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Local Government Taxation in Pakistan

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I. Introduction

The purpose of this paper is to evaluate the current practice of local government taxation in Pakistan and to point the way toward structural reforms that are both more rational and more in step with Pakistan's vision for its fiscal decentralization. The analysis here is restricted to sub provincial governments, i.e., districts, TMA's and union councils but with a decided emphasis on the former two. We do this by examining the current practice, and by drawing on international comparisons and "best practices" as laid out in the theory of fiscal federalism.

In the next two sections of this paper, we review the backdrop for local government taxation in Pakistan. First, the structure of local government and local governance, and local budget autonomy are reviewed. Second, we describe the system of intergovernmental fiscal relations that currently is in place, as a way of describing the setting in which any reform of the tax system would take place. In section III we turn to a description of the local government intergovernmental fiscal system as it now exists in

Pakistan, and follow this with a discussion of how well this fits with both best international practice and with the national decentralization plan in Pakistan. In sections IV and V we consider the international practice as regards local government taxation in developing countries. In the final section we consider options for reform and evaluate their feasibility.

This analysis suffers from an absence of data. There is no systematic compilation of local government finances in Pakistan, so it is not possible to give an overall quantitative assessment of the importance of local government finance. Instead, we must rely on anecdotal evidence and a small sample of data specifically gathered for this project.

II. Local Government in Pakistan

The structure of local government and the provisions for local governance are not well defined in the constitution. But it is laid out clearly in the provincial statutes. This structure plus the provisions for local budget autonomy give the context in which local government tax policy may be set.

Local Government

Local government is Pakistan is a provincial subject. Provinces can lay down the basic legal framework for their creation and operations. The constitution distributes revenue powers between federal government and provinces and in turn provinces decentralize some of their powers to the local government[1]. Functions and revenue raising powers are assigned to local governments through provincial laws. In practice, local governments have always been created under laws simultaneously legislated in each province. In 2001 four Local Government Ordinances were promulgated. However, the prototype ordinance was developed at the federal level and provinces complained that they had very little say in its formulation.

The country has seen three local government systems since 1959. First, the "Basic Democracies Scheme", a four tier system, was brought in by a military government, with a few expenditure subjects but little revenue raising powers assigned to local governments (Choudhury, 1959; Mahmood, 1965). This system was abolished in 1969 at the end of the military regime. In 1979 local governments were again created under a military regime. Separate local bodies were created under provincial control for urban and rural areas. Assignment of functions was not very different from the basic democracies and revenue assignment remained weak (Zaidi, 2005). The system continued, but with problems. In some cases the provincial governments replaced elected councils with appointed administrators, and this arrangement continued for nearly a decade. This system was replaced by the present structure of local governments in 2001.

The local governments in each province vary by size, population and taxable capacity. But the same three tier system is present in each of the four provinces. The total number of local governments in each province is shown in Table 1.

At the upper tier in this system is the District Government (DG). Most local government services have been assigned to the district. The most important are education,

[1] An exception to this rule is the agreement between the federal government and provinces whereby one-sixth of the GST revenue at the federal level is designated as a pass through grant to provinces to replace octroi and zila tax revenues of the local governments.

health, roads, agricultural extension and industrial development. The districts have been created from the pre-decentralization provincial departments. District governments have been assigned specified sources of revenue (See Table 2). They can define the base and set the rate in the Zila Council. The base, however, cannot be defined outside the constraints placed by the "Local Government Tax Rules" as prescribed by the provincial government (Government of Punjab, 2001).

At the second tier are the Tehsil (Taluka in Sindh and Town in urban districts) Municipal Administrations (TMA). Each district area is divided into TMA jurisdictions, with the number depending upon the area and population of a district. This tier was created from the pre-2001 urban local bodies by adding the rural hinterland. Originally, the Tehsil or Taluka were geographic entities created for land revenue administration. With the changes in 2001, the entire Tehsil or Taluka became entitled to services earlier provided only in the urban centers. The jurisdiction of local bodies (corporation, municipal committee, town committee) under the earlier local government system had extended to incorporated urban areas only. For rural areas another local body, the District Council, existed with a smaller set of functions. The TMA jurisdiction includes both rural and urban areas, with the earlier urban nucleus serving as its headquarter[2]. TMA functions are largely municipal services and urban building control[3]. .

As part of the transformation, the provincial Public Health Engineering (PHE) department, the agency for supply of drinking water and sanitation facilities in rural areas, was merged into TMA, providing it with the organizational structure to extend its services into the newly annexed rural areas. In practice, PHE has remained independent

[2] For some TMAs, there is no urban nucleus. The headquarters of these TMAs are unincorporated towns.
[3] In city districts, building control has been assigned to the district government.

of the TMA in many cases. In some cases, provinces have recreated PHE organizations at the district level to continue building water supply schemes.

TMAs have been assigned sources of revenue (see Table 2). They have retained the taxation powers of the previous urban local governments. In addition to them, urban immovable property tax has been assigned to the TMAs. However, the practice of decentralizing the tax to TMA has fallen behind the legal provisions. This issue is discussed in more detail below.

The third tier of local government is the Union Administration. The TMA area is divided into unions, both in urban and rural areas[4]. The unions perform a few minor functions and do not have the power to raise revenue. They are financed by a fixed provincial grant.

