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Fiscal Relations in Pakistan: The
Property Tax Dimension**

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The Challenge of Intergovernmental Fiscal Relations in Pakistan: The Property Tax Dimension¹

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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 (as the capital city), Kashmir and the Federally Administered Northern Areas. A substantial amount of variation exists among the provinces in terms of population, income, and economic activity. For example, the population of Balochistan is about 10 million with 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 agriculture and general diversity of the economic base. Sindh is the financial and commerce capital of the country, Punjab has some of the most productive agriculture, Balochistan has natural resources including oil but is lagging in infrastructure development, and investment in NWFP lags due to fall out from on-going strife in Afghanistan.

All of this leads to significant differences among Provinces in per capita income. For instance, per capita GDP in Punjab is US\$ 645 compared to US\$457 in NWFP².

The central issue of provincial finance in Pakistan is the significant vertical imbalance in the intergovernmental fiscal system. The four provincial governments account for 35 percent of all government expenditures but only 7 percent of all taxes³. 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). Is this possible?

In this paper, we report the current state of provincial revenue raising and analyze the potential for increased revenue mobilization. In the sections below, we document the current

² The current dollar conversion rate of US\$ 1 = Rs.75 has been used throughout the paper.

³ Calculated from Table 4.2, Statistical Appendix in Government of Pakistan, 2007.

situation regarding local revenue capacity and mobilization in Pakistan using case studies of Punjab and North-West Frontier Province. We provide an analysis of the difficulties of decentralization in Pakistan, but also the potential for moving the decentralization efforts forward by providing a closer match between expenditure responsibilities and revenue capacity. The contribution here, we think, is in showing how much revenue potential is to be realized with structural and administrative reforms that are in step with international practice. We illustrate this with the property tax.

The Intergovernmental Fiscal Problem

The constraints to an increase in revenue mobilization by provincial governments are formidable. They 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. There is also some murkiness in revenue assignments between levels of government, and some important constitutional limitations on the choices that provincial governments might make. 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 the government misses out on one of the most important advantages of fiscal decentralization – taxpayers holding their elected provincial officials accountable for the quality of services delivered.

Another dimension of fiscal imbalance is the mismatch between the weak tax administration skills of the provincial governments and the hard-to-collect taxes that they have been assigned to them. The latter include taxes on agriculture, professions, property and the consumption of services. The result of this mismatch (and politics) is that the level of taxes is equivalent to approximately 0.2 percent of regional GDP in each province by comparison with about 10 percent at the federal level.

The politics of decentralization are especially problematic in Pakistan. There is insurgency and political turmoil which sometimes point to a “go slow” approach to decentralization. But, Pakistan is poor and public services levels are deficient. The population is diverse in what they want from government. All of this has led to a demand for more decentralization. Former President Musharraf argued for tight control over the country in the name of fighting insurgents and terrorists, but also called for significant decentralization via a push for devolution of expenditure responsibilities and renewed call for local elections (Akramov et al 2008). The new provincial governments after coming to power in 2008 have cast doubts over the mandates of the local governments. To some extent this hostility arises out of the incomplete decentralization from center to the provinces. 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. Inadequate fiscal decentralization and administrative controls over the expenditure authority of local governments is one reason behind their service delivery performance which has come under criticism.

The economic, administrative and political constraints that have kept provincial tax revenues so low in Pakistan will continue to inhibit subnational government revenue growth, i.e., decentralization on the revenue side will be a hard sell. A summary of the findings of this paper are as follows:

- 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.

- 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 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.

The Setting for Intergovernmental Reform

The Constitution in Pakistan makes provision for provincial and local elections and affords subnational governments various expenditure responsibilities and revenue instruments. However, the revenue assignments for the provinces are limited to revenues that are less productive than the central government’s income and consumption taxes. 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 2008 for details). In this paper, we focus on the provincial level of government.

There are wide variations in the level of economic development among the provinces, which 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. Per capita GDP in Punjab is reported to be 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), the taxable capacity of NWFP is well below that of Punjab.

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, 2005a). 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 revenue raising 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. 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. Some analysts estimate that there is not much difference between the two provinces in the percent of population living below the poverty line.⁴ 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

⁴ World Bank estimates (2005), however, show the poverty rate in Punjab to be much below that in NWFP, and the backlog of public services to be much less.

area and four times as many people to serve.

