Punjab Fiscal Resources Review

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Abstract

This study raises policy issues arising from the fact that the present tax-expenditure policies and institutional set-up at both the provincial and local government levels of the Province of the Punjab are dated and need revision.

There is now an active awareness within the Punjab Province that substantial changes are necessary. The broad outlines of these required changes which have been identified in this study, as follows:

i) The Provincial Government needs to recognise that the 1997 National Finance Commission (NFC) Award's projected high level of Federal Divisible Pool Revenues are unlikely to materialise in the light of the substantial changes made in tax policies by the post 1997- Award Federal Government as well as by the depressed state of the economy. As a result the historical pattern of Federal Transfers covering more than 85 per cent of consolidated Punjab Provincial and Local Government expenditures is unlikely to be ever repeated. In fact the 1997-98 coverage of 75 per cent is likely to go down even further and this gap needs to be filled by active resource mobilisation and expenditure curtailment measures.

ii) The decline in Federal transfers has meant that the revenue surplus (Federal Transfers plus own resources minus current expenditures) available for funding the Punjab's development expenditures have also declined – from 75 per cent in 1996-97 to an estimated 13 per cent in 1997-98. This gap has been filled (in roughly equal proportions) by a massive increase in Cash Development Loan (CDLs) from the Federal Government, Foreign Debt onlent by the Federal Government, (primarily from the World Bank) and Draw-down of Provincial Reserves. The first carries a market rate of interest (about 17 per cent per annum) while the foreign loans (largely under SAP) carry concessional rates of interest. Here the proposed strategy would be to increase the revenue surplus, phase out the relativvely more expensive CDLs and borrow foreign funds (through the Federal Government) only on concessional IDA terms (i.e. 0.25 per cent interest, 50 years repayment plus foreign exchange risk).

iii) Debt service (on both domestic and foreign debt) to the Federal Government is increasing rapidly (9 per cent of provincial revenues in 1997-98) and needs to be monitored carefully. In addition unfunded pension liabilities of the provincial government to present and future retirees have the potential to create substantial problems. The provincial pension scheme needs to be amalgamated with the provident fund scheme (which is also unfunded since the provincial government has used these employee funds) and turned into a defined contribution scheme i.e. to a fully funded individual pension account scheme. Otherwise pension liabilities which are about 8 per cent of Punjab current expenditures and 35 per cent of Provincial own consolidated revenues in 1997-98 are likely to reach unsubstainable levels in the foreseeable future.

iv) The Tax-Expenditure structure needs to be rationalised between the Provincial Government and the Local Governments. Tax collection heads must be directly linked to expenditure responsibilities. The Provincial Government should only collect and retain the following existing taxes: (a) agricultural income tax, (b) 'land revenue' associated fees - primarily mutation fees - for transfer of agricultural land, (c) stamp duties on urban-property and non-property transactions, (d) motor vehicle taxes, (e) provincial excises and (f) electricity tax. It should also introduce its own Punjab General Services Sales Tax by adding it onto the proposed Federal Sales Tax and have it collected for the Provincial Government by the Federation. The last proposed tax would compensate for the taxes proposed to be transferred to the ULBs/RLBs. All other Provincial Taxes with the exception of the Cotton Fee which is used to fund research should be abolished. All these tax policy changes, together with improvements in the agricultural income tax, provincial excises, electricity tax and non-property related stamp duties will ensure a simple healthy taxation structure at the provincial level.

v) Provincial non-tax revenues can be increased substantially by increased cost recovery and efficiency improvement from the provision of community services and social services – particularly health and education (which show cost recovery percentages of 3 per cent and 5 per cent respectively). The economic services – particularly irrigation – have a cost recovery factor of about 40 per cent instead of providing a substantial surplus (or at least 100 per cent cost recovery) since irrigation water is substantially under-priced (currently about 20 per cent of the cost of tube-well water).

vi) At the Provincial level, substantial efficiency gains are possible in general administration, law and order (particularly the functioning of the courts) and provision of community services including health and education and economic services particularly irrigation. Reducing unnecessary regulations will increase public welfare and reduce administrative costs. The courts need massive productivity improvements through revision of procedures and increasing the costs of litigation which will only be adopted if 'financial autonomy' is given to the Provincial Judiciary. In education, the province should stop expanding its infrastructure and focus on improving the efficiency of its existing schools and colleges and introduce a transferable voucher system (encashable in both public and private institutions). In health it should deal mainly with curative medicine (i.e. hospitals) which should have administrative and financial autonomy. In the economic services increased efficiency through user associations, cost recovery and expropriation of surpluses through taxation in monopoly areas such as irrigation would result in both substantial welfare gains as well as increased revenues.

vii) All taxes relating to the direct functional areas of local bodies ULBs/ RLBs/DAs – should be transferred to these local bodies and collected by them directly. The major taxes here would be on: (i) Property Taxes to be collected by ULBs and RLBs; (ii) Full Cost–Recovery for provision of water supply, sanitation and waste disposal services (iii) A new Local Government Petroleum Tax (to be collected by the petroleum companies) which would fund new roads and related infrastructure (bridges, elevated expressways etc.); and (iv) Octroi/Export Taxes which would be used in part for funding the maintenance of major roads but in large part meeting the needs of the poor for slum and Katchi Abadi up- gradation. The Professional and Calling Tax should be transferred from the Provincial Government to the Local Bodies and be used to fund infrastructure for the use of such professional bodies. The remaining existing local government taxes are minor, save for nuisance value and extracting rents, and should be abolished except when they serve as user fees.

viii) To meet these increased revenue/expenditure responsibilities the ULBs/RLBs/DAs would have to be re-organised. The fundamental administrative change proposed is that all major cities (i.e. Municipal Committee and larger) should comprise a number of Municipal Committees (which should be the effective urban management unit). All areas developed by DAs (either in the past or the future) should be converted into a municipal committee or a number of municipal committees (depending on the size) and these should all be grouped on the pattern of Karachi into a metropolitan corporation with separate mayors for each of the Municipal Committees and a Lord Mayor as envisaged in the recent new Punjab Legislation. Thus all the Punjab's Municipal Corporations will become Metropolitan Corporations. The Municipal Corporation as a tier is being recommended for abolition on the grounds that it is too large and unwieldly as an administrative unit. The WASAs should become an autonomous part of the Metropolitan Corporation (shifting from the DAs). The DAs should be expanded to cover more cities but also be subjected to more financial discipline.

Study Conclusions:

All available qualitative and quantitative indicators point to the fact that Punjab's urban areas have been reduced to vast slums. There is an urgent need for urban renewal. If the measures proposed in this study are implemented, the financial position of both the Provincial Government and the Local Government (particularly the Urban Local Bodies) would be considerably strengthened. In addition to the greater potential for financing own development expenditure by Urban Local Bodies, the policy changes proposed above would make the Provincial Government credit worthy for an additional $ 200 million (Rs. 9 billion) annually of foreign borrowings on concessional IDA terms. This is in addition to its current level of foreign borrowings (through the Federal Government) of about $130 million (Rs.6000) annually. Similarly the ULBs would become cumulatively credit worthy for borrowing upto $ 80 million (Rs.3.5 billion) annually on concessional terms.

The Punjab's Provincial Finances – Existing Situation

1.1 **Introduction**. The Punjab's finances, as in all Provinces of the Federation of Pakistan, are dominated by the constitutional position that all major taxation bases viz. income taxes (except on agriculture), customs duties, all excises except on alcohol and narcotics and sales taxes, are with the Federal Government which distributes 38.5 per cent of it (the so called divisible pool) on a population basis to the provinces after retaining 62.5 per cent for its own federal purposes (primarily defense, communications and debt service on foreign and local borrowing). There proportions are determined every five years by a National Finance Commission and the most recent award was in February 1997. The major taxes available to the provinces are: agricultural income tax, property taxes, taxes on services (a legally undefined area), motor vehicle taxes and a host of minor local taxes. The Provinces use the proceeds from both the Federal Divisible Pool and their own resources to meet their provincial constitutional responsibilities which include virtually everything except defense. The situation is complicated by the fact that Local Governments are not specified in the Pakistan Constitution in terms of structure, taxation and expenditure responsibilities and hence exist only at the legislative and administrative discretion of the Provincial Governments. The Indian Constitution was recently amended to correct a corresponding anomaly.

1.2 The last National Finance Commission Award (February 1997) was pushed through by the care-taker government of Mr. Meraj Khalid and dramatically altered the ratio of division of resources between the Federal and Provincial Governments from 80:20 of all taxes except custom duties, wealth taxes and capital value taxes which were wholly retained by the Federation, to 62.5:37.5 of all taxes. This was primarily intended in order to rescue the faltering financial position of the Federal Government staggering under the burden of overwhelming national and foreign debt and high interest rates. The Provinces accepted this new formula mainly because Federal revenues were projected to grow at extremely high levels and therefore promised even higher absolute resources transfer to the Provinces. The subsequent Federal Government of Mr. Nawaz Sharif dramatically changed policies by lowering Federal tax rates. The parameters of the NFC award have therefore changed and the obvious policy signal is that the Federal Government will lower its tax profile and the Provinces should be raising theirs.

