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Challenges to Intergovernmental Fiscal Relations in Pakistan: The Revenue Assignment Dimension

Roy W. Bahl
Georgia State University, rbahl@gsu.edu

Musharraf Cyan
Georgia State University, cyan@gsu.edu

Sally Wallace
Georgia State University, swallace@gsu.edu

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Decentralization in Developing Countries

Global Perspectives on the Obstacles to Fiscal Devolution

Edited by

Jorge Martinez-Vazquez
Andrew Young School of Policy Studies, Georgia State University, Atlanta, USA

François Vaillancourt
Department of Economics, Université de Montréal, Montréal, Canada

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Roy Bahl, Musharraf Cyan and Sally Wallace

INTRODUCTION

Fiscal decentralization may be a popular political rhetoric, but it is not any easy policy sell. The share of total public expenditures made by subnational governments in developing countries has barely increased over the past three decades (Bahl and Wallace, 2005). Even in countries where expenditure decentralization had taken place (e.g. Indonesia), there has been far less movement toward revenue assignment to subnational governments.

This chapter is focused on the obstacles to success with this dimension of fiscal decentralization. We use the case of Pakistan where 35 percent of government expenditures are made by provincial and local governments but only 7 percent of taxes are raised by subnational governments. At a time when central government taxes are only about 10 percent of GDP, there is a premium on increased revenue mobilization at all levels of government. The federal government has called on the provinces to double their tax-to-GDP ratio in the medium term (Government of Pakistan, 2007). The literature on fiscal decentralization is by now quite rich with a great deal of focus on intergovernmental transfers. The subject of revenue assignment, and the explanation for why countries hold back on giving taxing powers to local governments, however, is much more limited. This case study of the obstacles to revenue decentralization in Pakistan sheds some new light on this question.

In the next three sections of this chapter we describe the structure of governance and the fiscal and socio economic disparities among the provinces. These disparities are themselves an important constraint on the structuring of the fiscal decentralization strategy. Then we take up the issues of revenue assignment and intergovernmental transfers, and the role that each has played in constraining Pakistan from capturing the full benefits of fiscal decentralization. A fourth section deals with the broader context by describing the more general intergovernmental fiscal problem that faces Pakistan. Finally, we consider the subject of property taxation as a route to effective revenue assignment in Pakistan. The contribution in this chapter, we think, is in showing how much revenue potential is to be realized with structural and administrative reforms to a system that has, in some respects, been a failed decentralization.

In this chapter, we focus on the provincial level of government and use two of the provinces, Punjab and North West Frontier Province, as case studies. The analysis we report is based on Bahl, Wallace and Cyan (2008).

GOVERNANCE

Pakistan is a large federation comprised of four provincial governments: Balochistan, North-West Frontier Province (NWFP), Punjab and Sindh. In addition, there are four areas or territories: Federally Administered Tribal Areas, Islamabad (the capital city), Kashmir and the Federally Administered Northern Areas.

The Constitution in Pakistan makes provision for provincial and local elections and affords subnational governments various expenditure responsibilities and revenue instruments. The basic unit of subnational government is the Province, with the underlying local governments divided into zillas (districts), tehsils (taluka in Sindh), and unions. The sub-provincial governance is led by local councils, which are headed by locally elected officials since 2001, see Akramov et al. (2008) for details. At the first level of local government is the district government. Tehsil or Taluka Municipal Administration or TMA comprise of sub-district jurisdictions and below them are the union administrations. In the highly urbanized jurisdictions, the first and second level local governments are the city district government and Town Municipal Administration with slightly different expenditure responsibilities than their rural counterparts.

A declaration in the 'Principles of Policy' in the 1973 Constitution[2] states that local governments should be established, but local government is treated as a provincial subject and is not mentioned in either the federal or concurrent list of expenditure responsibilities. Provinces are technically free in their choice of assignment of functions or revenues to local governments. Under a recent constitutional provision, local governments created in 2001 are protected, i.e., they may not be abolished until the end of 2009[3] giving them sufficient time to stabilize.

To some extent the rocky history of local governance in Pakistan and the uncertainties in the constitution have been obstacles to decentralization. Since 1960, local governments have paradoxically thrived under military governments but remained under stress during times of democratic provincial governments (Monshipouri and Samuel, 1995). The military governments attempted to engineer new political leadership through elected local governments and to some extent this also led to their uneasy relationship with the following democratic governments. On the other hand, the democratically elected provincial governments also have seen local governments as competitors at the constituency level. During the 1990s, local councils were disbanded and the local bodies were managed by appointed provincial civil servants for varying durations in the provinces.