What might be concluded from this 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.

The provinces in Pakistan also face the pressure of public debt. Both Punjab and NWFP face a structural fiscal deficit, 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 of 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.

A fiscal profile of the provinces is presented in Table 1. 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 (Table 1). 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.

⁵ Since 1974, equal per capita shares has been the basis for distributing revenues among provinces.

All four provinces receive most of their revenues from central government transfers⁶, 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 in Table 1 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, note from Table 1 that 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 This finding must be qualified because some transfers have been classified as non tax revenues so revenue mobilization is overstated for both provinces in Table 1. The proper conclusion to draw here is that neither province extends itself very much to mobilize resources from its own tax bases. Provincial revenue mobilization in general has been weak and has steadily worsened (World Bank 2004, p. 26).

Revenues and Revenue Structure

The structure of taxes is summarized for Punjab and NWFP provincial governments in Table 2. Comparable data on local government taxes are not available. It should be kept in mind that in both provinces, total own source revenues are so small that they play only a minor

⁶ Asian Development Bank, et. at. (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 2006-07 (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, page 37).

role in financing. 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 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 2 account for only 14 percent of the 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 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. In the analysis presented below, we look for the determinants of this underperformance using the property tax as a case study.

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. 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 system⁹. 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.

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. At present, the provincial pool for the NFC award is 41.5 percent of federal taxes and is scheduled to increase by 1 percent per year up to 46.25 percent by 2011. The distribution of this 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. 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. 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

⁹ 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. Out of these the first three are decided by the NFC.

the new award, in 2004-2005, because of the increased vertical share for provincial governments. 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) collections. The distribution of this pool is determined by baseline octroi and zilla tax collections (the two taxes were abolished in 1998 and the “baseline collection” refers to the collections in the final year). 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.

Urban Immovable Property Tax (UIPT)

The property tax is designated a local government tax and the city districts and TMAs have the authority to set the rate¹⁰. Assessment and collection can be at the district level. In terms of the actual practice however, the UIPT is a provincial level tax subject to revenue sharing with the city districts and TMAs in both provinces.

The UIPT is an old tax in Pakistan, but it has never generated significant amounts of revenue. 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.¹¹ 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

¹⁰ TMAs have the legal authority to set the rate in ordinary districts. The role of city districts at the proposal stage.

¹¹ Ghaus-Pasha et. al. (1998), p.11

proposed for 1996. With the new medium term policy framework, and the overall decentralization initiative in Pakistan, there is an imperative to upgrade the property tax to a significant revenue source (Cyan, 2007).

In both provinces, 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 question we raise here is how might this modest performance be improved.

Rates and Base

In, Punjab, the property tax is levied on a base of annual rental value at a flat rate of 20 percent on properties with an annual value of Rs 20,000 or less (US\$ 267). If annual rental value is greater than Rs 20,000, a flat rate of 25 percent is applied. The annual rental value is notionally calculated on the basis of the area of the plot in square yards and built up area in square feet¹². The UIPT in NWFP is an area-based system of taxation. The base of the tax in NWFP is the sum of land area in square yards and covered area in square feet. The implication of this method of determining the base is that more intensively used land will be taxed at a heavier rate than less intensively used land. In practice, there is only a very subtle (but very important) difference between the area-based system as practiced in NWFP and the rental value system as practiced in Punjab.

In both provinces, there are exemptions based on the size of the property, depreciation allowances, owner occupancy, and exemptions for government properties.

Valuation

Valuation is the responsibility of the provincial excise tax department (ETD) and the

¹² The actual rental value determination was given up in favor of this system to address wide ranging complaints against tax inspectors making discretionary assessments.

devolved district excise tax departments. In Punjab, a valuation table is developed using a combination of market data and expert judgment about rental values. This table serves as the basis for valuing all properties in the province.¹³ The methods employed to arrive at taxable value are somewhat similar to those used in other low income countries that follow the area method.