Most districts, notwithstanding their rural or urban character, are treated alike in the law. In general, the assignment of functions and sources of revenue is not different between urban or rural districts. The exception to the rule is the City District. (Highly urbanized districts are declared "City Districts"). The assignment of functions and revenue varies from the ordinary Districts only slightly. The major difference is that instead of being divided into Tehsil or Taluka Municipal Administrations, the City District is divided into Town Municipal Administrations. The division of functions between the two tiers in the City Districts has led to more centralization of service delivery at the city district. For instance water supply, urban planning and building control are district functions in City Districts but are with the TMA in ordinary districts. A higher share of urban immovable property tax for the city districts is under

[4] In the earlier local government system, union councils existed in rural areas only. For urban areas it was a single tier system and for rural areas it was a two-tier local government.

consideration (Urban Unit, 2007).

The Districts vary in size and population in each province, as is shown in Table 3. The variations are great. Karachi, with 11.3 million residents[5], is the biggest district of the country. Its organizational structure is somewhat different from an ordinary district but in general follows the pattern established by the centrally drafted law. The smallest district in Pakistan is Ziarat (Balochistan) with a population of 39,000 in 2004.

The districts vary in tax base endowments even though the law provides for similar taxes. The variations in land use -- agriculture, industry and urbanization -- are wide. Most districts in Balochistan have small urban conurbations with the population living in small villages spread over large tracts of arid land. The mean population of a district is less than 300,000. The largest urban center Quetta, which is the only city district in the province, is smaller in terms of population than the smallest rural district in Punjab. In terms of area, the Balochistan districts are the largest in the country. They have a sprawling expanse which is thinly populated, and this leads to a high cost of service delivery. They have a small agricultural base, are largely dependent on uncertain rain or high cost pumping stations for irrigation.

In contrast, Punjab districts are mostly endowed with fertile land and canal irrigation. Five districts are city districts with a high degree of urbanization and industrial concentration. In addition to these, Sialkot, Gujrat and Sheikhupura are also highly industrialized with large urban centers, but are yet to be classified as city districts. The mean population of a district in Punjab is around 2.5 million, and these usually have more than one urban center. The districts in Sindh, except Karachi, are agricultural with urban

[5] NIPS estimates, 2004.

nuclei. The mean population of a district in Sindh is 2 million but it is skewed due to the inclusion of Karachi. Most of the industry in Sindh in concentrated in Karachi. NWFP has one city district, four large urban centers located in ordinary districts with the remaining districts mostly rural. The mean population of districts in NWFP is less than a million.

Districts vary widely in terms of their development indicators. Studies have brought out these variations in each province. Districts have wide variations in health indicators, education outcomes and income levels. The variations are present between provinces and among districts in each province (Jamal and Khan, 2007).

The local government functional assignments are uniform with one notable exception, namely the designation of highly urbanized districts as ‘City Districts’. In the city districts, the local government assignments are different than the rural or ordinary districts. The tax structure is the same for both urban and rural districts. The data in Table 4 show the number of the two types of districts in each province.

Local Governance

Local governments at each level have an elected executive and an elected council. The elections create dual offices. At the lowest tier, members of the union council are elected through direct elections. Each union council consists of 13 councilors, including the Nazim and Naib-Nazim of the union. The Nazim serves as the executive head and Naib-Nazim functions as the speaker of the council. One third of the seats of the union council are reserved for women councilors. In addition, there are special seats reserved for peasants and laborers. Both men and women residents of the union elect councilors for the general and reserved seats under a multiple constituency ward system. Elections are held on the basis of adult franchise. The Nazims from all the union councils in a district, in addition to their election as Union Nazim, serve as ex-officio members of the Zila Council. They form two-thirds of the membership of the council. The remaining one-third of the council is comprised of reserved seats for women.

At the TMA level, the Naib-Nazims from all the unions in a TMA jurisdiction are also elected ex-officio members of the TMA council. Similar to the Zila Council, one third of the membership of the TMA council is in the form of reserved seats for women councilors. The district and TMA Nazim are elected indirectly. All the councilors of the unions in a district form the electoral college for the District Nazim. The electoral college for the TMA Nazim is the membership of the unions in the TMA jurisdiction. The Nazims can be recalled by a simple majority of the respective council.

Two rounds of elections to local governments have been held since 2001.

The councils at each level are empowered to approve budgets. No expenditure can be carried out without the budgetary approval. District accounts are maintained by provincial or federal accountants. The accounting forms for the districts have been prescribed by the Auditor General of Pakistan (AGP). TMA accounting has yet to catch up. The TMA accounts are managed by accountants within the TMA. An elaborate system of audit is present at the district level with annual post audit of district accounts carried out by the federal AGP. The TMA and union audit is carried out by a provincial agency, the “Local Fund Audit”. The Accounts Committee of the council receives an annual audit report for their respective executive and is empowered to hold it accountable in light of the audit report.

Local governments have a weak constitutional status. Despite a declaration in its favor in the 'Principles of Policy' in the 1973 Constitution[6], local government is treated as a provincial subject being neither mentioned in the federal or concurrent list of expenditure responsibilities. Provinces are technically unencumbered in the choice of assignment of functions or revenues to local governments. Under a constitutional provision, local governments created in 2001 are protected until the end of 2009 giving them sufficient time to stabilize, i.e., they may not be abolished. In the last three decades, local governments have paradoxically thrived under military governments but were considerably weakened under democratic provincial governments (Monshipouri and Samuel, 1995). The reasons for this are partly due to attempts by military governments at engineering new political leadership through elected local governments. On the other hand, the democratically elected provincial governments see local governments as competitors at the constituency level. During the 1990s, local councils were disbanded and the local bodies were managed by appointed provincial civil servants for varying durations in the provinces.