DISPARITIES: SOCIO-ECONOMIC

There is substantial variation among the provinces in terms of population, income, and economic activity which gives rise to problems with governance and public finance. For example, the population of Balochistan is about 10 million with a population density of 20.6 persons per square kilometer, while Punjab holds 82 million people with a density of 390 people per square kilometer. Much of the country's economic activity is devoted to agriculture, but again, there are wide variations in productivity of the land and general diversity of the economic base. Sindh is where the financial and commerce capital of the country, Karachi, is located, Punjab has some of the most productive agriculture, Balochistan has natural resources including oil but is lagging in infrastructure development, and there is a heavy concentration of poverty in NWFP as well as problems related to the on-going strife in Afghanistan. These economic, infrastructure, and population differences among provinces are reflected in significant differences in per capita income. For instance, per capita GDP in Punjab is US$645 compared to US$457 in NWFP.[4]

The wide variations in the level of economic development among the provinces have implications for revenue raising capacity. Based on province-level estimates of GDP, we see that Punjab has a much stronger economy than does NWFP (Table 4.1). Per capita GDP in Punjab is about equal to the national average level while in NWFP it is more than 30 percent lower. Though NWFP has some natural resource wealth (hydro power), its taxable capacity is well below that of Punjab. This level of disparity in fiscal capacity tends to force countries toward reliance on intergovernmental transfers (to equalize) rather than toward decentralized

Table 4.1 Disparities in Economic Condition

Variable	Pakistan	Punjab	NWFP
Population[a] (in millions)	161.7	91.2	21.2
(percent of Pakistan)	-	(56)	(13)
Per capita GDP (in rupees)	49,200	48,362	34,307
(percent of Pakistan)	-	(98)	(69)
Percent of GDP[c]			
Agriculture	19.3	27.0	29.6
Manufacturing	17.3	16.1	16.1
Percent of population below poverty line[d]	34.5	45.8	44.6
Land area (sq kms)[e]	796	205	74
(percent of Pakistan)		(26)	(9)
Urban population (millions)	53.9	28.6	3.9
(percent in urban areas)[f]	(33)	(31)	(18)
Percent increase in real per capita GDP (1998–06)[g]	23.4	22.9	23.1

Sources:

[a] National Institute of Population Studies estimates for 2006; national population for 2006 reported from Economic Survey of Pakistan 2007

[b] Calculated using data from Table 1.5 Economic Survey of Pakistan 2007 for year 2005–2006, P&D Punjab GDP Tables; Finance Department NWFP data; 2005–2006 Government of Punjab estimates GDP to have reached Rs.59,219 per capita in 2007 (reported in Pre-Budget Policy Address of Chief Minister Punjab, June 2007, p.2)

[c] Table 1.5 Statistical Appendix, Economic Survey of Pakistan 2007 GDP percentages of NWFP are for 2002–2003 from NWFP Economic Report 2005; of Punjab are for 2002–2003 from Table 1.5 Punjab Economic Report 2005

[d] The poverty data are for year 2002 from Sohail J. Malik (2004), pp. 12–13, a background study carried out by PRSP Secretariat, Ministry of Finance; 2006 Government of Punjab estimates poverty in 2007 at 21 percent (reported in Pre-Budget Policy Address of Chief Minister Punjab, Government of Punjab, June 2007, p. 8). The World Bank (2007) estimates that 35 percent of NWFP households lived below the poverty line in 2001/2002.

[e] Economic Survey of Pakistan 2007

[f] Planning Commission of Pakistan

[g] Calculated from 1.5, Statistical Appendix, Government of Pakistan (2007), Punjab Planning and Development Board GDP tables and NWFP Finance Department data.

revenue assignment. The latter favors those with stronger fiscal capacity and tends to exacerbate the difference in revenues available.

Punjab's tax base is larger than that of NWFP but is also likely to be easier to reach. Over 80 percent of population in NWFP is rural, employed in agriculture or self-employed in family businesses (World Bank, 2005b). Only 18 percent of the population lives in urban areas, compared to one-third of the population in Punjab. Presumably, tax collections in urban areas are easier than collections in rural areas. NWFP also has a heavy concentration of subsistence farming in its economy, which further weakens taxable capacity.

While the potential for raising revenue from local taxes and charges is considerably greater in Punjab than in NWFP province, it is no easy matter to assess and collect provincial and local taxes in either province. According to the Pakistan Labor Force Survey (Federal Bureau of Statistics, 2006a, Table 17), the non-agricultural informal sector accounts for 77 percent of total employment in Punjab. The comparable shares of this hard-to-tax sector are 72 percent in NWFP and 73 percent in all of Pakistan.

Are there trends in play that might, over time, reduce these income disparities? The two provinces have grown at about the same rate over the last decade (Table 4.1). Agricultural output has shown a significant increase in the 2000s and this has contributed to the per capita real growth in both Punjab and NWFP. It is not clear, however, that these improved conditions have significantly increased taxable capacity or reduced expenditure needs in either province.

There are substantial differences in the socio-economic makeup of the two provinces. Punjab's economy is much larger (population and land area) and it is significantly more urbanized. Can we infer differences in expenditure needs from these disparities? The answer is that we cannot. The percent of high-cost, poverty level population certainly pressures budgets upward. NWFP is more rural and mountainous, suggesting a higher cost of getting services to people, but Punjab has three times as much land area and four times as many people to serve.

DISPARITIES: FISCAL

What might be concluded from the pattern of disparities is that the per capita cost of providing the same level of services may not be so different between the two provinces, but the present level of services and the capacity to finance these services is much lower in NWFP.