In NWFP, the tax rate and base are combined into one coefficient, of which there are eight in the province. The size of these coefficients depends on the location of the property and its use. The province is divided into four location classes based on the desirability of the location, availability of amenities, etc. The determination of location class is done by field inspectors who possess knowledge of the areas, and this determination is reviewed and eventually validated by the provincial government. One might characterize the approach as being based more on expert judgment than on systematic analysis. The exercise of classification of each property according to location and use was carried out in 2001 and has not changed since. Khan (2004) points out that a formal property survey was carried out only in Peshawar.

The actual tax rates (location values) are notional, but appear to be an attempt to reflect both relative values and a policy choice that commercial land use should pay more property tax than residential land use.

Intergovernmental Dimensions

As it currently operates, Punjab's urban immovable property tax is an intergovernmental transfer rather than a local government tax. 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:

¹³ This is the approach taken in most developing and transition countries where reliable data on market rents or property sales values are not available.

Province	15 percent
TMA's	85 percent

In NWFP property tax revenues are allocated 85 percent to the TMA's on a basis of origin of collections, and 15 percent is retained by the provincial government.

According to the Local Government Ordinance (2001), the property tax is to be fully devolved to the local governments. In theory, the TMA's have the authority to set the tax rate and to administer the tax. In fact, neither the province nor the TMA's 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.

Issues and Problems

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.

In Punjab, the legal basis for property taxation is annual rental value. Many observers take the position that this tax base is not appropriate for Pakistan. One reason is that most residential properties in urban Pakistan are owner-occupied vs. rented, so the capital value of a premise would be a more compatible base. Advocates argue that it would be more acceptable to taxpayers. Another issue is that vacant properties are not taxable under the present system because they "have no rental value". A capital value base presumably would allow taxation of vacant properties. Finally, the valuation of industrial properties is uncertain under a rental value system, because a capitalization rate must be assumed. Under a capital value system, a reconstruction cost method of assessment, or even a book value approach, could be used. These

latter two problems are longstanding criticisms of the annual value system that might be remedied by adopting a capital value base for property taxation. There are, however, problems with the capital value base. Most of these have to do with valuation.

The evidence available suggests that properties that are in the tax base in both provinces are dramatically under-assessed. Unfortunately, there are no independent estimates of property values or rental values, so it is not possible to get a fix on the true tax base. Moreover, the governments do not carry out an assessment-sales ratio study that would allow calculation of the degree of underassessment, so it is not possible to make an objective estimate of the revenue cost of underassessment. Educated guesses, anecdotal evidence and some available data however, suggest that the degree of underassessment is quite large.

We might also look for evidence of undervaluation using data related to the sales of property. Declared values for land transfers are notorious for being understated in developing countries, and the degree of understatement in Punjab might tell us something about the degree of undervaluation in the case of the urban property tax. An evaluation of the stamp duty in Punjab involved comparison of the taxed value with “indicative market value” in selected areas in Lahore district (Government of Punjab, 2007c). The results show assessment ratios (assessed value to market value) that ranged from 55 to 79 percent. This evidence is based on stamp duty assessments, and it is not based on a scientific survey, so it is only an indication of the degree of undervaluation for the urban property tax.

In both provinces, the legal base for taxation is dramatically narrowed by exemptions and other preferential treatments. The government does not keep a record of the revenue cost of the exemptions, but an impressionistic judgment by excise tax officers is that the cost is equivalent to about 20 percent or more of tax collections.

In Punjab, the UIPT is structured to fall more heavily on improvements than on land. This is built into the system because the same tax rate is applied to square yards of land and square feet of covered area. This feature of the tax structure might be seen as discouraging efficient land use and encouraging a less intensive use of land. This disincentive to a more efficient use of land is reinforced by the full exemption of vacant properties. At current low levels of property tax, these disincentives to more intensive land use may not matter very much, but under an upgraded property tax they would be of greater importance.

In terms of administration, property tax records are manually recorded in both provinces and there is no automation in billing or in tracking collection rates. This makes an efficient collection process very costly and likely dampens the collection rate. Payment records are said to be out of date, and the matching of property tax payment with motor vehicle registration and other third party information cannot be done.