The friction between provincial and local governments has been an ongoing phenomenon as has been in the past (Cheema et al 2005). Since the creation of the new local government system in 2001, the assignment of revenue, and the posting of officers and other subjects have been contested fields. Provinces have exercised a close control over the local budgetary functions, retaining establishment control, prescribing priorities for local budgets and sometimes requiring ex-ante provincial approval for incurring expenditures. In some cases the local functions have been centralized by the provinces. In

[6] Article 32, Constitution of Pakistan, 1973. Article 140 A also stipulates creation of local governments in each province.

2005, amendments to the law were made after an agreement between the provinces and the federal government, which allowed provinces to unseat Nazims if they did not perform well and prescribe developmental priorities for the local councils.

After the recent elections in February 2008, the newly elected provincial and federal governments have once again raised questions about the local governments, their mandate, activities, accounts and performance. Large scale centralization has been actively debated in the press. The National Assembly has debated the future of local governments with some of the members calling for their abolition. Provinces are also debating abolition of the new local governments and some advocate reverting the system to the 1979 law, which allowed most of the currently assigned functions like education, health, roads and rural water supply to be directly performed by provincial organizations.

Fiscal Autonomy

Under the 2001 law local governments have been given expenditure autonomy and revenue raising powers. Within their assigned functions, according to the legal provisions, they can allocate funds to their priorities. In practice however, the provinces exercise controls on expenditure. The controls are tighter on expenditure undertaken from conditional transfers.

The districts have the largest imbalance between own source revenue and expenditure, with only a fraction of their revenue raised locally. They are largely dependent on provincial transfers. The data in Table 5 show that this pattern holds in all the four provinces. In Punjab, it ranges from 76 to 91 percent of all district government revenues being derived from provincial transfers in this illustrative sample of six districts.

Karachi is the only district from Sindh for which data are available. The local tax revenue of 20 percent of the total revenue is quite high by comparison with other districts in this illustrative sample. But this is not likely representative of the revenue structure in other Sindh districts. In Balochistan, local tax and non-tax revenues are nil except for Quetta, which is the provincial capital as well as the only city district in the province. Unlike Karachi, Quetta raises only 2 percent of its revenue from local taxes. Mardan and Peshawar are the urban districts in NWFP. Again the local tax revenue is less than 2 percent of total revenue.

District governments have two tax collection agencies which have the capacity to administer taxes. They are the district level formations of the provincial Excise and Taxation Department and the provincial Board of Revenue. The District Excise and Taxation Department collects provincial taxes including the property tax. The land revenue department collects land revenue, mutation and registration fee and agricultural income tax for the province. Other than these two departments, district governments (except the city districts) do not have their own administratively developed tax collection machinery for local taxes. These two departments are mainly concerned with collection of provincial taxes. The provinces exercise varying degrees of control over the two district departments, which are their main revenue collection agencies. They are administratively, but in practice only nominally, part of the district government. In case of the land revenue department, it functions as a component of the district. District control varies in provinces with the NWFP BOR exercising direct authority over the district offices. The district's control over E&T is weak. Both agencies collect primarily provincial taxes[7]. The capacity of the two departments is fairly sound (Government of Punjab, 2007a; Government of Punjab, 2007b). The district departments collect provincial taxes according to the targets given by the provincial authorities. But since none of the district levies has been assigned to these departments, the district's tax administration does not benefit itself. In addition to these two departments, in most cases districts have inherited a weak tax collection establishment for local taxes from the earlier District Councils. This staff focused mostly on zila tax (an export levy) and was not trained appropriately. The staff now works under the Excise and Taxation Department in the district.

The TMAs are better prepared to mobilize revenue than are the district governments. The earlier local bodies had an own source revenue in the form of octroi and zila tax. This tax was abolished in 1998. To compensate the local bodies, an additional 2.5 percent was added to the federal GST rate[8] and the income from this addition to the rate was declared to create a hold harmless grant for the local bodies. The rate increase became effective in 1999 but the replacement grant was not commissioned until 2002. TMAs have since received a grant calculated as one-sixth of the total GST collection by the federal government. Administration of the pass-through grant was initially problematic because of deductions by the province prior to distribution. In the last few years the grant has been streamlined and TMA revenues have become more predictable as a result. The urban immovable property tax, another important levy, has been assigned to the TMAs but administrative decentralization of the tax has yet to come about. The revenue is currently shared between the district and the TMA following a

[7] The notable exception in case of Land Revenue Department is Local Rate**.**
[8] With this addition, the GST rate became 15 percent.

15:85 ratio[9]. In the earlier decades, urban local bodies had accumulated experience of administering other revenue items now sources of revenue for TMA. Systems and skills, although weak, exist for local tax administration.

The data in Table 6 indicate the extent of TMA dependence on provincial and federal transfers (in this illustrative sample of TMAs). The results show that TMAs in more urban areas finance a large share of revenues from tax and non tax sources. In general they are less dependent on intergovernmental transfers than are districts. In this respect, TMAs more closely resemble a fiscally decentralized local government.