Both Punjab and NWFP face a structural fiscal deficit (Bahl, Wallace and Cyan, 2008), i.e. they must borrow and postpone certain planned expenditures to eliminate the gap between revenues and expenditures. The situation is not dire in that the size of the deficit is only 0.85 percent of GDP in Punjab and 1.11 percent in NWFP. This is in contrast to the India experience where the aggregate deficit of the state governments reached 4 percent of GDP by the end on the 1990s (World Bank, 2005b). Still, these amounts are not inconsequential and could grow if corrective fiscal measures are not introduced. However, if the central government continues to bail out the provinces with fiscal transfers, the implications of these deficits may not be fully recognized at the province level. The provinces in Pakistan also face the pressure of public debt which adds to the complexity of the decentralization effort. The debt is centrally coordinated and central government grants that help offset the debt reduce the autonomy and accountability of the local governments.

Since there are wide inter-province variations in per capita GDP, significant fiscal disparities might be expected. Surprisingly, that is not what we observe. The level of per capita provincial government expenditures in NWFP is only about 3 percent lower than that in wealthier Punjab in 2006–2007. The explanation for this relatively small expenditure disparity is that the National Finance Commission (NFC) awards are distributed on an equal per capita basis,[5] tax effort is about the same in the two provinces (see below), and access to loan funds is about proportional to population.

All four provinces receive most of their revenues from central government transfers,[6] but NWFP and Balochistan are most dependent on intergovernmental transfers relative to own source revenues.[7] The heavy reliance of provinces on federal transfers has been noted with concern by the State Bank of Pakistan (2007a, p. 54). It also has been noted that the overall level of revenue mobilization has shown little growth in either province. The provincial dependence on transfers has been increasing since 1974 (Pasha et. al. 1992).

The picture is also surprising when it comes to Provincial revenue effort (measured here as the ratio of own source revenue collections to GDP). The expectation is that the poorer, more rural province (NWFP) would have fewer good "tax handles", and would raise even less than its lower GDP would suggest. However, revenue mobilization in Punjab and NWFP (tax and non tax sources) are about the same, and in both cases the ratio is less than 1 percent of provincial GDP.[8] The proper conclusion to draw is that neither province extends itself very much to mobilize resources from its

Table 4.2 Revenue Structure in 2005–2006

	Punjab		**NWFP**	
	Rupees (in millions)	**Percent of own source revenues[a]**	**Rupees (in millions)**	**Percent of own source revenues[a]**
Direct Taxes:				
Urban Property Tax	674	2.28	300	6.70
Agriculture income tax	658	2.23	70	1.56
Registration fee (Transfer of Property)	2,113	7.15	42	0.94
Land revenue[b] (includes mutation fee)	3,392	11.48	330	7.37
Taxes on professions, trades & callings	225	0.76	75	1.67
Indirect Taxes:				
Motor vehicle tax	4,154	14.06	677	15.11
GST on Services	2,224	7.53	420	9.37
Stamp duties	5,859	19.83	300	6.70
Entertainment tax	13	0.04	13	0.29
Electricity duties	1,270	4.30	270	6.03
Hotel tax	245	0.83	29	0.65
Provincial excises	846	2.86	30	0.67
Education cess	0	0.00	57	1.26
Cotton cess	443	1.50	-	0.00
Other[c]	31	0.11	43	0.96
Total[d]		74.97		59.27

Notes:

[a] Own source revenue is a total of tax and non tax receipts.

[b] Includes transfers by mutation and miscellaneous land revenue.

[c] The "other" category is calculated as a residual and there are wide variations between years, indicating there may be changes in classification. The NWFP collection reported under "other" is Rs.150 for 2005–2006, while it was less than Rs.5 million in the three preceding years. We use the average amount of the four years for this table.

[d] The total does not add to 100 because non-tax receipts are not included.

own tax bases nor is there evidence under the current system that they are encouraged to do so by the central government. Provincial revenue mobilization in general has been weak and has steadily worsened (World Bank, 2004, p. 26).

REVENUE STRUCTURE AND ASSIGNMENT

The structure of taxes is summarized for Punjab and NWFP provincial governments in Table 4.2. Comparable data on local government taxes are not available.[9] It should be kept in mind that in both provinces, total own source revenues are so small that they play only a minor role in financing. The level of provincial taxes is equivalent to approximately 0.2 percent of regional GDP in each province by comparison with about 10 percent for taxes at the federal level.

While there are more than 15 tax sources available to the provincial governments, most revenues in Punjab are derived from taxes on property transfers (including stamp duties, mutation[10] and registration fees) and from taxes on motor vehicles. In the case of NWFP, motor vehicle taxes, property transfer taxes and the GST on services are the most important own source revenues. The concentration of tax revenues may be illustrated by the following. In Punjab, 8 of the 14 tax sources listed in Table 4.2 account for only 14 percent of the provincial government tax revenues. In NWFP, 8 of the tax sources listed account for only 10 percent of the collections. Administrative effort seems to be spread quite widely across these revenue sources. This suggests that a less complicated tax structure might allow more administrative effort to be directed toward those taxes that have a greater revenue potential. This recommendation has also been made in earlier reports (World Bank, 2000).

While the tax structures described in Table 4.2 outline the current practice, they do not show the structure that would arise if full revenue potential was reached. In fact, the provinces do have access to some taxes that have broad enough bases and potentially enough built-in growth to form a more revenue productive tax system. This list would certainly include the property tax, motor vehicle taxes and the sales tax on services. However, all of these taxes presently are levied at very low effective tax rates, so that they yield a relatively low level of revenues. Punjab and NWFP follow almost exactly the same pattern of tax administration, owing to the fact that a uniform system was in place for all provinces between 1954 and 1970.