Reform Options

Two basic, underlying issues must be faced in property tax reform in Pakistan from the perspective of fiscal decentralization. The first is whether this tax will become an important source of financing for government services. If a significantly higher level of revenue is to be reached, a comprehensive reform of the property tax is called for. The base and rate structure, the administration, and the intergovernmental arrangement all should be changed (The Urban Unit 2006). Coordination of these changes and a phasing in plan will necessarily be part of the reform program. Administrative issues alone would likely require an overhaul of the law. Whether the needed fixes are politically feasible, and whether there is any incentive to adopt them, are the more important issues.

The second underlying issue is whether the tax will 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.

Comprehensive Structural Reform: UIPT

The UIPT is not yielding very much revenue, and it is failing in its non-fiscal objectives. This suggests that it could be a good time for both provinces to overhaul the entire structure of the tax. 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 and demonstrate how it might be evaluated. 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 is could be set at Rs 3.6 billion¹⁴. This would bring both provinces to the international average, but it also would imply a dramatic increase in property tax revenues. We would propose that this increase be obtained from four measures, as summarized in Tables 3a and 3b. The following actions might be taken.

First, bring in the new valuation roll in Punjab, which assesses market rental value and puts the correct relative values on properties. In NWFP, put in place a formal structure that calls for periodic revaluation and begin construction of a new valuation roll.

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 low valued properties. This would include eliminating the 5 marla exemption¹⁵ and the preferential treatment of owner occupiers. It also would require that provincial government properties make a payment in lieu of property tax for services received.

¹⁴ These amounts are equivalent to \$US 333million and \$US 48 million, respectively.

¹⁵ All owner occupied properties with areas less than 1360 square feet (5 marla) are exempt from property tax. In Punjab, 66 percent of owner occupied properties fall into this class.

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 3a), 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 3b).

Indexation would bring in another Rs 827 million (US\$ 11 million) in Punjab and Rs 78 million (US\$ 1 million) in NWFP, leaving gaps of Rs 11.2 billion (US\$ 149 million) and Rs 2.1 billion (US\$ 16 million), respectively. These gaps might be filled by increasing the nominal tax rate. We also propose that a single tax rate be adopted in Punjab. There is no justification for an additional higher rate, because superior amenities, etc. have already been 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 the number of square feet of covered area plus the number of square feet of land area. 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 (Government of Punjab, 2007a) that will move it toward the assignment of property tax policy and administration to local governments. In the interim it should implement the legal tax sharing arrangement with local governments. There are strong arguments to make the property tax 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

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.

There are also disadvantages to adopting this intergovernmental approach, and concerns that might be raised about the potential success of the medium term framework. First, 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? Second, 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 disadvantages.

As a first step, the provincial governments could move toward a redefinition of certain of their 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 local government cash flow planning during the fiscal year.

- No intercept from property taxes should be allowed for 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 has recently been discontinued.

Because of the deficiency in local public services, a reasonable goal of government might be to increase the effective rate of property taxation. But local governments have not been willing to use the rate setting powers that they now have. The alternative, transfers from the province, are “easier” money in that they have little political cost to local politicians. This is the mindset that must be broken if decentralization is to succeed. One way to do this is to provide a significant incentive for local governments to increase the level of property taxation. The province might attach a tax effort feature to its grant program to try and coax this increased property tax effort out of the local governments.

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).

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 the central government and there is little incentive for them to expand their revenue mobilization. If decentralization is important to the country as a means to increase the value that citizens place on public services, a number of steps need to be taken. Our focus here is on the revenue side, but it is by now obvious in all cases of decentralization that the necessary condition for successful reform of revenue assignments is that expenditure assignment must be clear, and reasonable. The legal boundaries in terms of revenue and expenditure must be clearly stated and enforced. Our contribution in this paper is to show how the elements of one reform – in this case the property tax – might be brought together and evaluated.

This paper focused on one specific alternative—expanding the UIPT, but there are other needed reforms to put decentralization on track for success.

The design of the tax reform to support decentralization should center on four elements:

- The first is to determine appropriate targets for provincial tax revenues, i.e., by how much should revenues be increased?
- The second is to identify structural reforms that would make the provincial tax system operate in a more efficient way, would hit these revenue targets, and would further the decentralization goals that the government has adopted.
- The third is to put appropriate incentives in place to encourage provinces to implement tax reforms that will generate increased revenues.
- The fourth is to lay out the elements of a feasible implementation program for these structural reforms.