Table: I.1 Punjab Provincial Budget (1997-98) vs. NFC Projections
Rs. Billion Current Prices

	1996/97 (Estimates)	1997-98 (Budget)	1997-98 (NFC)	2001-02 (NFC)	NFC Growth Rate %
Revenue Receipts	85.1	83.2	97.4	186.1	17.6%
Own Revenues	14.3	17.0	14.5	24.0	13.5%
Transfers from Fed Govt.	70.7	66.2	83.0	162.1	18.1%
(Divisible Pool Transfers)	(70.7)	(64.4)	(80.8)	(158.9)	(18.3%)
(Straight Transfers)		(1.8)	(2.2)	(3.3)	(10.7%)
(Special Grants)		(1.0)	(0.0)	(0.0)	
Current Expenditures	75.5	80.7	88.0	163.3	16.8%
Revenue Surplus/Deficit	9.6	2.5	9.5	22.8	
Development Expenditures	13.0	19.7	8.3	15.2	16.3%
Overall Surplus/Deficit)	-3.4	-17.2	1.2	7.6	

Source: Government of Punjab Budget Documents and Report of the National Finance Commission, April 1997.

1.3 As Table I.1 above indicates, Punjab has begun to adjust to the changed situation by raising its own revenues through additional fiscal measures for 1997/98 in order to compensate for the drop in the actual NFC transfers between 1996-97 and 1997-98. However, the increase in current expenditure (in line with inflation) has meant that the Punjab Annual Development Budget is now entirely to be financed by Federal Cash Development Loans, Foreign Loans onlent by the Federal Government and draw down of reserves - all in roughly equal proportions. (See Table I.2).

1.4 A starting point for analysis of the Punjab's finances is to look at its consolidated accounts (Table I.2). Punjab's total revenues for 1997-98 are budgeted at Rs.114.5 billion (including Federal transfers and loans but excluding draw down of the Punjab's own reserves) and total expenditures at Rs.116.3 billion. Of the Rs.31 billion of own revenues generated in the Punjab, Rs.17 billion (55 per cent) accrued to the Provincial Government, Rs.9 billion (29 per cent) to ULBs, Rs.4 billion (13 per cent) to Zila Councils (RLBs) and Rs. 1 billion (3 per cent) to the workers Social Security (Health) Institution and were used almost entirely by these agencies to meet current expenditures. The Provincial Government also used almost all its Federal Transfers for current expenditures. The notable exception were the ULBs which financed Rs.2 billion of development expenditures from their own resources. On the development side almost 93 per cent of all capital expenditures (or Rs.18.3 billion of a total of Rs.19.7 billion) relating to all public agencies (Provincial Government, ULBs, RLBs, DAs, WASAs etc) were allocated directly through the Provincial ADP and were largely tied to foreign loaned projects – with some flexibility being offered by the drawn down of Rs.6 billion of the Punjab's reserves for its development expenditures. The conclusions from these numbers are fairly obvious. First, the Province of the Punjab needs to raise more revenues, both at the Provincial and Local levels. Second, Local Government Bodies are unnaturally constrained both in raising revenues and in their expenditure decision making which in large part explains the breakdown of infrastructure services in all localities – both urban and rural.

Table: I.2 Punjab Consolidated Fiscal Accounts 1997/98 (Budget)

Rs. Billion

	Resources/Revenues			Expenditure			Surplus/
	Total	(Tax)	(Non Tax)	Total	(Current)	Capital)	Deficit
PUNJAB RESOURCES & EXP. (exc Reserves)	114.5	82.0	32.5	116.3	90.1	26.2	-1.8
Prov. Revenues and Current Exp.	83.2	74.4	8.8	80.7	80.7		2.5
(Provincial Revenues)	(17.0)	(10.0)	(7.0)				
(Federal Transfers)	(66.2)	(64.4)	(1.8)				
Provincial Borrowing and Dev. Exp.	17.3		17.3	19.7		19.7	-2.5
(Federal Grants)	(1.0)		(1.0)				
(Cash Dev. Loans).	(6.0)		(6.0)				
(Foreign Loan - Fed.Govt.)	(6.2)		(6.2)				
(Reserves + = decrease)	(5.6)		(5.6)				
(Debt Service to Fed. Govt.)	(-1.5)		(-1.5)				
Metropolitan Corporation Lahore	2.5	1.1	1.5	2.4	2.2	0.2	0.2
(LMC)	(1.2)	(0.9)	(90.5)	(1.2)	(1.0)	(0.2)	(0.0)
(LDA)	(0.5)		(0.5)	(0.4)	(0.4)	(0.6)*	(0.1)
(WASA)	(0.9)	(0.2)	(0.7)	(0.8)	(0.8)	(0.7)*	(0.1)
7 Municipal Corporations	3.4	1.5	1.9	3.7	2.8	0.9	0.3
(MCs)	(2.2)	(1.4)	(0.8)	(2.5)	(1.6)	(0.9)	(0.0)
(DA's)	(0.7)		(0.7)	(0.7)	(0.7)	(0.9)*	(0.0)
(WASAs)	(0.5)	0.1	(0.4)	(0.5)	(0.5)	(0.5)*	(0.0)
78 Municipal Committees	2.5	1.4	1.1	2.6	1.9	0.7	-0.1
140 Town Committees	0.5	0.4	0.1	0.5	0.3	0.2	0.0
34 Zila Councils	4.0	2.4	1.6	5.8	1.5	4.3	-1.8
Social Security (Health) Institution	1.0	0.8	0.2	0.9	0.7	0.2	0.1

Source: Compiled from Government of Punjab Budget Documents. Data for Town Committees relates to actuals for 1996-97. Development expenditures marked with (*) denote financing from Provincial ADPs. Zila Council Development expenditures budgeted for 1997-98 are about Rs.2 Billion more than 1996-97 actuals and these Zila Councils normally run large surpluses on their accounts.

Structure of Revenues and Expenditures – Provincial Level

1.5 **Revenues Shared from the Federation**. Provincial Revenues comprise revenues from three sources: (I) Federal Tax (Divisible Pool) shares and Direct Transfers, (ii) Provincial Tax Revenues, and (iii) Provincial Non-tax Revenues (largely cost recovery). The Federal Divisible Taxes now comprise all Federal Taxes (excluding income tax on renumerations paid by the Federal Government which is retained by the Federal Government). The net distributable share is determined after the deduction of 5 per cent collection charges retained by the Federal

Government. The first distribution is between the Federal Government and the Provinces (62.5 per cent: 37.5 per cent) The second distribution is between the provinces on the basis of population under which according to the last published Census (1981) the Punjab gets 58.8 per cent. The rates of the major Federal Taxes are: (I) Income Tax (individuals 15-35 per cent, companies 50-60 per cent); Custom Duties (10-60 per cent); Sales Taxes (8-12 per cent), Excise Taxes (10-80 per cent), Wealth Taxes (2 per cent of assets value) and Capital Value Tax (CVT) (5 per cent of asset value).

Table: I.3 Punjab Share of Federal Divisible Taxes

Rs.Billion

	(1991 NFC) 1996-97 Estimates	(1997 NFC) 1997-98 (Budget)
Income Tax	36.3	19.5
Custom Duty		17.9
Sales Tax	24.6	13.5
Federal Excise Duties	8.0	12.6
Wealth Tax		0.5
Capital Value Tax		0.3
Total	69.0	64.4

Source: Government of Punjab Budget Documents.

Note: The 1997 NFC Award changed the divisible pool by including customs duties, wealth taxes and capital value tax in the pool and changing the portions distributed to the Provinces from 80 per cent to 37.5 per cent. The divisible pool excludes the straight transfer of revenues accruing from petroleum and gas. Electricity profits are transferred outside the NFC and Federal Budget framework directly to the Provinces (largely to NWFP). Direct transfers to the Punjab are budgeted at Rs.1.8 billion for 1997-98 compared to Rs.6 billion and Rs.10 billion each to Balochistan and NWFP for direct transfer of gas revenues and electricity profits respectively.

1.6 **Provincial Taxs Revenues**. As discussed earlier all major tax bases are reserved for Federal collection by the Constitution except for land based taxes. Thus accordingly 60 per cent of Punjab's Provincial revenues (or Rs.6.0 billion of a total of Rs.9.7 billion) come from four land taxes: (i) The recent agricultural income tax (Rs.1.5 billion); (ii) agricultural land transfer taxes – mutation fee (Rs.1.3 billion); (iii) urban land transfer taxes – stamp duties (Rs.2.9 billion); and (iv) urban property taxes (Rs.0.3 billion) retained by the Provincial Government (actual collection is Rs.1 billion and the balance is passed on to the ULBs). Other major taxes are the motor vehicle taxes (Rs. 1 billion); excises on alcohol/spirits (Rs.0.5 billion) and electricity duty (Rs.1 billion - this was the first step towards taxing services). The remaining taxes of Rs.1 billion are minor with the relatively large ones being cotton fees (Rs.0.3 billion) and entertainment taxes (Rs.0.2 billion). The details of the taxes including tax rates and changes suggested are discussed later in Sections II and III of this report.