The Excise Tax Department is responsible for collection of most taxes, including the taxes on urban property, motor vehicles, excises and entertainment. The Board of Revenue collects the taxes on rural properties, agricultural income, property transfers and other stamp duties. There appears to be little coordination between the two arms of the provincial tax administration and this compromises collection efficiency (Bahl, Wallace and Cyan, 2008). The sales tax on services is assessed and collected by the central government on behalf of the provinces, but there is little cooperation between the two levels of government in terms of information sharing.

INTERGOVERNMENTAL TRANSFERS

The system of transfers to provinces in Pakistan is quite transparent. The National Finance Commission (NFC) award is by far the largest of the three transfers in the system.[11] The NFC is charged with making a decision every fifth year on the size of the sharing pool and on the distribution of this amount among the four provinces.

At present, the provincial pool for the NFC award is 41.5 percent of federal taxes and is scheduled to increase by 1 percentage point per year up to 46.5 percent by 2011. According to the structure of the NFC grant program, the only revenue growth for a province during an award period comes from increases in the rupee amount of the vertical share.[12] This in turn depends on the growth in federal government tax revenues. So, there is stability in the distribution system that helps long term fiscal planning. The largest increases in the real per capita amounts received came at the time of the formation of the new award, in 2004–2005, because of the increased vertical share for provincial governments.

The fundamental issue with the NFC award is that the Constitution mandates that the four provinces must agree on the proposed formula. Given the great differences in wealth, needs and demographic conditions in the four provinces, agreement is quite unlikely. This consensus requirement has held up the final decision of the NFC. The present distribution of the NFC revenue sharing pool among provinces is by population shares: NWFP receives 13.82 percent and Punjab receives 52 percent. The shares of Punjab and NWFP have remained approximately constant since 1999, since their population shares have not changed.

The other two types of NFC transfers are much smaller. The sharing pool for the GST transfer is 1/6 of national sales tax (GST on goods) collections. The distribution of this pool is determined by baseline octroi and zilla tax collections.[13] NWFP receives 9.93 percent of this pool which was its share of baseline collections and Punjab receives 50 percent of the pool according to the same principle. This transfer is designated for pass-through to local governments. The third transfer is for grants-in-aid to provinces (subventions). The size of the overall pool is mandated to grow at the rate of growth in federal taxes. The considerable stability that we find in the composition of the flow of the NFC transfers to Punjab and NWFP suggests that Provinces can rightly view this flow as an annual entitlement.

The NFC awards get mixed marks in terms of effectiveness. Certainly there is transparency in both the vertical and horizontal sharing arrangements. Both the tie to federal tax collections and the mandated increases in the sharing rate over the next five years gives some elasticity to the funding base for provincial governments. On the other hand, a population formula does not allow for equalization among the provinces according to fiscal capacity, and the steady and growing flow of resources to provincial governments gives no incentive for increased tax effort.

CONSTRAINTS TO REVENUE ASSIGNMENT

The constraints to revenue assignment and to an increase in revenue mobilization by provincial governments are formidable in Pakistan. The challenges are inextricably connected to the more general problems with the system of fiscal decentralization and there are several hurdles to overcome before revenue mobilization can be moved forward. These range from structural problems with the present tax system, to administrative shortcomings, to the absence of incentives for provincial governments to increase their tax effort, to a low level of revenue mobilization at the central government level. There is also some murkiness in revenue assignments between levels of government, and some important constitutional limitations on the choices that provincial governments might be allowed to make. Constitutional provisions have been interpreted in a way that some of the options for decentralization are not considered. Importantly, it is doubtful that local residents see much connect between the level of taxes they pay to provinces and the expenditure benefits they receive. This means that in the decentralization brought in by the 1973 Constitution, the government missed out on one of the most important advantages of fiscal decentralization; providing a way for taxpayers to hold their elected provincial officials accountable for the quality of services delivered. We might conclude from all of this that the obstacles to fiscal decentralization are rooted in problems with the system that is now in place and in the political economy in Pakistan.

Another dimension of the fiscal imbalance problem is the mismatch between the weak tax administration skills of the provincial governments and the hard-to-collect taxes that have been assigned to them. This is a major constraint on revenue decentralization, and the failure to invest in upgrading this administrative capacity may lead to a self-fulfilling prophesy. In recent years, there have been discussions about the assignment of some tax collection responsibilities to the provinces but inadequate administrative capacity is cited as a reason for not going ahead with such proposals. Under the military government (1999–2002), decentralization from the federal to the provincial levels was at one time being actively considered.[14] This discussion was reinforced by the decentralization to the zilla level of important provincial expenditure and revenue assignments under the constitution in 2001.

The politics of fiscal decentralization are especially problematic in Pakistan. There is insurgency and political turmoil which sometimes points to a "go slow" approach to decentralization. But public services levels are deficient, and the population is diverse in what they want from government. So, there is a demand for more decentralization at one level but concern for public safety and national unity provide an undercurrent of demand for increased centralization. Former President Musharraf argued for tight control over the country in the name of fighting insurgents and terrorists, but also called for significant decentralization from the provincial to local level via a push for devolution of expenditure responsibilities and renewed call for local elections (Akramov et. al., 2008). This mixed message complicates the potential for true decentralization. After coming to power in 2008 the new provincial governments have questioned the mandates of the local governments. To some extent this arises out of the incomplete decentralization from center to the provinces, which was promised in 2001 but never implemented. But part of it is attributed to the constituency level competition between the members of provincial assembly and the heads and councilors of local government. Both incomplete fiscal decentralization and inadequate administrative controls over the expenditure authority of local governments are argued to be reasons for their weak service delivery performance.