With respect to expenditures, local governments have legal autonomy for budget making under the provincially mandated Local Government Budget Rules, 2002. The rules lay out an elaborate system for budget preparation and approval by the local councils. In practice, however, there are several constraints on expenditure allocation. First, more than 90 percent of local expenditure is allocated to salaries. An overwhelming number of the civil servants working in local governments are provincial or federal employees, posted to them or assigned on deputation. Only a small fraction of staff are local government's own employees. Local governments have very little discretion in determining the number of posts in each of their departments. Provincial finance departments keep a close watch on the establishment size and the level of positions. The creation of new positions requires prior provincial approval. The federal government under the unified pay scale system lays down the basic salaries and increments for all categories of employees. Provinces follow the federal announcements for salary raises. Local governments are not legally bound to do so, but in practice departure from the

[9] Section 118 lays out the collection and sharing principles (Government of Punjab, 2001).

uniform pay scales is neither practical nor possible. Federal salary increase means an immediate fiscal burden for the local governments. In the last 7 years, the federal government has increased salaries three times. In one case, it translated into a 15 percent increase in the local government salary budget.

Local governments do not have the authority to fire federal or provincial civil servants. They can fire their own employees, which are a smaller fraction of the total. Increasingly, the education and health sectors are moving toward fixed term contract employment. These employees are hired at the local level and the local government can fire them. However, their number and compensation packages are decided at the provincial level.

In theory, capital budgets are less constrained and, the local governments can allocate funds according to local priorities. In practice, a major fraction of the capital grants flow to them with strict conditions attached. In recent years, development grants in education and health specified the objects of expenditure in detail. In Punjab, grants were only made available to local government in education, health and water supply after they signed MoUs to carry out expenditures according to agreed conditions.

On the development side federal and provincial programs overlap local functions. Both federal and provincial governments finance programs in education and health. They vary in terms of the extent of central control over them (for details see Cyan and Porter, 2007). Most donor financed programs have followed an approach where local governments have been given some discretion in expenditure choices, but provincial level project offices play an active role in planning, project design, implementation, accounts and accountability. The extent and nature of this control varies across sectors.

III. Pakistan's Intergovernmental Fiscal Structure

Local governments (districts, TMAs, and Union Councils) are the bottom tier of the intergovernmental fiscal system in Pakistan. Yet these governments are closest to the people, hence are an important part of the fiscal decentralization strategy. To understand their potential role in fiscal decentralization, it is necessary to understand both the expenditure responsibilities and revenue-raising powers that they have been assigned, as well as their intergovernmental transfer entitlements. We take up those issues in turn, in the next three sections.

The issue is complicated by the fact that it is difficult to assess the operation of provincial-local fiscal relations independent of an assessment of federal-provincial fiscal relations. The budget constraint that each provincial government faces depends on the amount of grant (award) passed down by the central government. The tighter the budget constraint, the less likely it is that provincial governments will release more taxing powers to local governments or increase their vertical share of transfers.

Expenditure Assignment

The key piece of legislation that underlies the intergovernmental fiscal system in any country is the budget law or local government ordinance that lays out expenditure assignment. This follows the Constitution but specifies the exact division of expenditure responsibility between the levels of government. It is the expenditure assignments to each level that allow us to evaluate the adequacy of both the revenue assignment and the system of transfers.

The Constitution lays down a federal list of expenditure responsibilities, and a concurrent list. Residuary functions (functions that are on neither of these lists) become the responsibility of the provincial government. The provincial government, in turn, defines the expenditure responsibilities of the local governments in the local government ordinances. This means that expenditure assignments can vary widely across provinces depending on the extent that provincial governments wanted to use their third tier governments in service delivery, i.e., depending on how committed the provinces are to fiscal decentralization.

Provincial governments have two choices in this case: they may assign responsibility for certain expenditures exclusively to the local governments, or they may establish a "concurrent" list. Concurrency may mean that a function could be delivered by either level, or that delivery of the service may be done jointly. Concurrency has the strength of allowing the recognition of different service delivery abilities of different levels of government. It has the weakness of not being a transparent approach and of leading to possibility that a service may not get provided at all. Table 7 shows the division of functions between the province and local government.

Revenue Assignment[10]

The Constitution in Pakistan lays down a separation of taxing powers. In general, the provinces are denied access to the broad-based and more revenue productive income and consumption taxes. These tax assignments have left the provinces with bases that are hard to reach (the income tax on agriculture and the sales tax on services), or costly to administer (the property tax). Some would argue that the Constitution also closes off

[10] This section draws from Bahl, Wallace and Cyan, 2008.

possibilities for tax base sharing by the federal and provincial levels of government. India's intergovernmental system is also built around the constitutional principle of separation of tax bases (vs. concurrent taxing powers, as are allowed in many federal countries) (Bahl, Heredia-Ortiz, Martinez-Vazquez and Rider, 2005).

The upper limit of the taxing power of local governments in a province is the amount of revenue raising power that is given to the provincial government. In fact, very little revenue raising power rests with provinces hence the local governments will also have a limited revenue raising capacity. In neither case will taxes play a very significant role in financing government expenditures.

Provincial and local government taxes are authorized by provincial acts and the provincial governments have some authority to alter tax rates and bases and to administer their own taxes. The tax structure and administration in the four provinces are similar in many respects suggesting either a heavy central influence or some "copycat" behavior.[11]

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 8 account for only 14 percent of the tax revenues. In NWFP, 8 of the tax sources listed account for only 10

[11] Since the abolition of "one unit" governance in 1970, the provinces appear to have adopted Punjab tax laws and followed the tax policy of Punjab. The Inter-provincial Coordination Committee also seeks tax harmonization. The recent meeting of the provincial finance ministers also took place with a similar objective ('Provincial Finance Ministers to Discuss Vehicles Tax, *The News*, June 4, 2008).

percent of the collections.[12]

Local governments are assigned their taxing powers by the province, and in fact, these powers are very limited. There are no data available to measure the level of local taxes, so we cannot say how small the amounts are. Moreover, we cannot provide a catalogue the levies that each local government imposes, for the same reason. The taxes that are known to be imposed are discussed in Section VI of this report.