Table: I.4 Punjab Provincial Tax Receipts

Rs. Billion

		1996-97 Estimates	**1997-98 (Budget)**
1	Agricultural Income Tax	1.3	1.5
2	Agr. Land Transfer Tax (mutation fee)	1.3	1.3
3	Urban Land Transfer Tax (stamp duty)	2.5	2.9
4	Motor Vehicle Tax	1.0	1.1
5	Electricity Duty	0.8	1.0
6	Provincial Excises	0.4	0.5
7	Property Tax *	0.2	0.3
8	Others (Cotton fee, entertainment Tax etc.)	1.0	0.9
	Total	8.7	9.7

Source: Government of Punjab Budget Documents

***Note:** Only 25 per cent of the Property Tax is retained by the Provincial Government which is shown in this Table.

1.7 **Provincial Non-Tax Revenues and Current Expenditures**. It is convenient to look at current expenditures first by internal ratios and then in terms of cost recovery ratios. An examination of the composition of current expenditures indicates that the largest share at 42 per cent (Rs.34 billion out of the total of Rs.80.7 billion in 1997-98) went to social services and particularly education which received Rs.27.6 billion or 34 per cent (excluding public universities which are financed by the Federal Government through an interesting non-constitutional tradition initiated by the then President General Zia ul Haq). This was followed by expenditures on law and order functions of Rs.6.9 billion (9 per cent); Rs.6.2 billion (8 per cent) on pensions; and Rs.4.5 billion (6 per cent) on irrigation. Details of current expenditures and non - tax revenues are given in Table I.5 and Section II of this study.

1.8 Cost recovery percentages are examined in Table I.5 below. Excluding pensions, subsidies and debt service expenditures, interest and dividend income, total cost recovery percentages were 7 per cent in both 1996-97 and 1997-98. Cost recovery for economic services was 40 per cent in 1996-97 and 39 per cent in 1997-98. Cost recovery on community services (largely water supply and sanitation in rural areas) was 27 per cent in 1997-98. The highest expenditure and the lowest cost-recovery percentages were in the social services particularly education (cost recovery percentage of 2.5 per cent) and health (5.0 per cent). While providing social services like education and health and community services such as rural water supply services to the poor justifies low cost recovery, room for efficiency gains in the sector are also explored in Section II. There is much less justification for low cost recovery for economic services particularly irrigation and this is also discussed further in Section II.

Table: I.5 Punjab Current Expenditure and Non Tax Revenues and Cost Recovery Percentages

Rs. Billion, Current Prices

	1996-97 Estimates	1997-98 (Budget)
1. Total Current Expenditure Excluding Pensions, Subsidies and Debt Service	67.8	72.7
2. Total Non Tax Revenues	5.5	5.8
Cost Recovery Percentage	8.0%	8.0%
3. Total Exp. on Gen. Civil Adm.	6.0	4.5
4. Total Receipts from Gen. Civil (Adm.)	0.2	0.2
Cost Recovery Percentage	3.0%	4.0%
5. Total Exp. on Community Services	3.4	4.4
6. Total Receipts from Community Services	1.0	1.2
Cost Recovery Percentage	29.0%	27.0%
7. Total Exp. on Education	24.4	27.6
8. Total Receipts from Education	0.6	0.7
Cost Recovery Percentage	2.0%	2.5%
9. Total Exp. on Health	5.1	5.8
10. Total Receipt from Health	0.2	0.3
Cost Recovery Percentage	4.0%	5.0%
11. Total Exp. on Irrigation	4.3	4.6
Total Receipt from Irrigation	1.7	1.8
Cost Recovery Percentage	40.0%	39.0%

Source: Compiled from data in "Pakistan, Provincial Budgets 1997/8" World Bank, September 25, 1997.

Note: Interest and Dividend payments amounted to Rs.1.4 billion, subsidies to 0.2 billion while interest income was estimated at Rs.0.2 billion in 1997-98. Pensions amounting to Rs.6.2 billion in 1996-97 and estimated at the same levels for 1997-98 are excluded from `General Civil Administration' expenditures.

Un-funded Obligations – Pensions and Provident Fund

1.9 The pension obligations of the Punjab Government were budgeted at Rs.6.2 billion in 1996-97 and are estimated at the same level billion for 1997-98. These pension obligations are likely to mount very quickly for the current Provincial Government establishment of now more than 6,00,000 employees (5,00,000 of them teachers in the Education Department). In addition, the absence of a pension scheme for Local Government Service employees has created on incentive for them to leave the service of the Local Bodies and become Provincial Government Employees. Both these factors necessitate an urgent review of Provincial Pensions. It is recommended that the present unfunded pension scheme be changed to a fully funded defined contribution scheme where individuals make pension contributions as they presently do with their Provident Fund. These are matched by the Government, placed in the individual's interest/profit bearing account and becomes a pension annuity on retirement. Incidently, the present Provident Fund Scheme is also unfunded since the previous governments have used the Provincial Provident Fund contributions to meet current and capital expenditures. The Provident Fund is currently managed on a pay–as–you–go basis with receipts estimated at Rs. 1.3 billion and draw-outs at Rs.1.1 billion budgeted for 1997-98. The total amount of unfunded pension liabilities of existing Provincial Government employees as well as the total unfunded Provident Fund obligations have not yet been made available from the Punjab Government.

Development Expenditures

1.10 The almost negligible revenue surplus left in the Punjab for 1997-98 has meant that if it were not for the fact that Rs.5.6 billion of reserves were drawn down, the Punjab's Annual Development Programme of Rs.19.7 billion would be entirely donor project driven. The IDA/ADB/EUR Social Action Programme (Rs.5.7 billion ADP in 1997-98) which drives 80 per cent of all current and capital expenditure in the Provincial Education, Health and Rural Supply Budgets together with Rs.4.4 billion with other donor funded projects would have meant that Rs. 10.4 billion of Rs. 14.1 billion (72 per cent) available from Federal Foreign Loans for the ADP would be donor driven. In order to free resources for local programmes to reflect the priorities of the new Provincial

Government reserves were to be drawn down from Rs.28 billion to Rs.22 billion during 1997/8.

1.11 **The Development Priorities currently are:** (in descending order by resources available) (i) education; (ii) health, (iii) rural water-supply (iv) physical planning and housing (largely urban water supply, sanitation and urban roads and administrative infrastructure); (v) agriculture; (vi) inter-district roads and bridges; (vii) water and power and (viii) rural development. These are summarised in Table I.6 below. In addition, as noted earlier almost all development programmes in urban and rural areas are carried out through the Annual Development Programme (ADP), Non-ADP Development Programmes for ULBs are budgeted at Rs. 2 billion in 1997-98.

1.12 The two major aspects of concern regarding the way the current Punjab Annual Development Programme is structured are: (i) Foreign donor dependence – particularly since it is in the form of projects with specific project conditionality rather than in Development Funds where there is room for flexibility and innovation; and (ii) Lack of freedom to Local Governments to develop their own investment development programmes.

Table: I.6 Punjab ADP (Development) Expenditures, 1997-98 Budget

Rs. Billion

	Foreign Funded (Aid Donors)	Local Funded (Fed.& Prov.)	Total	%
IDA/ADB/EUR Social Action Prog.	4.5	1.1	5.7	29
(Rural Water Supply)			(2.5)	(13)
(Education)			(2.4)	(12)
(Health)			(0.7)	(4)
Other Foreign Funded Projects	1.8	2.6	4.4	22
Agriculture		1.6	1.6	8
Water and Power		1.1	1.1	6
Roads and Bridges		1.1	1.1	5
Chief Minister's Priority Programmes		1.0	1.0	5
Rural Development		0.6	0.6	3
Physical Planning and Housing		3.0	3.0	15
Others		1.2	1.2	6
Total	6.3	13.4	19.7	100

Source: Government of the Punjab Budget Documents.

Structure of Revenues and Expenditures –Local Levels

1.13 Local Governments raise about Rs.10 billion through their own resources of which they spend Rs.8 billion on current expenditures and Rs.2 billion on capital expenditures (1997-98). They also spend about Rs.2 billion of ADP Funds (1997-98). Within this total, Rural Local Councils (Zila Councils) raise about Rs.4 billion in own resources and usually spend about Rs.1.5 billion on current and Rs.2 billion on development programmes. In 1997-98 they propose to spend Rs.5.8 billion on development but these expanded levels of capital expenditure are unlikely to be realised. Table I.2 (displayed earlier) and Table I.7 below detail these for the Metropolitan Corporation Lahore, the 7 other Municipal Corporations, the 78 Municipal Committees, the 140 Town Committees and the 34 Zila Councils in the Punjab.