Perhaps most important of all considerations about the proper reform package is its political acceptability. Special treatments are rarely given up without a fight, and the more

influential are those who have enjoyed the preference, the tougher will be the fight. In addition, the reform package should include a net revenue increase of significant amount. Taxpayers usually are resistant to tax increases, even when account is taken of the possible improvement in public services. Tax reform coupled with tax increase will require a strong political will on the part of the leadership in both provinces.

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

Punjab finances only 9 percent of its expenditures from its own taxes, and NWFP finances only 3 percent. The remainder of revenues come from intergovernmental transfers and from loans. This state of affairs raises two problems. First, it weakens the link between the expenditure benefits enjoyed by local residents and the burden associated with paying for those expenditures. The result is a weak accountability of provincial/local officials to their voting constituency. Second, provincial and local governments have a comparative advantage in raising certain types of revenue. Their failure to aggressively collect these revenues imposes a “cost” in

terms of an overall lower level of revenue mobilization in the country. The consequence is a lower level of public services than otherwise would be the case.

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

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

To address the problem of incentives for increasing taxes, the federal government may want to reconsider the structure of transfers by including a reward for increased revenue mobilization in the distribution formula.

In Punjab and NWFP, the principal tax collecting agencies are the Board of Revenue (BOR) and the Excise and Taxation Department. The BOR is mainly concerned with taxes on rural lands. Specifically, it assesses and collects stamp duty, mutation fee, registration fee, land revenue and agriculture income tax. In the case of stamp duty and registration fee, BOR is also responsible for collections in urban areas. The ETD collects UIPT, motor vehicle taxes,

professions tax, provincial excise duty and some smaller provincial taxes. In the case of the sales tax on services and electricity duty, the finance departments of the federal and provincial governments, respectively, play a primary role. In all of this work, there appears to be little collaboration between ETD and BOR, or between the federal and provincial government.

This state of affairs is counterproductive to effective policy and collection. The kind of problems that arise might be illustrated with three examples. First, the valuation tables for the property transfer taxes and the UIPT are separately done, even though both taxes rely on much the same information to establish a base of taxation. Increasingly, the two agencies are said to be coordinating at the field level to ensure reliability of information, but still their records are not aligned with each other. Second, the record keeping function can fall between the two agencies. In areas which are newly urbanized, the local official in charge (the patwari) does not update his record to reflect the development of housing units on erstwhile agriculture land. If the area is not notified as urban, the ETD does not cover it in their surveys nor do they pick it up on their valuation registers. The fact that BOR is primarily concerned with rural lands means that its record keeping does not extend into urban areas. The systems and expertise of the BOR is not used for urban areas. The result is that nearly all urban areas lack a systematic record of property titles. Third, there is no way to cross check for compliance problems, either within or between agencies. For example, motor vehicle registrations cannot be cross checked against land ownerships records (which could aid compliance and would be a desirable feature of a motor vehicle registration system that had a residence requirement).

The present organizational structure is recognized by many observers as sub-optimal. The Government of Punjab has discussed creating a unified tax authority. A Provincial Board of Revenue might be set up with all provincial tax assessment and collection functions assigned to

it. (Property titling may or may not be included in its functions). A joint BOR, organized according to tax functions would give the provinces a better functional capacity to raise the revenues assigned to them. It should be equipped with computerized systems of tax base documentation, qualified tax administrators and adequate resources to manage collection. There are numerous advantages to be had from a unified tax administration at the provincial level.

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Table 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 2002-03 from NWFP Economic Report 2005; of Punjab are for 2002-03 from Table 1.5 Punjab Economic Report 2005

^d The poverty data are for year 2002 from Sohail J. Malik (2004), p. 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

Table 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.

Table 3a. 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 2006-07 ^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 2006-07 estimated GDP of Punjab Bureau of Statistics)

^b Revenue impact is given as the new demand worked out for 2006-07, assuming new roll will be implemented. This is computed by subtracting the actual collection in 2005-06 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

Table 3b. 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 2005-06 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

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