Intergovernmental Transfers

Most local government financing is done through a system of intergovernmental transfers, or grants. The system is well thought out and more or less meets the tests of a transparent grant system. The awards in practice have not been very clear in some areas. The particulars of the transfers (e.g., formulas and vertical shares) will vary from Province to province, but in each case the basic structure is similar. Based on an “illustrative” sample, we can say that transfers account for nearly all of the financing of district governments, and from 60-80 percent of the financing on TMAs.

A provincial Finance Commission (PFC) in each province is charged with designing the transfer system. A PFC comprises the Minister of Finance, Secretaries of Finance, Planning and Local Government, three Nazims and three independent members appointed by the Governor.

The PFC decides on the vertical share (transfers as a percent of total provincial government expenditures), and on the formula for distributing the general purpose grant. Once established, the award is effective for three years. Table 9 shows the vertical share

[12] Bahl, Wallace and Cyan (2008)

and the formula for each province.

In addition to the general purpose award, the line ministries in the provinces give project grants. These are earmarked for specific purposes.

There is no incentive element built into these transfers to encourage revenue mobilization, i.e., in no province is the award made conditional upon a target level of revenue effort. In Sindh the PFC attempted to reward high tax jurisdictions but it is not clearly applied to local tax effort.

IV. Principles for a Good Local Government Tax

Are there some generally accepted guidelines that can be useful in identifying the "right" set of local government taxes in Pakistan? In fact, there are such guidelines, and we might use these to both evaluate the practice in Pakistan and suggest the direction of a reform program.

The traditional view about "a good local tax" is well summarized by Oates (1996, page 36):

> "(1) Lower levels of government…should, as much as possible, rely on benefit taxation of mobile economic units, including households and mobile factors of production. (2) To the extent that nonbenefit taxes need to be employed on mobile economic units, perhaps for redistributive purposes, this should be done at higher levels of …government. (3) To the extent that local governments make use of nonbenefit taxes, they should employ them on tax bases that are relatively immobile across local jurisdictions."

This view leads to a general recommendation that subnational governments should choose immobile tax bases that are easily administrable. In many countries this is taken to mean narrow-based taxes that are not revenue productive (and are of not much interest to higher level governments).

Where does this leave us in terms of some basic principles for choosing a "good" local government tax? It does rule out certain taxes, but it does not help identify a viable list for local governments.

To construct a list of taxes with potential for local governments in Pakistan, we might go back to the basics of tax assignment, and look to the maxims by which candidate local government taxes might be evaluated. Most public finance economists recite revenue adequacy, revenue neutrality, vertical equity, administrative feasibility, "correspondence" and political feasibility as the goals. Less often observed is that a well-structured subnational government tax will vary depending on whether the subject is a province, a city or a rural local government. This is very much the issue in Pakistan.

<u>Revenue Adequacy</u>

The primary goal for local government taxation is to raise revenues. This suggests that the potential revenue source might be evaluated in terms of three "yield" characteristics. First, the base should be broad enough so that adequate revenues can be raised at a reasonable tax rate. An "adequate" level of revenues will depend on the expenditure responsibilities that have been assigned to the local government. If the provincial government in Pakistan has adopted fiscal decentralization as a development strategy, and has assigned some important functions to district governments and TMAs, a local government tax base that is cobbled together from the "minor" taxes – entertainment, restaurants, signboards, etc. – will not be adequate to cover the service delivery costs and guarantee the accountability of elected local officials. Neither will reliance on politically and administratively difficult taxes (e.g., agricultural income tax, property tax) allow provincial or urban local governments to move measurably closer to becoming self-sufficient in terms of financing. Some form of broad-based tax will be required for urban governments. The needs of rural local governments will be more modest. The state of the practice in developing countries these days, however, is that relatively few provincial or local governments have been assigned broad based taxes. In most low income countries, local governments continue to be heavily reliant on intergovernmental transfers.

Second, there should be automatic growth in the tax base that keeps up with the target growth in expenditures. Without this level of elasticity to the base, the subnational government tax base will not be able to support the required growth in the budget and it will become necessary to return regularly to voters (or to the province) for approval of new tax actions.

Third, and contrary to the above, it is frequently argued that subnational government tax bases should be stable rather than cyclical, because subnational governments support many essential local services. Moreover, subnational governments cannot run deficits, so they do not have a borrowing route to smooth out erratic revenue flows. Under the 2001 ordinances local governments are not allowed to raise debt. In the case of Pakistan, the urban property tax presents such a case of instability, because the revenue flow is dependent on revaluation which takes place in cycles.

Administration

A good subnational government tax will be administrable at a reasonable cost. This is an especially binding constraint for local governments in Pakistan, and the smaller the local government unit, the more binding the constraint becomes. For example, the property tax -- particularly the job of valuing parcels -- is notoriously hard to do and very expensive if done right. The taxation of small business is also costly because it often is not based on self-reporting systems and requires a great deal of field work in the assessment and collection process[13].