Table: I.7 Punjab Local Council Income and Expenditure, 1997-98

Rs. Billion

	Income			Expenditure		
	Octroi/ Export Tax	**Property Tax**	**Total***	**Current**	**Capital**	**Total**
Metropolitan & Municipal Corporations (8)	1.9	0.4	3.4	2.5	1.1	3.6
Municipal Committees (78)	1.0	0.2	2.0	1.5	0.5	2.0
Town Committees (140)	0.3	0.1	0.5	0.3	0.2	0.5
Zila/District Councils (34)	2.3	1.3	4.1	1.5	4.3	5.8
Total:	5.5	2.7	10.0	5.8	6.1	11.9

Source: Government of Punjab, Local Government Department.

Note: Total includes other incomes (tax and non tax) of local bodies.

1.14 The three major sources for the local councils are: (i) Octroi/ Export Taxes (Octrois for ULBs and Export Taxes for RLBs) collected by the LBs through the auction of tax collection with rates set by the Provincial Governments; (ii) Property Taxes (set at 25 per cent of annual rental value with set deductions) collected by the Provincial Excise and Taxation Department and passed on to ULBs/RLBs after deducting 20 per cent and (iii) Property

Transfer Fees for ULBs at 5 per cent of the Land/Property value. These account for 90 per cent of their revenues. Other sources of income for ULBs include Fees for bus stands and slaughter houses and some minor local fees/taxes.

1.15 Property Taxes accrue to WASAs in Lahore, Faisalabad, Multan and Rawalpindi in proportion to whether they manage water and sanitation. If they manage both they get the entire 80 per cent, if they manage water only they get 40 per cent (half); and if they manage all the water and half the sewage they get 60 per cent of the total Provincial Property Taxes for the area or three quarters of the distributed amounts.

1.16 Development Authorities realise their income largely from two sources: (i) Commercialisation Fees and (ii) Fines for commercial use of residential zoned property.

1.17 These diffused sources of income and dispersion of expenditure responsibilities across agencies (detailed below in Table I.8) create substantial problems of ownership and management resulting in poor performance. These are discussed further in Section III of this report.

Table: I.8 Punjab Local Bodies Functions and Responsibilities

	Functions	Responsibilities
1.	Curative Health Care	Provinces and ULBs
2.	Land Development	Provinces, ULBs and DAs
3.	Preventitive Health Care	Provinces, ULBs
4.	Primary Education	Provinces, ULBs
5.	Water Supply and Sanitation	Provinces, ULBs, WASAs
6.	Solid Waste Collection	ULBs, WASAs
7.	Street Lighting	ULBs and DAs
8.	Fire Fighting	ULBs and DAs
9.	Parks and Playgrounds	ULBs and DAs
10.	Road Maintenance	Provinces, ULBs and DAs
11.	Building Control	ULBs and DAs

Source: Government of Punjab, Local Government Department.

Authority to Borrow and Structure of Debt

1.18 Borrowing by the Provincial Government is regulated by Article 167 of the Constitution which allows the Provincial Governments to borrow by an Act of the Provincial Assembly. But if these governments have borrowed any amount whatsoever from the Federal Government then they have to obtain its prior permission for any borrowing from any other source. The Punjab floated its last Public Loan in 1994 for Rs.106 million and its total market loan was liability Rs.386 million at the beginning of 1997/1998. The Punjab borrows entirely from the Federal Government either in the form of Cash Development Loans (CDLs) at market rates of interest or obtains foreign (largely concessional loans) through the Federal Government. The total rupee debt outstanding to the Federal Government is Rs.77 billion and foreign exchange debt to the Federal Government is Rs.16 billion. Debt servicing for 1997-98 is estimated at Rs.1.3 billion for rupee loans and Rs.0.1 billion on foreign loans. The entire structure of the debt and the debt service obligations over the next five years have not yet been made available.

1.19 Local Bodies powers to borrow are regulated under Section 133 of the Punjab Local Government Ordinance 1979 which allows them to borrow with the permission of the Provincial Government and also to issue 24 month prommissory notes secured by immovable property or taxes and duties. All Local Bodies and Development Authorities and almost all Statutory Corporations in the Punjab are defaulters to the Federal Government and have not serviced their debt for several years if at all.

Table: I.9 Punjab Government Loans Outstanding to Local Bodies, 1997/98

Rs. Billion

		Principal	**Interest**	**Total**
1.	Local Bodies	0.5	1.0	1.5
2.	Development Authority (including WASAs)	9.4	4.6	14.0
3.	Statutory Corporations	6.4	4.4	10.8

Source: Government of Punjab, White Paper on the Budget, 1997-98.

II. The Punjab's Provincial Finances – Proposed Changes

Objectives

2.1 The objectives of a reform of the Punjab's finances should be to: (i) Ensure that the Punjab's finances are healthy enough to bring about accelerated growth in the Punjab and especially the achievement of a range of socially desirable objectives – particularly the provision of education and health facilities; (ii) Make equitable the tax burden across all sections of society and ask consumers of public services to pay for such services if they have the ability to pay; (iii) Transfer to ULB/RLBs/DAs taxation authority for taxes which are intended for them; and (iv) Eliminate taxes which do not raise revenues and only serve as instruments for such collection authorities to extract rent.

Revenue Structure

2.2 The application of the above principles leads to the conclusion that the structure of provincial finances should be confined to the taxes identified in Table II.1 below. The major tax proposed to be added is a tax on services which should be 2 per cent of the final sale value of all goods sold in the Punjab and should be added to the proposed Federal General Sales Tax (probably 8 per cent) to be implemented from July 1999. It could be immediately introduced in all hotels instead of the present occupancy tax. The taxes proposed to be transferred hundred per cent (including collection) to ULBs/RLBs is the Property Tax and the Tax on Professions and Calling Tax. Taxes proposed to be deleted are: (i) Taxes on Hotels (replaced by the 2 per cent Sales Tax proposed above); (ii) Paddy Husking Tax (Rs.55 lakhs in 1997-98); (iii) Education Cess (Rs.45 lakhs in 1997-98); (iv) Tobacco Vending Fee (Rs.13 lakhs in 1997-98); (v) Real Estate Agent Fee (Rs.50 lakhs in 1997-98); and (vi) More than a dozen other taxes each collecting less than Rs.20 lakhs per annum.

Table: II.1 Proposed Punjab Provincial Tax Base

1. Federally Collected Taxes which are paid by the people of the Punjab Distributed 62.5% : 37.5% between the Federation and the Provinces.	(i)	Income Tax (except on agricultural income)
	(ii)	Customs Duties
	(iii)	Excise Duties (Except on alcohol and Narcotics)
	(iv)	Sales Taxes
	(v)	Capital Value Taxes
2. Provincially Collected Taxes to be paid by the people of the Punjab	(i)	Agricultural Income Tax
	(ii)	Rural Land Transfer Fee (Mutation Fee)
	(iii)	Urban Land Transfer Fee (Stamp Duties)
	(iv)	Excise on alcohol (industrial)
	(v)	Motor Vehicle and Driving Taxes
	(vi)	Electricity Duty
	(vii)	Sale Tax on Services (new)*, including on hotels, restaurants and shops
	(viii)	Cotton Fee

Note: This proposed tax list is exclusive: The proposal is to add only one new tax marked by an asterisk (*) and drop all other taxes from the list of Provincial Taxes.

2.3 The rationalisation and restructuring of the tax structure will lead to a strengthening of the Punjab's financial base. All the taxes which are proposed to be retained or added have historically shown considerable buoyancy. In fact all the above taxes have tax base to GDP coefficients in excess of unity (i..e that tax revenues at existing tax rates will grow at rates faster than the rate of growth of the economy). In addition there is also substantial room in the medium term to expand both the tax rates (i.e. higher taxes) and the tax base (i.e. greater coverage). Thus the Agricultural Income Tax can be moved to assessment of imputed income at Annual Rental Values and taxed at Federal income tax rates. The land transfer fees (both rural and urban) do not presently cover the value of building structures and these can be built into the Land Transfer Taxes. The Motor Vehicle Taxes can be substantially increased for luxury vehicles. The Electricity Duty can be substantially enhanced while the 2 per cent Sale Taxes on Services to be called the General Services Sales Tax can be introduced immediately in the Province starting with hotels as in other countries. As Table II.2 indicates that this would lead to a doubling of the Punjab's tax revenues.