It is likely that the economic, administrative and political constraints that have kept provincial tax revenues so low in Pakistan will remain formidable constraints to decentralization. The weak provincial revenue effort is an argument that has been used many times against further decentralization from the federal to the provincial governments. And, the arguments are not unfounded. Over, the last several years, the provincial governments have not even utilized the tax policy discretion that is available to them to increase their revenue mobilization.

A summary of the findings of a recent study (Bahl, Wallace and Cyan, 2008) demonstrate the deep challenges to further revenue decentralization in Pakistan:

- Provincial taxable capacity is low, and much of the tax base (rural and a large informal sector) is hard to reach.
- Tax administration is weak. Records are out of date, tax bases are undervalued and incomplete, and skilled tax staff are in short supply. Collection rates are low in both provinces.
- Tax exemptions and preferences have narrowed existing tax bases, and many taxes are subject to specific rates (for details see, Bahl, Wallace and Cyan, 2008).
- The federal government has indirectly slowed revenue growth by encroaching on the provincial tax base in the areas of motor vehicle taxation and the sales tax on services.
- Provincial politicians have felt pressure from strong interest groups (e.g. agriculture, property owners) to hold off on increasing taxes, and in a sense they have been "protected" by growing allotments under the National Finance Commission (NFC).
- Few assigned taxes have enough revenue potential to be serious contenders to support provincial budgets. We argue here that the urban immovable property tax is one interesting candidate.

URBAN IMMOVABLE PROPERTY TAX (UIPT)

A logical (and obvious) candidate for increased subnational government revenue mobilization is the urban immovable property tax (UIPT). While the reform path is reasonably clear, there has been little movement toward a restructuring of the property tax. To demonstrate the nature of the obstacles to revenue decentralization, the failure to strengthen the property tax might be examined as a case in point.

The UIPT is an old tax in Pakistan, but it has never generated significant amounts of revenue. Its current version is levied under the 1958 statute. For instance, the national property base was estimated to be Rs. 70 billion (US$933.33 million) in 1996 and if the statutory tax rate were only 10 percent, the national collection would have been Rs. 7 billion (US$93.33 million) in that year.[15] Property tax collection in all four provinces in 1995–1996 was only Rs. 506 million (US$6.75 million). In 2002–2003 it had increased to Rs. 2.795 billion (US$37.27 million), still much below the Rs. 7 billion target estimated for 1996. Because of the overall decentralization initiative in Pakistan, many would argue that there is an imperative to upgrade the property tax to a significant revenue source (Cyan, 2007).

In both provinces studied here, the urban property tax accounts for only modest amounts of revenue. Collection in Punjab is about 4 percent of own source revenues and 0.03 percent of GDP and in NWFP, about 6.5 percent of own source revenue and 0.04 percent of provincial GDP. The questions we raise here are how might this weak revenue performance be improved, and what are the obstacles to doing so.

Intergovernmental Dimension

As it currently operates, Punjab's urban immovable property tax is an intergovernmental transfer rather than a local government tax. In some ways, this reduces its potentially important role in the decentralization effort. The tax rate and base are set by the province, and tax administration is carried out under the leadership of the province. The revenues are mandated for distribution to the districts and TMAs as specified in the Local Government Ordinance 2001:

District	15 percent
TMAs	85 percent

According to the Local Government Ordinance (2001), the property tax is to be fully devolved to the local governments.[16] In theory, the TMAs have the authority to set the tax rate and to administer the tax.[17] In fact, neither the province nor the TMAs have been willing to use their taxing power. It was reported that in NWFP, the property tax was handed over to two districts for one year, but they "turned it back". However, the handing over did not involve transfer of administrative controls of tax staff to the districts, collections were to be deposited in provincial accounts, and the province did not provide any substantive mentoring to the districts.

UIPT is not a major source of revenue for provinces or local governments. In addition to the structural problems (see Bahl, Wallace and Cyan, 2008), this is due to the murky assignment of roles between the province and local governments. The difficulty is illustrated in Table 4.3.

Reform Options and Obstacles to Reform

In both provinces, the UIPT is beset by a number of problems. Foremost, the tax raises very little revenue, which reduces its potential as a mechanism to further decentralization. Is there a chance it could become a serious revenue producer and thus provide support for local government accountability? To serve such a purpose, the base and rate structure, the administration, and the intergovernmental arrangement all should be changed (The Urban Unit, 2007). Whether the needed fixes are politically feasible, technically feasible, and whether there is any incentive to adopt them, are the more important issues. An underlying issue is whether the tax would be left to local governments (city districts and TMAs), or to the provincial government, to govern the tax so as to reach the target level of revenue.