For some of the broad-based taxes that are levied on businesses (e.g., corporate income tax, VAT), provincial or local government assignment in Pakistan is not possible because of the book audit required in the tax administration. Local governments do not have the personnel in place to carry out such tasks or the budgets to support such personnel. Moreover, taxes on large business' income or value-added are levied on a firm basis rather than a plant basis and the tax administration cooperation required among local governments would be next to impossible.

Local government tax administration costs are prohibitively high for some taxes. This will not be true in other cases. This leaves us with the policy question of whether there are possibilities for more effective and lower cost tax administration by local governments? One might think of four ways for Provincial and local governments to overcome their inherent disadvantages.

1. Subnational governments may only be assigned those tax bases that are most easily administered. Provinces and some of the larger cities might concentrate on individual income taxes, certain selective sales taxes, operating licenses for large businesses and taxes on the use of motor vehicles. Smaller local governments would concentrate on levies on shops, motor vehicles, factories, registered professionals, and property.

2. Administrative costs may be kept in check by limiting the number of taxes included in the system. In a sometimes desperate search for revenues, local

[13] For a good discussion of the complications of presumptive taxes on small businesses, see Engelschalk (2004).

governments will pile on many specific local levies. These tend to be costly to collect and sometimes arbitrary in their administration. .

3. Subnational governments might find ways to compensate for what otherwise would be an expensive tax administration cost. An example is shortcuts to administering the property tax which might include substituting tax mapping based on site visits for expensive aerial mapping, or using area-based assessments instead of more sophisticated approaches based on comparative values.

4. There is the possibility that local governments could piggyback on the tax base of the higher level governments thereby avoiding any tax administration responsibility. A good example would be a provincial government surcharge on the central government individual income tax. This is an important point. The path to a stronger local government fiscal position may involve first strengthening the provincial government's taxing powers and tax administration.

Correspondence between Benefits and Burdens

If a local government is able to export its taxes to those in other jurisdictions, then its residents will vote to overspend relative to the taxes that they pay. While this situation is the dream of local politicians, it leads to an efficiency loss that is not in the national interest. Residents in the tax importing jurisdiction, on the other hand, will vote a budget that is commensurately lower than the total local government taxes that they pay.

The "correspondence" principle would limit local government tax choices to those where burdens cannot be exported. More precisely, we should say that those who receive the benefits of local government expenditures should bear the burden of the taxes levied by that local government. This might raise a number of interesting issues in Pakistan. For example, local government would not be allowed to levy a sales tax on a factory that sells its product outside the local area (e.g., cigarettes) or on services whose tax burden might be exported (imported processing. On the other hand, a non-resident who commutes into the province to work could be charged (a portion of) a provincial payroll tax, or non-residents who shop in city markets could pay the local consumption tax on the grounds that they use city services.

This principle of correspondence cannot be completely followed, because there is some exporting of nearly all taxes. The question is one of degree. For example, a portion of the property tax – that levied on firms who sell in national markets or are owned by non-residents – is probably exported. This is a small error, by comparison, say, with allowing a local government to levy an excise tax on a cigarette factory that sells in a national market.

Vertical Equity

Local governments are probably ill-advised to structure their tax system so as to distribute tax burdens toward rich and away from poor residents. There are a number of reasons for this advice. First, income redistribution is a component of national social policy in Pakistan, and is best approached through the federal tax system. Second, local government pursuit of redistribution through the tax system is likely to be thwarted by migration and tax compliance problems. Third, the expenditure side of the budget might be the better route to dealing with the status of low income families.

Local governments in Pakistan might do better to deal with the vertical equity issues in the following way.

Treat all taxes as a user charge for services delivered, a kind of benefit tax. If there is to be a distributional consideration, it could be to minimize any additional tax burdens on those below the poverty line. This might lead to a decision to exempt the lowest value premises from the property tax, to not impose taxes or charges that would deny the very poor access to basic services, and to consider cross subsidization in setting user charge rates so as to protect those families with incomes below the poverty level.

Moving Ahead?

The reform of the local government tax system is a tall order, especially in Pakistan where the administrative capacity of most local governments is weak and there is an absence of a tax paying culture. One might consider a phased approach. Certainly the greatest need would be for the larger urban governments, because their service delivery needs are greater, their taxable capacity is greater, and their tax administration is stronger. A goal of public policy ought to be to make these local governments more self-financing than others. Rural local governments can develop their fiscal systems with the more traditional local taxes, including the property tax, and with user charges, fees and intergovernmental transfers. In most developing countries, there is not the expectation that rural local governments will become financially self-sufficient. The same expectation should hold in Pakistan.

V. The International Practice

The most important reason why provincial and local government taxing powers are limited is the unwillingness of higher level governments to give up control over productive tax bases. The underlying reason is this: revenue mobilization is a significant problem in developing countries, and the fiscal needs of provincial and local governments are often seen as a lower priority issues.

The result of this tax competition is that subnational governments are often assigned the least productive and sometimes the most difficult-to-administer taxes, e.g., property taxes, agricultural income taxes, entertainment taxes, etc. The result is not unexpected. The subnational government share of total government taxes is only about 10 percent in developing countries. The share of local (third-tier) governments is much lower.

Tax Choices: Urban Local Governments

Urban local governments have a significant tax base and therefore an ability to mobilize a significant amount of revenue from local tax sources. Typically, they are home to a substantial share of the national economy and they often have developed an administrative infrastructure that is strong enough to impose modern taxes. In many countries, the largest cities have been given provincial status. However, their boundaries tend to be much smaller than those for most provinces, hence tax assignment is more constrained by correspondence concerns. The practice of local revenue powers in large cities is suggested by the examples in Table 10.