Table: II.2 Financial Implications of Proposed Tax Base and Tax Changes for Provincial Taxes

Rs. Billion

	Tax	Present Base	1997/98 (Budget)	Proposed Base	1997-8 (Impli-cation)
1.	Agricultural Income Tax	Uniform Capacity Tax Rs./acre separate for Irrigated and Non Irrigated and Field Crops and Orchards	1.5	Annual Rental Value	3.0
2.	Land Revenue i.e. Mutation and Other Fees	Value of land	1.3	Value of Land	1.3
3.	Urban Property Transfer-Stamp Duties	Value of Land (Building Societies have own transfer fees)	3.0	Value of land and Building (Building Societies would continue to collect own transfer fees as before)	5.0
4.	Motor Vehicle Related and Driving License Taxes	Engine Capacity	1.1	Value of Vehicle	2.5
5.	Excises on alcohol including industrial alcohol	Sale price for alcohol Nominal for Industrial alcohol	0.5	Sale Price	0.8
6.	Electricity Duty	Unit Charge	1.0	2% of Sale Price including all Federal Taxes and Surcharges	3.0
7.	General Services Sales Tax			2% of Sale Price on all Retail Establish-ments Selling Goods and Services	3.0
8.	(Property Tax)		(0.3)	To be Transferred to ULBs)	(0.0)
9.	Other Taxes		1.3	Other Taxes	(0.0)
		Total:	9.7	Total:	18.6

Revenue Administration

2.4 Revenue administration would be substantially simplified by the adoption of the above changes. The Board of Revenue would be largely unaffected and continue to collect agricultural income tax and 'land revenue' – largely rural land transfer mutation fee – related taxes. It would also collect urban property transfer taxes where applicable but the value of building would now be included according to a set formula. Building Societies and Development Authorities are presently outside the scope of the Board of Revenue and have their own transfer fees. This is only appropriate and should continue. The Excise and Taxation Department would be re-organised and its Property Tax Collection functions transferred to the ULBs and RLBs. It would, however, be given the additional responsibility for the collection of the newly proposed General Services Sales Tax which will be initially on hotels and subsequently added to the Federal Sales Tax when it is introduced.

Expenditure Cost Recovery and Efficiency Gains

2.5 While an effective doubling of provincial taxation proceeds is possible and desirable in the medium term, it must be realised that their ability to finance the Punjab's total current expenditures (currently Rs. 81 billion) will only increase from 13 per cent to 24 per cent. Thus without increasing expenditure cost recovery and realising efficiency gains, no substantial improvement in the overall fiscal situation can be achieved.

2.6 As Table I.3 below indicates overall cost recovery percentages are only 9 per cent for public services directly delivered to consumers excluding general administration and law and order. For Economic Services (Rs. 9 billion in 1997-98) the ratio is 30 per cent; for Social Services (Rs.34 billion in 1997-98) the percentage is 4 per cent, and for Community Services (Rs.4.4 billion in 1997-98) the percentage is 14 per cent.

Table: II.3 Punjab Current Expenditure Cost Recovery Percentages, 1997-98 (Budget)

	Current Expenditure (Rs. Billion)	Receipts from Civil Admn. (Rs. Billion)	Cost Recovery (%)
1. General Administration	10.7	0.2	na
Administration	4.2	0.2	5%
Pensions	6.5		
2. Law and Order	4.4	0.6	14%
3. Community Services	4.4	0.6	14%
Water Supply and Sanitation	0.7		
Others	3.7		
4. Social Services	34.2	1.2	4%
Education	27.6	0.7	3%
Health	5.8	0.3	5%
Others	0.8	0.2	25%
5. Economic Services	9.0	2.7	30%
Irrigation	4.6	1.8	39%
Others	4.4	0.9	20%
Total (excluding Dividend Income and Expenditure, and Pensions)	51.8	5.3	10%
Total (Excluding Gen. Adm and Law and Order, Dividends and Pensions	47.6	4.5	9%

Source: Government of Punjab Budget Documents.

2.7 **General Administration and Law and Order**. The major area here where efficiency and cost recovery factors are directly linked relate to the functioning of the courts. The Judiciary has recently asked for Financial and Administrative Autonomy as is being given to selected Hospitals and Colleges in the Punjab (discussed further below). It is recommended that this be granted. It will lead to more efficient allocation of supporting human resources through ability to 'hire' and 'fire' support staff and services and corresponding efficiency gains in the procurement of material resources (building, infrastructure, equipment, consumables). In addition there will be corresponding increases in Court Fee introduced by the Judiciary itself to meet the costs of litigation and this by increasing transaction costs for the litigants should also help in reducing 'frivolous' or 'non-urgent' litigation and lead to increasing recourse to non-judicial dispute resolution mechanisms which are also desirable in modern civic societies.

2.8 **Economic Services**. The area most amenable to efficiency gains and increased cost recovery is the provision of economic services. This is particularly true of the irrigation sector where cost – recovery factors are 39 per cent of total O & M expenditures of Rs.4.6 billion (1997/98). There is absolutely no justification for this since irrigation water is currently priced at about 20 per cent of alternative tube-well water. These 'rents' are largely expropriated by the Irrigation Department. The creation of Provincial Irrigation Development Authorities (PIDAs) with financial autonomy therefore needs to be expedited. Over all cost-recovery factors for economic services should be in the 80 to 90 per cent range.

2.9 **Education**. The issue of cost recovery in public education in the Punjab which spent Rs.27.6 billion on it in 1997-98 is a sensitive social and political issue. While the cost recovery factor of 3 per cent is low, this is not the relevant issue. The simple fact is that primary education costs the Province of the Punjab Rs.175 per month, secondary education Rs.115 per month and college education Rs.400-450 per month in current expenditure costs alone. If one adds capital costs (depreciation) the costs double. The question that arises is whether the students are getting value for the money that the Government spends on them. Empirical evidence indicates that this is not so. A Survey was conducted last year (1997) by Mr. Shahid Kardar of Systems, Ltd, Lahore involving 6500 Third Grade (Class) students in public schools and private schools charging less than Rs.100 per month. It showed the following results: (i) Public School teachers were paid three times the salaries of private teachers; (ii) A Third Grade level Maths Test administered showed 90 per cent of Private School students passing and only 30 per cent of Public Schools students passing at 33 1/3 per cent Pass Level; and (iii) The same Maths Test administered to the Professors with a 90 per cent Pass Level had 95 per cent of the Private School Teachers passing while only 40 per cent of the Public School Teachers passed. The policy recommendation which follows is obvious. Introduce a Transferable Voucher System at present current cost levels (Rs.175 month for school students, Rs.500 a month for colleges) and allow students to pay with this voucher either at a Public School or College or a Private School or College. While this still meets the subsidy objective it will at least lead to competition, reduce costs and improve efficiency. The reduction in capital expenditures on new educational institutions will be important. However, this will have to be accompanied on the public policy side by making available increased sites for private schools and abolishing the notorious ‘commercialisation’ fee which is the same whether one constructs a school or a commercial plaza in all urban areas of the Punjab. For the public schools to compete, financial and administrative autonomy will have to be delegated downwards to the institution level. At the college level, there is increased room for cost recovery at elite institutions from rich students. These measures alone should lead to cost-recovery factors increasing to about 10 to 15 per cent in education.

2.10 **Health.** Cost recovery in health (currently at 5 per cent) where the Government spends about Rs.6 billion annually is an equally sensitive issue in the Punjab. Here the Punjab Health Department seems to be taking the right policy decisions by giving financial and administrative autonomy to select Teaching Hospitals. If this is extended gradually to all major public hospitals in the Punjab it will not only lead to greater efficiency but increased cost-recovery, particularly if as planned, hospital doctors can see private patients after hospital hours in hospital premises on the payment of appropriate fees to the hospitals. In the medium term such measures should increase cost-recovery ratios in the health sector from 5 per cent presently to about 20 to 30 per cent in the medium term.

2.11 **Community Services**. This is primarily focussed on the road communication network, government network, government buildings and rural water supply and sanitation. Current cost recovery factors are low at 14 per cent. The use of increased tolls on bridges, etc. and increased cost recovery on rural water supply should lead in the medium term to cost-recovery ratios approaching 30 per cent.

Five Year Financial Forecasts – Surplus Available for Development Expenditure

2.12 It is possible to try to give a quantitative picture to the policy measures proposed above by incorporating these into a Five Year Financial Forecast for the Punjab’s Provincial Finances. The proposed policy changes would be phased in over a five year period.