The UIPT does not yield very much revenue, and fails in its non-fiscal objectives. This suggests that it could be a good time to overhaul the entire structure of the tax. Not that property tax changes will be readily accepted now, but structural reform will be more difficult at a later time when the level of the tax is higher. In the analysis below, we describe the elements of such a structural reform, evaluate the impacts and describe the primary obstacles to reform. We emphasize that these reforms are technically feasible, and that the constraints lie mostly in the area of the political economy.

Bahl, Wallace and Cyan (2008) argue that the revenue "target" for the property tax in Punjab could be set at Rs. 25 billion at 2006/2007 levels of the tax. The target for NWFP could be set at Rs. 3.6 billion.[18] This would bring both provinces to the international average, but it also would imply a dramatic increase in property tax revenues. In both provinces, the target implies more than a tenfold increase. It is proposed that this increase be obtained from four structural reform measures, as summarized in Tables 4.4 and 4.5.

First, bring in the newly completed valuation roll in Punjab, which assesses market rental value and puts the correct relative values on properties. This step alone would double revenues in Punjab. In NWFP, put in place a formal structure that calls for periodic revaluation and begin construction of a new valuation roll. The present system in NWFP is area based, with a rate schedule that is meant to reflect access to services and infrastructure. At present, there is no provision for raising these property tax rates.

The second step is to broaden the base of the property tax in both provinces. The numerous preferential treatments in the present system should be eliminated or rolled back and preferences should be limited to those traditionally provided (e.g. religious use, charities) and to low valued properties. This reform would include eliminating the 5 marla exemption and the preferential assessment of owner occupiers.[19] It also would require that provincial government properties make a payment in lieu of property tax for services received. Vacant properties would be taxed, and industrial properties would be moved to the commercial valuation table. If these base broadening measures were all introduced at once, on the new valuation base, they would bring in Rs. 7.5 billion (US$100 million) in Punjab (row 4 of Table 4.4), and Rs. 1 billion (US$13 million) in NWFP. Even without the introduction of a new valuation roll, this is equivalent to 125 percent of current collection in Punjab and 50 percent in NWFP (Table 4.5).

Table 4.3 Roles and Responsibilities for Administration of the Urban Immovable Property Tax

Roles	Who performs the role	Comments
Definition of the base	Provincial Excise Tax department with provincial assembly's approval	There is seldom any consultation with the local governments when exemptions are granted.
Valuation	Excise Tax department (provincial) in consultation with the district Excise Tax offices	There is no involvement of local government or the land administration department of the district government; for the purposes of registration fee and tax on transfer of property, the valuation table is prepared by the land administration department at the district level.
Assessment	Excise Tax department at the district level	Excise Tax is nominally under the district government but administratively reports to the provincial Excise Tax department.
Rate setting	TMA Council	The rates are given in the provincial laws in most cases but to bring in the urban areas not formally declared as such they were declared as zero rated and the TMA Council were given the authority to raise the rate from zero upward.
Collection	Excise Tax district offices	
Deposit of collections	Provincial accounts	
Transfer of shares	Finance Department	There are complaints of delays and lack of clarity on shares. In the past intercepts have been made for unpaid utility bills and outstanding debt payments.

Table 4.4 Illustrative Property Tax Reform Program for Punjab (Rupees in millions)

	Revenue Impacts of Reform Package (2006–2007 data)	Amount (in Rs millions)
1.	Revenue Target 2006–2007[a]	25,478
2.	PT Collection 2006–2007	2,311
3.	Gap	23,167
4.	Revenue impact of introducing a new valuation roll on the existing tax base[b]	2,889
5.	Revenue impact of base broadening measures after introduction of the new roll[c]	7,551
6.	Indexation (Additional Revenue)[d]	827
7.	Payment in lieu of tax	611
8.	Revenue gap (3-4-5-6)	11,289
9.	Property tax rate required to cover the gap[e]	0.40

Notes:

[a] Revenue target is 0.5% of Provincial GDP (uses 2006–2007 estimated GDP of Punjab Bureau of Statistics)

[b] Revenue impact is given as the new demand worked out for 2006–2007, assuming new roll will be implemented. This is computed by subtracting the actual collection in 2005–2006 from the new demand worked out by ETD after revaluation

[c] Net impact of removal of exemption for 5 marla properties, vacant properties and provincial government properties, and removing preferential treatment for owner-occupied properties and industrial properties.

[d] It seems that one time new rolls do not pick up the full impact of indexation; this is the amount net of increase due to new rolls

[e] We use a rate of 22% (an average effective tax rate, considering the nominal rates of 20% and 25%) to calculate ARV of the assessed property. Then we add the projected revenue from reform to the baseline collection and calculate the new ARV, using the rate of 22%. In the end we use the calculated ARV and the total revenue target to calculate the effective tax rate required to bridge the gap

Indexation of assessed values would bring in another Rs. 827 million (US$11 million) in Punjab and Rs. 78 million (US$1 million) in NWFP. These measures would fall short of the revenue target by Rs 11.2 billion (US$149 million) in Punjab and Rs. 2.1 billion (US$16 million) in NWFP. These gaps could be filled by increasing the statutory tax rate. We also propose that a single tax rate be adopted in Punjab. There is no justification for the present practice of an additional higher rate based on land use,

Table 4.5 Illustrative Property Tax Reform Program for NWFP (Rupees in millions)