Income and Payroll Taxes. Local governments in urban areas could impose income or payroll taxes. These would fall primarily on workers in the formal sector, therefore would be administratively feasible. An income tax could provide a revenue-productive and elastic base. It would be administratively feasible if imposed as an add-on to a federal government income tax, i.e., as a piggyback income tax. The piggyback could be on the federal government tax base or on federal government tax liability. Both forms are used by state and local governments in U.S. states.

Urban local governments could administer a payroll tax, which would be collected at source from the formal sector of the economy. Collections could be facilitated by information sharing with the federal taxing authority. There would be no requirement for filing in this case. Even if the tax were to be locally administered, collection efficiency could be enhanced by information sharing on the tax base.

With respect to the correspondence problem, a problem would arise because of workers who commute in to the city. Because the tax would be collected at the place of work (for administrative reasons), commuters will pay the same tax as resident-workers, but would receive a lesser set of expenditure benefits. Another knock on the local income taxes is that they raise the price of labor and therefore may discourage job growth in the city. Probably the biggest pull back on urban local government payroll taxes is that higher level governments would see this as encroachment on an important central tax base.

Local government income taxes are used in the United States and in some other industrialized countries. Slack (2006, p.106-107) reports that income taxes represent the most important source of local tax revenues in 13 of the 27 OECD countries. However, they are used only infrequently in the developing countries. A subnational government income tax is probably more appropriate as a provincial government levy in developing countries. However, this would open the possibility of a piggyback form of revenue sharing with the urban local governments.

South Africa's RSC levy is a combination payroll tax and turnover tax and accounts for a significant share of revenues in some large cities. In aggregate, this tax accounted for about 2 percent of total national government revenues, with about one-third of this coming from the payroll tax (Bahl and Solomon, 2003). The RSC levy comprised about one-third of local government revenues in Capetown and about 20 percent in Johannesburg. Though the RSC levy was revenue productive, this was in spite of bad design and virtually no coordination with the central government income tax or consumption tax.[14]

East African local governments have levied a tax on presumptive incomes according to a graduated rate schedule that is laid down by the central government. This tax is still levied in Uganda, though it has been declining in importance. It has been abolished in Kenya and Tanzania.

Despite this sparing use of income and payroll taxes for provinces and metropolitan cities, the case for their adoption is strong. Many students of intergovernmental finance in developing and transition countries have called for more consideration of piggyback income taxes (Bahl and Wallich, 1995, p. 367; McLure, Martinez-Vazquez, and Wallace, 1999; and Bahl, 1999).

Consumption Taxes. Consumption taxes are a difficult proposition, even for large city governments. In developing countries, retail sales taxes are not administratively feasible. Gross receipts taxes levied on an origin basis can be revenue productive, but create distortions by shifting tax burdens from producing to consuming regions.

[14] As of FY 2007, the RSC levy is abolished in South Africa, and replaced for a two year period with a compensating grant.

Relatively few large urban governments in the developing world rely heavily on sales taxes.

There are however, some exceptions. Buenos Aires, both city and province, rely heavily on a gross receipts tax. The tax rate varies widely by type of product. In Nicaragua, the local gross receipts tax is levied at a rate of 1 percent. Colombian municipalities also derive most of their revenue from a gross receipts tax. South African cities have derived a significant amount of revenue from a combination payroll and turnover tax. All of these taxes are levied on an origin basis, so all are guilty of the tax exporting charge. In fact, for years there have been calls for replacing the gross receipts tax in Buenos Aires with a value added tax.

Some urban local governments in South Asia have raised significant revenue from the *Octroi* which is a combination of sales tax and terminal tax. It is levied on goods entering the city, according to a complicated rates schedule, and is collected at Octroi stations. It has posed compliance costs on sellers (the queries at the Octroi posts can cause long delays) and invited corruption. Nevertheless, the Octroi was revenue productive, e.g., 50 percent of revenues for the Bombay Municipal Corporation. The Octroi has now been abolished in all but three Indian states and in Bangladesh[15].

<u>Taxes on Motor Vehicle Use.</u> Motor vehicle use is an excellent source of taxation for urban local governments. The growth in cars, trucks, and motorcycles exceeds the growth in population in many cities and accounts for a significant amount of discretionary spending. Several forms of taxing motor vehicle use meet the tests for good local taxes.

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[15] As noted above, in Pakistan octroi was abolished in 1998.

Certainly tolls and parking taxes can generate revenues and directly charge motor vehicle use. Motor vehicle licenses can be more revenue productive if levied at high enough rates and if authority to levy these can be wrestled away from high level governments.

The prize as a revenue source for local governments would be the tax on motor fuels. It would be revenue productive and revenue elastic, and it might be administratively feasible in most developing country cites if collected from distributors. It would ideally be a destination tax with rates varying among cities, and this might induce some fuel carrying hence there would be some avoidance problems.

Taxes on motor fuels are a component of revenue systems in many large urban areas in developing countries. Surprisingly, however, they have not come to be a dominant component of the revenue system. This is in part because they are constrained by central government hesitation to allow any encroachment on its petroleum excise base, in part because fuel prices are so sensitive a political issue that the center desires complete control, and in part because local governments themselves are hesitant to take on the political cost that might come with heavier taxation of motor vehicle use.

<u>Property and Land Taxes.</u> The property tax is the mainstay of local government finance in most countries. It fits the criteria for a proper local government tax, is not usually coveted by higher level governments, and it is accepted by taxpayers in developing countries as long as rates remain relatively low. Land values are soaring in many metropolitan areas, and have been for many years, hence the property tax revenue take should be lucrative.