Table: II.4 Punjab Provincial Financial Forecasts, 1997/8 – 2002/3

Rs. Billion
Constant 1997/8 Prices

	No Policy Changes			Proposed Policy Changes	
	1997/8	**2002/3**	**Growth Rate %**	**2002/3**	**Growth Rate %**
Total Revenues	76.9	79.9	0.7%	84.8	2%
Federal Transfers	66.2	66.2	0%	66.2	0%
Provincial Tax Revenue	9.7	12.4	5%	18.6	13.8%
1997/98 Budget Measures	1.0	1.3	5%		
Net Administration Exp.	73.9	85.7	3%	69.3	-1.3%
Adm. Expenditure	51.8			51.8	
(Education)	(27.6)			(27.6)	
(Health)	(5.8)			(5.8)	
Adm. Income	5.3			9.9	
(Education)	(0.7)			(4.1)	
(Health)	(0.3)			(1.5)	
Debt Service	-1.4	-1.8	5%	-1.8	5%
Provincial & Fed Govt.	0.2				
Interest to Fed Govt.	1.2				
Interest Income	0.3	0.4	5%	0.4	5%
Surplus Available for Develop. Expenditure	-1.9	-7.2		14.1	

2.13 **Implications for Development Expenditures**. The ability to own a current account surplus of about Rs. 14 billion ($ 280 billion) once the proposed policy changes are in place would give substantial flexibility to the Development Planners of the Province of the Punjab. The present scarcity of available resources has meant the adoption of a "triage" policy, i.e. projects at early stages of implementation have been halted in order to finish projects at advanced stages of implementation. The dependence on foreign assistance has also necessitated the provision of excessive counter-part funding as discussed in Section I. With greater availablity of own resources for development, the Punjab will be able to complete all its own projects under various phases of implementation and provide counterpart funding for donor aided projects (but hopefully with more equitable cost sharing arrangements), embark on new projects and also be able to borrow prudently from the Federal Government more foreign concessional loans particularly of the type envisaged for the Municipal

Development Fund. Borrowing to set up Funds rather than for specific projects have greater advantage in terms of flexibility of use and the ability to choose the most efficient sub-projects. Given the large volume of development funds tied up in specific programmes (e.g. SAP), it is recommended that future borrowing from foreign donors be restricted to either specific (smaller) projects or for the setting up of Funds, and involvement of foreign donors in 'Province-wide Programmes' should be avoided.

III. The Punjab's Local Body Finances – Proposed Changes

Objectives

3.1 The objectives of reform of local bodies finances are broadly similar to the Provincial level objectives and are intended to: (i) Ensure that the Local Bodies are financially strong and robust so that they can fulfill the responsibilities entrusted to them. These responsibilities for ULBs centre around the development of our urban areas and their maintenance to required standards; (ii) Have equitable distribution of tax burden and cost – recovery for public services particularly water supply and sanitation and maintenance of public roads; (iii) Have Local Bodies achieve control over the administration of taxes linked directly to their responsibilities. This would mean the transfer of 100 per cent of property taxes to the Local Bodies as well as the property tax valuation and collection responsibilities. In addition a new tax on the sale of petroleum products is proposed (1 per cent of price) which would be collected by the petroleum companies through point of sale and transferred to the LBs. This would be earmarked specifically for road maintenance.

3.2 Table III.1 summarises the structure of revenues and expenditures and Table III.2 details the revenue by major source. To recapitulate, the major source of revenues is the Octroi for the ULBs and the Export Tax for the RLBs. The rates for these taxes are fixed on `weight basis' by the Provincial Government (e.g. for wheat at Rs.1.1 per quintal of 100 kgs.) This is followed by the property tax which is collected by the Provincial Government on annual rental value basis and transferred to the ULBs theoretically on population basis after deducting 15 per cent for "collection expenses". In actual fact the property tax is largely expropriated by the WASAs (who take half if they are in the water business and three quarters if they are in the water and sewerage business and who also try to have a separate cost recovery of 100 per cent).

Another tax on property is the transfer of property tax which is set at 5 per cent and collected at the time of property transfer in urban areas (a separate stamp duty of 8 per cent and 1 per cent registration fee is also levied by the Provincial Government, and capital value tax of 5 per cent is levied by the Federal Government). There is also a building tax or fee for new construction. Finally there are the water rates or WASA charges and other fees. An interesting aspect of the finances of the Development Authorities which function alongside the MCs and WASAs is that they get almost 26 per cent of their income from `commercialisation' charges and 42 per cent of their income from "fines" on properties which are contravening their building usage regulations.

Table:III.1 Punjab Local Body Revenues and Expenditures 1997/98 (Budget)

Rs. Billion

	Resources/Revenues			Expenditure			Surplus
	Total	(Tax)	(Non Tax)	Total	(Current)	(Capital)	Deficit (Rs.Bn)
Total ULBs	9.0	4.4	4.6	9.2	7.2	2.0	-0
Total RLBs	4.0	2.4	1.6	5.8	1.5	4.3	-1.8
Total Local Bodies	13.0	6.8	6.2	15.1	8.7	6.3	-2.0
Metropolitan Corporation Lahore	2.6	1.1	1.5	2.4	2.2	0.2	0.2
(LMC)	(1.2)	(0.9)	(0.3)	1.2	(1.0)	(0.2)	(0.0)
(LDA)	(0.5)		(0.5)	0.4	(0.4)	(0.6)*	(0.1)
(WASA)	(0.9)	(0.2)	(0.7)	0.8	(0.8)	(0.7)*	(0.1)
7 Municipal Corporations	3.4	1.5	1.9	3.7	2.8	0.9	0.3
(MCs)	(2.2)	1.4	(0.8)	(2.5)	(1.6)	(0.9)	(0.0)
(DAs)	(0.7)		(0.7)	(0.7)	(0.7)	(0.9)*	(0.0)
(WASAs)	(0.5)	0.1	(0.4)	(0.5)	(0.5)	(0.5)*	(0.0)
78 Municipal Committees	2.5	1.4	1.1	2.6	1.9	0.7	-0.1
140 Town Committees	0.5	0.4	0.1	0.5	0.3	0.2	0.0
34 Zila Councils	4.0	2.4	1.6	5.8	1.5	4.3	-1.8

Source: Compiled from Government of Punjab Local Government Department and other official Budget Documents. Data for Town Committees relates to actuals for 1996-97. Development expenditures marked with (*) denote financing from Provincial ADPs and amount to Rs.2.7 billion. These are not included in the capital expenditure totals in this table. Including these will increase ULBs capital expenditures to Rs.4.7 billion and total local body capital expenditures to Rs.9 billion. Zila Council Development expenditures budgeted for 1997-98 are about Rs.2 Billion more than 1996-97 actuals and these Zila Councils normally run large surpluses on their accounts.

Table: III.2 Punjab Local Body Revenues, 1997/98 (Budget)

Rs. Million

	Total	Octroi (ULBs) Export Tax (RLB)	Pro-perty Tax	Trans-fer Pro-perty Tax	Build-ing Tax	Water Rate	License Fee	Fines	Other
Lahore Metropolitan Corp.	1183	693	95	175	130*	95*	86*		220
Other 7 Metro. Corp.	2709	1237	304	168	129*	95*	85*		1000
78 Munic. Committees	2504	1129	217	208	68	88	245		55
140 Town Committees	510	345	50			28	41		46
Total ULBs	6906	3404	666	551	327	306	447		1321
Lahore Dev. Authority	459						120	195	144
Other Dev. Authorities	700						180*	300*	220
Lahore WASA	863		224			596			43
Other WASAs	500		100			350			50
Total DAs & WASAs	2552		324			946	300	495	457
Total ULBs & Stat Bod.	9458	3404	990	551	327	1252	747	495	1778
34 Zila Councils	4070	2289	1010						771
Total ULBs and RLBs	13528	5693	2000	551	327	1252	747	495	2549

Source: Compiled from Government of the Punjab, Local Development Department and Individual Agency Budget Estimates.

* Numbers marked with asterisks are estimates.

Proposed Changes in Local Government Revenue Structures

3.3 Table III.3 summarises the recommendations of the study. In brief it suggests that: (i) the valuation of properties and collection of property taxes be handed over to the ULBs/RLBs and that the basis of valuation be changed from annual rental value to a value basis and the tax be levied at a very reasonable rate of 0.25 per cent of market value; (ii) the basis of valuation of the new buildings tax also be moved from an arbitrarily determined amount to 0.25 per cent of market value; (iii) water rates be moved so that there is 100 per cent cost recovery of current expenditure plus depreciation; (iv) the professions and callings tax be moved from the Provincial Government to the ULBs/RLBs which should fix the rates and use these proceeds for the welfare of these professions, and (v) that a new tax – the petroleum road users tax-be introduced with a rate of 1 per cent of sales price of petroleum products. This tax would be collected by the petroleum companies and deposited directly into the accounts of the ULBs/RLBs. It's use would be dedicated to the maintenance of urban and rural roads.