	Revenue Impacts of Reform Package (2005–2006 data)	Rupees in millions
1.	Revenue Target 2005–2006[a]	3,631
2.	PT Collection 2005–2006	300
3.	Gap	3,331
4.	Revenue impact of introducing a new valuation roll on the existing tax base[b]	150
5.	Revenue impact of base broadening measures after introduction of the new roll[c]	1,030
6.	Indexation (Additional Revenue)[d]	78
7.	Payment in lieu of tax[e]	511
8.	Revenue gap (3-4-5-6)	2,073
9.	Percent increase in location coefficient required to cover the gap	200

Notes:

[a] Revenue target is 0.5% of GDP

[b] NWFP does not have a projected demand based on a new roll; we are assuming it will be 1.5 times the 2005–2006 demand

[c] Net impact of removal of exemptions for owner occupied units, higher rates for industrial property, taxation of vacant plots (from Table N-PT Base Broadening)

[d] Using 2002–2003 as the base line year

[e] Payment in lieu of taxes calculated as 12 percent of ARV (Government expenditure is 12 percent of GDP).

superior amenities, etc. These factors should be accounted for in the valuation of the property.

In addition, the taxation of land and improvements should be brought to the same basis, i.e., the tax base should be calculated according to the number of square feet of covered area plus the number of square feet of land area.[20] Since this involves increasing the tax on land relative to that on buildings, it will lead to an additional revenue increase. Data are not available to estimate the magnitude of the revenue increase.

Intergovernmental Reform

The provincial government in Punjab has adopted a medium term framework for reform (Government of Punjab, 2007a) that will move it toward the assignment of responsibility for property tax policy and administration to local governments. In the interim it will continue to implement the legal tax sharing arrangement with local governments. In the longer run, the property tax will be a local government revenue source, with the TMAs having rate setting powers and some degree of administrative control, as announced in the policy framework. While this is in fact the present legal arrangement for the property tax, de facto it is not yet the practice in either province. It would be useful to revisit the benefits of the legal arrangements laid down in the 2001 local government ordinance, and to begin implementation, for the following reasons:

- This will permit a stronger link between property taxes paid and local public services received.
- Taxing powers will make elected local officials more accountable to the voters for the quality of local public services delivered.
- Local officials have greater familiarity with the local economy hence a comparative advantage in some areas of tax administration, e.g. identification of properties for the tax roll.
- This intergovernmental rearrangement will enhance the chances of revenue increase. Provinces seem reasonably content with the flow of NFC transfers, and are not aggressive about increasing collections from any of the taxes at their disposal.

There are also drawbacks to adopting this intergovernmental approach and concerns that might be raised about the potential success of the medium term framework. One drawback is inertia. Local governments already have the authority to set the tax rate and to administer the tax, and they have chosen to do neither. Why will things be any different under Punjab's medium term framework, and why might things change in NWFP? The other drawback is that some local governments may not be technically up to the job of property tax administration. This could result in a long transition period. The first challenge in structuring the reform program and implementing it would be to get around these obstacles.

As an interim step, the provincial governments could move toward a redefinition of certain intergovernmental practices.

- So long as the provincial government remains involved in collections, it should notify each local government of its revenue entitlement (the amounts collected in its area). This should be done on a timely basis so as to assist the cash flow planning by local governments during the fiscal year.
- No intercept from property taxes should be allowed for the failure of local governments to make utility payments. If there are to be intercepts, they should come from the general grant to local

governments. To intercept from property taxes weakens the perception of the linkage between property taxes paid and local public services received. In fact, the practice of intercepts for utility payments in both provinces has recently been discontinued.

There is also the issue of who should administer the property tax. There is a strong a priori case for local administration and there is a legal basis for this in Pakistan. This is the long term plan under the new framework in Punjab and presumably it is the plan in NWFP. However, there is a question of administrative capacity at the district and TMA levels. This leaves three options:

- Divide responsibilities along functional lines, for example, leave preparation of the valuation table and recordkeeping with the province, but let the local government be responsible for collections and for identification of new properties to be added to the tax rolls.
- Let the local governments assume further administrative responsibility when they demonstrate readiness, as measured by some objective benchmarks.
- Let the tax administration be led by the province, but allow the local governments to set the tax rates (perhaps above some minimum level).

All of these reform options would increase the revenue importance of the UIPT.

CONCLUSIONS

Pakistan's intergovernmental system has not grown very far from a centralized system of fiscal governance. The provincial governments continue to rely heavily on transfers from the central government and there is little by way of provincial government tax effort.

The questions raised in this chapter are about the obstacles to fiscal decentralization that must be removed if subnational governments are to be successful with own source revenue mobilization.

The obstacles to decentralization in Pakistan, based on this illustrative case are:

1. Provincial budgets are dependent on federal transfers from shared taxes. This restricts budgeting choices, but at the same time it allows provincial politicians to be less than fully accountable to their voting constituents. Traditionally provincial officials have

found it easy to blame funding shortage on deficient federal transfers. In this way, dissatisfaction with government is transferred by local and provincial politicians to the federal government. Unlike the proposal for an increase in provincial tax effort, that would entail a political cost, there is no political cost for arguing for a higher share from federal taxes.

