the types of tax that they levy, determine deduction rate and set their own tax rates (Dafflon, 2006). Municipalities can levy taxes that are assigned to them by the respective canton.

One of the most significant features regarding assignment of tax is that residual powers are vested in cantons rather than confederation. The revenue sources of the confederation are personal income tax, the value added tax and various excise duties. Other taxes like taxes on individual wealth and corporate capital and expenditure are assigned at the cantonal and local governments. Personal and corporate income taxes are levied at the three layers of government (Schmidheiny, 2017).

4. Tax Assignment in Nepal: Lessons from Federations

Under the unitary system of governance in Nepal, the central government used to collect around 90 per cent of the total tax revenue of the country. The small proportion of collected tax was used to transfer to the local bodies based on the simple formula using five variables including population, weighted poverty, area, weighted cost, and weighted tax effort. Tax collection proportion of the local bodies was very small reflecting the weak revenue base relative to their expenditure responsibilities. Therefore, it is an urgent need in Nepal to increase the tax collection proportion of the local bodies in federal system of governance.

The Constitution of Nepal 2015 has provided the following tax collection responsibilities among the three tiers of governments.

Table 3: *Tax Assignment among the three tiers of governments in Nepal*

Source of Revenue	Federal	Province	Local
Customs duty	✓		
Value Added Tax(VAT)	✓		
Excise Duty	✓		
Income Tax(Corporate)	✓		
Income Tax (Personal)	✓		
Payroll Tax	✓		
Entertainment Tax		✓	✓
Advertisement Tax		✓	✓
Registration Charge (Land and House)		✓	✓
LandTax(Land Revenue)			✓
PropertyTax			✓
Business Tax			✓
VehicleTax			✓
House Rent Tax			✓

Source: The Constitution of Nepal, 2015

The Constitution of Nepal 2015 has clearly assigned the revenue sharing mechanism between three layers of the government. Schedules 5 to 9 of the constitution have provided the lists of the federal, state, local powers-both expenditure and revenue assignment. It has also provisioned the concurrent expenditure and revenue raising powers of the federation and State, and federation, state and local level.

As per the schedules 5 to 9 of the constitution, the main revenue sources of Nepal including custom duty, value added tax (VAT), excise duty, corporate income tax, and personal income tax are assigned to be collected by the central government (Table 3). It will concentrate around 80 per cent of total tax revenue collection under the jurisdiction of the central government.

Entertainment tax, advertisement tax and registration charge of land and house are put under the jurisdiction of the state and local level governments concurrently. Similarly, service charges, punishment and fine and tourism charge are under all the three levels of governments concurrently. Property tax, land revenue, vehicle tax, business tax and house rent tax are kept under the jurisdiction of the local level (Table 3).

5. Conclusion

The present constitution has provisioned most of major taxes including the payroll tax, excise duty and value added tax at central level. According to the constitutional provision, the central government collects around 80 percent of tax revenue and 90 per cent of the total revenue. Constitutionally, sub national governments are provided with more expenditure responsibilities compared to revenue raising power. This situation creates the significant vertical fiscal imbalances among the levels of governments. To address the problem there should be amendment in present constitution. In this regard, the paper suggests that- besides the existing provision of constitution, payroll tax should be assigned to the state governments and excise duties (Licence Fee) on alcoholic beverage and tobacco at consumption level should be collected by the sub national governments after their legal and institutional setup and enhancing their capacity of tax administration. This can be supposed to be helpful in order to reduce vertical fiscal imbalances. Furthermore, Value Added Tax (VAT) should be collected concurrently at both the central and state levels in future after developing the revenue mobilization capacity of the state governments which will also contribute to minimize the vertical fiscal imbalance. Additional tax bases should be explored by the sub national governments to support their expenditure need and minimize the fiscal imbalances.

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