Table: III.3 Punjab Local Body Financial Implications of Proposed Tax Changes, 1997/98 (Budget)

Rs. Billion

Tax	Present Base	1997/8 Budget	Proposed Base	1997/98 Implica-tions
Octroi (ULBs)	(Unit Tax Fixed by PG)	3.4	(Unit Tax Fixed by PG)	3.4
Export Taxes (RLBs)	Unit Tax by PG)	2.3	(Unit Tax Fixed by PG)	2.3
Property Tax (ULBs)	Annual Rental Values	1.0	0.25% of Market Value	3.0*
Property Tax (RLBs)	Fixed by RLB	1.0	0.25% of Market Value	3.0*
Transfer of Property (ULBs)	5% of Rated Value	0.6	5% of Rated Value	0.6
Building Tax (ULBs)	Fixed by ULB	0.3	0.25% of Cost	1.0*
Water Rates *(ULBs)	Cost Recovery	1.2	100% of Cost Recovery	2.0*
License Fees (ULBs)	Fixed by ULB	0.8	Fixed by ULB	0.8
Fines (ULBs)	Fixed by DA	0.5	Fixed by DA	0.5
Other, (ULBs)	Fixed by ULB	1.8	Fixed by ULB	1.8
Others (RLBs)	Fixed by RLBs	0.8	Fixed by RLBs	0.8
Transferred from** Provincial Govt.				
Profession & Calling	Fixed by Prov.Govt.	(0.2)	Fixed by ULB/RLB	0.5
New Proposed Tax***				
Petroleum Road User Tax			1% of Sales Price	2.0
	TOTAL ULBs, RLBs	13.1		21.7
	(TOTAL ULBs)	(9.5)		(14.1)
	(TOTAL RLBs)	(4.1)		(7.1)

* Proposed Base Changes in Existing Taxes.

** Transferred from Provincial Government.

*** Proposed New Tax (Revenues of the Petroleum tax are expected to accrue equally to ULBs and RLBs).

Revenue Administration

3.4 It is proposed that the Municipal Corporation as an institution be abolished as an unviable entity (see Section IV), and replaced by Metropolitan Corporations which would now only function as co-ordinating bodies (as in Karachi) and would have within them a number of Municipal Committees (the size of each of which would not exceed 500,000 inhabitants). Also as the Development Authorities develop new areas these would be set up as independent Municipal Committees. Accordingly, the Municipal Committee would now become the prime focus for revenue collection as well as execution of all urban functions except arterial roads and water supply and sewerage (which would be transferred to the Metropolitan Corporation). This would reduce the urban management unit to a manageable size and ensure citizen-local government inter-action. The success of the Cantonment Boards and the Lahore Model Town Society is in great manner due to this size advantage.

3.5 The Municipal Committees (headed by a Mayor) would collect all property taxes including transfer of property taxes and building taxes, license fee and all other minor taxes and fees. The Property Tax staff of the Excise and Taxation Department would be transferred to the ULBs/RLBs (they would, however, retain their status as Provincial Government Employees). These Municipal Committees would have responsibilities for all municipal functions except arterial roads and WASAs (which will lie with the Metropolitan Corporations) and building control (which will lie with the DAs).

3.6 The Metropolitan Corporations (headed by a Lord Mayor) would have under it the WASAs which would function as independent financial entities as is the case with them under the DAs. They would also have responsibility for the maintenance of arterial roads. In addition they will be given the responsibility of preparing and funding special projects for the upgradation of poor areas in their constituent municipalities. To finance these activities they would have control over Octroi receipts which they should collect themselves or auction depending upon their experience with collections.

3.7 The Development Authorities should have responsibility for the development of new housing areas constructed with public funds and their number should be expanded to cover all major towns and municipal committees. While the building control authority should be retained with them it is proposed that their 'dependence' on 'fines' and 'commercialisation fees' be stopped by placing these receipts in a Development Fund for the Authority which should only be used for Development activities and not finance their current budget as presently. They should be financed directly from the Provincial Budget and be placed under the financial control of the Local Government Department.

3.8 As has been pointed out in the first section, the fact that Local Government Service is not attractive has meant that ULB/RLB employees are demoralised. This is particularly so with regard to pensions where Local Government teachers in primary schools are deserting their place of work in droves and there is tremendous pressure to hand over the Primary Schools to the Education Department. It is proposed that all Primary Schools be retained by the Municipal Committees and that all employees of ULB/RLBs have equal employment conditions to Provincial Government employees including the proposed new Pension Scheme.

Expenditure Cost Recovery and Efficiency Gains

3.9 Local Government Institutions world-wide generally try to meet cost recovery targets for direct consumer services rendered—mostly water supply, sewerage and sanitation. For other services (primary schools, health, roads, lighting, parks etc) they generally balance aggregate income against aggregate expenditure (both current and development),. The Punjab Government's Local Government Expenditures on a functional basis are available only for a sample of the Municipal and Town Committees and are reported in Table III.4.

3.10 Water supply and sewerage cost recovery rates on current expenditures for the WASAs range between 80-90 per cent (with the Lahore WASA at 88 per cent and the other WASAs at 80 per cent). However, the Municipal Committees which run their own water supply and sewerage schemes appear to be recovering current costs. Cost-recovery rates for the town committees are poor and average 44 per cent for the 10 town samples. Visits to the sample towns studied indicated that water-rates can be doubled or tripled and in towns where this has been done there has been no significant adverse citizen reaction. It is therefore proposed that cost recovery rates for water supply and sewerage be moved upto 100 per cent including depreciation.

3.11 The best way to get efficiency in local urban services is to involve the citizens and let them deal with local bodies of a size where they can get some attention and satisfaction by virtue of the fact that they are tax payers and voters. Smaller local sized units would also mean greater citizen involvement in local schools, hospitals, roads, lighting and parks. This is the reason for the strong Municipal Committee Level Government proposal for all urban areas.

Table: III.4 Punjab Local Government Expenditure Patterns, 1997/8 (Budget)

				Rs. Million
	Municipal Committees		**Town Committees**	
	10 M.Committee Sample	**%**	**10 Town Sample**	**%**
Revenue Expenditure	285	100	66	100
General Administration	33	12	20	30
Primary Education	71	25	-	-
Sanitation	49	17	15	23
Medical Care	5	2	3	5
Water Supply & Drainage	43	15	8	12
Roads & Street Lights	69	24	5	8
Others	15	5	15	22
Development Expenditure	133	100	24	100
Primary Education	6	5	-	-
Sanitation	14	11	2	8
Medical Care	3	2	-	-
Water Supply & Drainage	23	17	5	21
Roads & Street Lights	41	30	9	38
Others	46	35	8	33

Source: Lahore School of Economics Survey-Sample Municipal Committee and Town Committee Budgets.

Table: III.5 Punjab: Water Supply and Sewerage Cost Recovery Percentages 1997/8

	%
Lahore WASA	88%
Other WASAs	80%
Municipal Committees (all)	117%

Town Committees (sample of 10)	44%

Note: Cost Recovery data above refer to current income and expenditures and exclude depreciation.

Source: Government of Punjab , Local Govt. Department and Agency Budgets

Five Year Financial Forecasts – Surplus Available for Development Expenditures

3.12 A quantitative forecast on the basis of the financial and cost recovery proposals for ULBs/RLBs made in this Section is summarised in Table III.6 below.

Table: III.6 Punjab Local Government Financial Forecasts 1997/8 – 2002/3

Rs. Billion, Constant 1997/8 Prices

	No Policy Changes			With Proposed Policy Changes	
	1997/8	**2002/3**	**Growth Rate**	**2002/3**	**Growth Rate**
Total Revenues	13.6	16.6	5%	21.2	9.3%
1. ULBs	9.5	11.6	5%	14.1	8.2%
2. RLBs	4.1	5.0	5%	7.1	11.6%
Net Administrative Expenditure	8.7	12.7	10%	10.8	4.4%
1. ULBs All Services except Water Supply & Sewerage	5.9	8.6	10%	8.6	10%
2. ULBs Water Supply & Sewerage	1.3	1.9	10%	0.0	
3. RLBs All Services	1.5	2.2	10%	2.2	10%
Surplus Available for Dev. Exp.	4.9	3.9		10.4	
1. ULBs	2.3	1.1		5.5	
2. RLBs	2.6	2.8		4.9	

Implications for Development Expenditures

3.13 The availability of funds for development expenditure will be vastly improved by the proposed policy measures. It is estimated that when these fiscal reforms are implemented the ULBs would have annual surplus available for development of about Rs.8 billion ($ 180 million) per annum while RLBs would have development surplus of about Rs.6 billion ($ 130 million) available annually and these surpluses would be maintainable over the next five years.

3.14 The availability of these surpluses should allow much greater flexibility to ULBs/RLBs to carry out development activities in response to their citizen's requirements. It will also enable the ULBs/RLBs to be credit – worthy to borrow from the Provincial Government and other sources, particularly the proposed Municipal Development Fund.