2. The vertical share for intergovernmental transfers to provinces has been increasing. This takes the pressure off subnational government political leaders to increase their rate of revenue mobilization.
3. The weak tax administration at the provincial level is a major constraint to revenue decentralization. At the provincial level there are two agencies that are responsible for tax administration but neither has shown interest in capturing the potential gains from a merger or closer collaboration. To some extent this state of affairs is due to the relatively low importance that provincial governments assign to provincial taxes. But it may also be that the weak capacity of the departments is seen as a difficult issue to address and so the provinces have not exerted adequate effort in this field. The repeated attempts made at land record computerization since 1992 have ended in incomplete results and finally abandonment and succession by new projects. A similar story may be told about the failure to adequately upgrade the numbers and the skills of the tax administration staff.
4. A major obstacle is poorly structured taxes. For example the property tax is so riddled with exemptions, and the base is so undervalued, that it can yield no more than a fraction of its potential.
5. The constitutional scheme of expenditure and tax assignment allows shared responsibility for expenditures but not shared powers to tax. There are shared taxes between the federal and provincial governments but the authority to define the base, set the rate and collect revenues all rests with the federal government. The provinces receive their share through the NFC sharing formula. The sharing of tax bases, with provincial government rate setting is not allowed according to the dominant constitutional interpretation. This limits the possibilities of decentralized tax assignment.
6. The concurrent expenditure list of the constitution has been a subject of much debate. Since the new government's coming to power in early 2008, a discussion has been underway about abolishing the concurrent list. If this happened, and if the result was the assignment of more expenditure responsibilities to subnational governments, more pressure could be put on these governments to increase their rate of revenue mobilization.
7. A less visible but formidable obstacle is the organization of the

provincial civil services. Most of the employees working for the local governments belong to the provincial cadres. They were assigned to the local governments in 2001 to meet immediate staffing needs. But it is not a short term arrangement. Senior civil servants in the local governments will continue to belong to the provincial cadres, with their career prospects linked with the province. There is not much opportunity for the local governments to create their own cadres because their establishment is controlled by the provincial finance departments. The higher level governments in Pakistan maintain linkages and a measure of control over lower tiers by posting officials from their cadres to the senior positions in them.

8. The federal government maintains the accounts of the provincial governments. It maintains district accounts but TMA accounts are separately maintained. The provincial accountants general are federal employees and their primary reporting and accountability is to the federal controller general of accounts. Despite constitutional provisions to the contrary and provincial demands for decentralization of accounts, the federal government has failed to yield on this practice. This remains an impediment to developing subnational capacities, the weak capacity at the same time serving as a continuing argument against decentralization.

NOTES

1. This chapter draws heavily from Bahl, Wallace and Cyan (2008).
2. Article 32, Constitution of Pakistan, 1973. Article 140 A also stipulates creation of local governments in each province.
3. The provincial local government ordinances have been placed in a special schedule of the constitution which requires prior agreement of the president for any amendments to the law.
4. The current dollar conversion rate of US$ 1 = Rs.75 has been used throughout the chapter.
5. Since 1974, equal per capita shares has been the basis for distributing revenues among provinces.
6. Asian Development Bank, et. al. (2004). Vol. II, pp.18–19.
7. Some non-development and development grants outside the NFC arrangement are classified as non-tax revenue receipts. In Punjab these amounted to Rs. 18,348 million in 2006–2007 (Government of Punjab, 2007b) and in NWFP they were Rs. 9,713 million in the same year. NWFP reports the royalty on hydro-electricity, Rs. 6000 million, as a non-tax receipt (Government of NWFP, 2007c).
8. Earlier estimates had placed the level of tax effort in Punjab well above that in NWFP (World Bank, 2000, p. 37).
9. For a discussion of local taxation in Pakistan, see Bahl and Cyan (2008).
10. A mutation is a change in the record of rights of the revenue estate. It is carried out in a two step process culminating in a record of ownership in favor of the new owner. In the first step the details of the transaction or inheritance are recorded in the mutation register and certified by a revenue officer in a public gathering after inviting objections. In the second step a red entry is made in the current edition of the record of rights, consistent with the certified details in the mutation register.

11. Actually, there are five types of federal transfers: (1) shared tax revenues; (2) GST financed pass-through grant for local government; (3) subventions; (4) natural resource royalties; (5) discretionary federal grants. The first three are decided by the NFC.
12. Under the interim award of 2006 a one percentage point growth in the provincial share, subject to increase federal tax collection, during the implementation of the award has been allowed for the first time.
13. The two subnational government taxes were abolished in 1998 and the "baseline collection" refers to the collections in the final year.
14. The National Reconstruction Bureau established by the military government in 2000 discussed center to province decentralization during its early years from 2000 to 2002.
15. Ghaus-Pasha et. al. (1998), p. 11
16. The federal government led the initiative which resulted in the creation of local government in all the four provinces and the decision making by-passing provincial government to a large extent. The local government ordinances which created local government and assigned expenditure and revenue responsibilities to them were drafted by the federal government and provinces were given no choice but to adopt them largely unchanged.
17. TMAs have the legal authority to set the rate in ordinary districts. The role of city districts is at the proposal state.
18. These amounts are equivalent to US$333million and US$48 million, respectively.
19. All owner occupied properties with areas less than 1,360 square feet (5 marla) are exempt from property tax. In Punjab, 66 percent of owner occupied properties fall into this class.
20. At present, valuation coefficients are applied to the sum of land area in square yards and building are in square feet.

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