IV. Governance Issues – Proposed Provincial and Local Body Responsibilities

Background and Issues

4.1 There are two major sets of interlocking issues of governance regarding the Provincial -Local Body relationship. The first relates to the division of fiscal and administrative responsibility between the Provincial and Local Governments and the structure of such Local Governments. The second relates to the management within these Local Governments of various responsibilities such as education, health, sanitation and overall development. The first of these arise largely from the fact that the Pakistan Constitution while recognising the need for 'Local Government' does not spell out the division of responsibilities between the Provincial and Local Governments; nor does it lay down the political, administrative structures relating thereto. In Pakistan, and in the Punjab, the current Local Body structures are primarily established by the Local Government Ordinance 1979 promulgated by the Martial Law Government of the then President General Zia-ul-Haq which modified previous Local Government Legislation. This Ordinance currently governing present local government structures creates and spells out the areas of responsibilities of the four tiers of the ULBs – Town Committees (upto 25,000 inhabitants), Municipal Committees (25,000-5,00,000 inhabitants); Municipal Corporations (5,00,000 – 2,500,000 in habitants) and Metropolitan Corporations (above 2,500,000 inhabitants). Punjab presently has one Metropolitan Corporation (Lahore); seven Municipal Corporations (Faisalabad, Gujranwala, Multan, Rawalpindi, Sialkot, Sahiwal and Sargodha), seventy eight Municipal Committees and 140 Town Committees. The law also specifies the manner in which the rural areas of the administrative districts – the Zilas (of which there are 34 in the Punjab) – come under the preview of the Zila Councils. This Local Government Ordinance 1979 was attempted to be amended during the last government but these amendments were not ratified by the Provincial Assembly. However, last year the present Provincial Government amended the law to allow the creation of mayoral divisions within metropolitan corporations of the Punjab and was an extension of the successful adoption of a system of 'district municipal committees' within the Metropolitan Corporation of Karachi.

4.2 Within the local governments there are a multiplicity of institutions at work. In the ULBs the larger cities have Municipal Bodies (Metropolitan and Municipal Corporations), which run existing infrastructure, Development Authorities which develop new infrastructure and urban areas, and Water and Sanitation Agencies (WASAs) which run these facilities. The smaller cities and towns perform all these functions themselves. Within all the ULBs Provincial Government Departments carry on administrative, taxation and development activities. However, it is in the Zila Council areas that Provincial Government Departments (like the Public Health and Engineering Department responsible for water supply and pollution controls) carry out the dominant functions. The rationalisation of responsibilities between various tiers of Government and between various agencies needs to be addressed.

4.3 A complicating factor regarding governance in urban local bodies relates to the fact that the cities and town have seen a doubling of their population every ten years, particularly in the last three decades as the rural populations (mainly the poor) have streamed into the cities. These new urbanites carry political clout in their voting power and in fact now exercise almost all the crucial swing votes in urban elections, not only in the outlying areas but also in areas under the control of the urban body itself. These new urbanities have different objectives and priorities relating largely to the development of the *Katchi Abadies* and poorer areas which the present system is very poorly positioned to deliver.

Assessment of Existing Institutions

4.4 The existing institutions for the big cities function in a complex manner. The civil jurisdictions lie with the (soon to be) ULBs. The responsibilities for development of new areas is with Development Authorities of which the Chairman is the Chief Minister for Lahore and the Minister of Local Government is the Chairman for the rest. However, once the areas are developed these are passed on to the ULBs excepting the power of building control which remains with the DAs (this is their biggest source of revenue and 'political' power). The water supply and sewerage functions are increasingly with the WASAs which expropriate 50 per cent to 75 per cent of distributed property tax revenues in addition to cost recovery to finance these activities.

4.5 An assessment of performance (both through consumer and control body interviews and by looking at quantitative data) indicates that the Water Supply and Sewerage functions by the WASAs are carried out very poorly. This compares with the comparatively much better (but still poor) solid waste collection performance undertaken directly by the ULBs. The difference in performance relates directly to the fact that WASAs are not accountable – being placed organisationally under the DAs but only nominally – being financially and administratively independent.

4.6 The Development Authorities are by and large doing a good job in developing new areas although, with the increased cost of land and development by private building societies, their scope of activities is relatively restricted. However, their attention is now being focussed instead on new development on building control which has come under intense pressure as commercial activities mount. Both for financial reasons (42 per cent of income of LDA comes from fines on violation of building regulations and 26 per cent from commercialisation) as well as for administrative reasons (the sheer volume of work and the political power and corresponding 'rents' by these policing activities) the DAs have now been reduced largely to 'commercialisation agencies'.

4.7 The ULBs/RLBs themselves also face immense problems of governance. Since these are political bodies, major sources of revenues and expenditure are generally 'sold' to politically influential individuals or benefit the elected (and when these are administrators – the non-elected) managers of the cities, towns and rural bodies. While there are many honest politicians and administrators their ability to serve or be elected in the complex urban environment (with more than 50 per cent of the population being the new poor urbanites as was discussed earlier) is increasingly in doubt. This is particularly so because the smaller unit – the Ward of the ULBs have no financial and administrative power. In the Municipal Corporations it is common practice that at the first meeting of the Corporation the Mayor has a resolution passed that delegates to him all the powers of the elected body. After this first meeting no other meeting is called and all important decisions regarding octrois, development expenditure, etc. are taken by him and a few powerful political associates. When there are no elected bodies the situation is even simpler. Normally a non-civil servant (generally a political appointee representing the choice of the party or individual in power) is appointed to run the Municipality with all the powers concentrated in his person.

The Position of the Citizens and the Taxpayers.

4.8 In this situation the urban citizen and particular the property tax payer is reduced to the role of a helpless onlooker who gets sub-standard or no service for civil amenities which other societies take for granted. This is particularly hurtful to the property tax payer who pays very high taxes and gets nothing in return. In other societies (e.g. Canada) this problem has been addressed by allowing only property tax-payers to vote in local body elections. In the Pakistan context, this proposal would be too extreme (there are only 160,000 property tax payers amongst the more than one million voters in Lahore) and would not meet the social and political requirements of the present situation where the situation calls for empowerment of all sections of society.

Policy Recommedations

4.9 It is recommended that the Pakistan Constitution be amended to provide for the formal third tier (after the Federal and Provincial) of Local Government and specifying its areas of revenue raising and administrative responsibilities. The Indian Constitution which also suffered from not having such a defined structure of Local Government has been recently amended to provide for such a tier. The Punjab Government should examine the Indian Amendment and after improving on it in the light of the Punjab's own experience, pass it on to the Federal Government for discussion between the Federation and all the Provinces and, hopefully, subsequent enactment.

4.10 In the meantime, a Provincial Finance Commission should be established. It should be chaired by the Chief Minister and have representatives of both the Province and Local Bodies. It should meet every five years (like the National Finance Commission) and after reviewing the financial position of the Province and the Local Bodies, allocate both taxes and transfers (including borrowing and grants) between them in the light of expenditure responsibilities.

4.11 The tier of Municipal Corporation should be abolished to bridge the gap between the citizen and the city government. All cities should have one or more Municipal Committees (Municipalities) of sizes of less than 5,00,000 inhabitants. These Municipal Committees should retain all property taxes and all other local taxes and be responsible for all civil amenities except water supply and sewerage (but including solid waste disposal).

4.12 Towns with more than one Municipal Committee should become Metropolitan Corporations. The Metropolitan Corporation would collect Octrois which would be its sole source of income (in smaller cities, i.e. less than 5,00,000, the sole Municipal Committee or Town committee would collect the Octroi). It should be responsible for all arterial infrastructure particularly major roads and water supply and sewerage. All existing and potential WASAs should be transferred to these Metropolitan Corporations. The recent amendments by the present Provincial Government creating a Lord Mayor and allowing for the Metropolitan Corporation to be split into Municipal Areas reflects this aspiration. By abolishing the tier of the Municipal Committee the present legislation may still serve, otherwise it should be amended.

4.13 The Development Authorities are a very useful instrument of development policy and should be introduced in all the big cities. They should perform only development functions. WASAs should move to the Metropolitan bodies as proposed above immediately. In addition they should transfer all new developed areas to a newly created Municipal Committee for that area so that the inhabitants of the newly developed area can function as a civic society. Finally, in order to get rid of their `commercialisation culture', their administrative budgets should not be allowed to use 'fines' on violation of commercialisation rules or 'commercialisation fees' as sources of revenue for administrative expenditure. These should accrue directly to a Special Development Fund for the Development Authority and should be used only for the development of new areas. The administrative cost of the Development Authority should be met from the Provincial Budget and the Local Government Department should be the financial authority for such Development Authorities.

V. Conclusions

5.1 The credit worthiness of the Punjab Government (subject to its undertaking the proposed fiscal reform measures) has been established. It is potentially in a position to generate financial surpluses for development (and the servicing of borrowing) of about Rs.15 billion ($ 330 million) annually, constant 1997/8 prices, from the time when the fiscal reforms are implemented. This will enable it to be in a position to take on and service the external debt of about $ 200 million annually on concessional IDA terms. The exact sequencing of the additional debt and debt service will depend on the pace at which it can undertake the proposed fiscal reforms.

5.2 Similarly, the proposed fiscal reform package for the Punjab ULBs should generate an additional Rs. 5.5 billion ($ 110 million) annually. This will enable them to take on external debt of about Rs. 50 million annually on concessional IDA terms from the time the proposed reforms are in place. The pace of the proposed local body finance reform will, as in the case of the provincial level finances, also determine the exact pace at which these ULBs can take on debt.