Revenues. Some countries make heavy use of the property tax, and do make a high property tax effort. For example, Canada raises a revenue amount equivalent to about 4 percent of GDP, and the United States raises nearly 3 percent of GDP. The share of GDP raised from property taxes in developing countries is many times lower, as may be seen from the comparisons in Table 11.

Bahl and Martinez-Vazquez (2008) have studied the question of what characteristics of a country lead to more use of the property tax. Using a sample of 45 developing, transition and industrialized countries for the late 1990s, they find that the "effective property tax rate" is significantly higher in higher income countries, more populous countries and countries with a greater degree of urbanization. If a country has a 10 percent higher level of GDP, cet. par., the effective property tax rate is expected to be 4 percent higher. A 10 percent higher urbanization rate is associated with a 1.7 percent higher effective property tax rate. While all countries are not reported in this comparison, the results are telling: the property tax might be a mainstay of local government revenue systems in developing countries, but it does not dominate revenue raising. Moreover, this same analysis shows relatively little growth relative to GDP, so we might also conclude that despite growth in property values, it has not been buoyant.

The average effective rate of property tax in developing countries is less than 0.5 percent of GDP. As a share of subnational government revenue, it is about 12 percent.

This does not mean that the property tax is not able to carry a significant portion of local government expenditures. It does in some cities in developing countries (Table 12). Certainly the base of land and/or improvement value is broad enough to generate significant revenue at a low rate. From a revenue standpoint, the property tax may be the most underused source of revenue at the local government level.

Administration. The property tax is difficult, and costly, to administer well. However, it is one tax where local governments have a comparative advantage in several facets of the tax administration.

- Identification of taxpayers requires regular tax mapping of parcels, which benefits greatly from local knowledge. The same is true of ownership patterns, which can be learned from local records.

- Recordkeeping requires a tracking of new building activity, and land use changes that are linked to local regulatory activity.

- Assessment requires local knowledge of changing value patterns within the metropolitan area.

- Collection may be the one area where the local government has a comparative disadvantage. Because its elected officers are closer to the voters, enforcement – particularly in cases of the local powerful – may be especially difficult.

Correspondence. The burden of residential property taxes is generally borne by local residents. Certainly for the owner-occupied housing part of the tax base, the correspondence test is passed. This is also the case for most rented residential properties, though some absentee landlords may bear some of the burden in the form of a reduced rate of return on their investment. For non-residential taxpayers, the issue is whether they sell their product in local or external markets. To the extent the local property tax base exempts residential properties, and many do, a greater portion of the tax may be exported. Pakistan is a case-in-point. In general, however, the property tax might be seen as a reasonable way to charge for benefits received from local services.

Other Property Taxes. Some countries allow local governments to raise money from property transfer taxes. This can be a lucrative source of revenue, because land sales in many countries can be a significant share of GDP. However, where levied, property transfer taxes do not account for a great deal of money for local governments, usually because of undervaluation of the sales base. A criticism of property transfer taxes is that they impede land transactions, and provide an incentive for buyers and sellers to understate transaction values, thus depriving the local property assessor of accurate information about local land markets[16].

Local governments can also tax land in other ways. In particular, betterment levies of various kinds are an effective way to recapture the cost of infrastructure expenditures from beneficiaries. The principle here is simple. A benefit zone is identified for an infrastructure project, and the cost of the project is recovered from beneficiaries by some formula and over a period of years. Though many countries have such levies on the books, they are not widely used.

Tax Choices: Small Municipalities and Rural Local Governments

Revenue mobilization by small local governments is a special challenge. Their potential tax base is narrow and mostly in the informal sector, and their experience with tax administration is very limited. Things are made even more complicated by the absence of a culture of paying taxes, and by the fact that these governments may provide little public service benefits in return for tax payment. Inevitably, most of their expenditure budget will be financed by intergovernmental transfers.

[16] For a discussion, see Bird and Slack (2004).

Nevertheless, independent taxing powers are important for smaller and rural local governments because it is necessary to make local officials accountable, just as in the case of urban local governments. Many countries have recently begun a push to stimulate local self-governance in the rural sector[17]. A reasonable goal in such countries is to get rural local governments on the learning curve for fiscal decentralization, including upgrades in local tax practices.

Property and Land Taxes. The property tax in rural areas will be much more rudimentary than that levied in urban areas, and likely will yield very little when viewed as a share of GDP. As a share of local government revenue, however, it may be quite important. The obvious revenue constraint is that the local population has little capacity to pay, but there is also the problem of little local skill in administering a property tax, especially with respect to valuation. On the other hand, there are some comparative advantages that small local governments might have in this area, and some administrative "shortcuts" that they might take.

- Because the community is small, mapping of all parcels might be accurately and easily done.
- Assessment might be done on a basis of physical area, rather than value, so as to minimize skill requirements in the valuation process.
- Small communities might be able to use peer pressure along with penalties to enforce collections.

Taxpayers might see more easily the linkage between what they pay and the benefits they receive, hence there might be less resistance to paying taxes than in urban places.

Some of the practice is reviewed in Table 13.

[17] For a discussion of the India case, see Sethi (2005).

Business Licenses. Businesses might be subjected to a license tax on grounds that they generally benefit from doing business in the local government area. These benefits might include the use of city roads, sanitation facilities, an education and health system that leads to more productive workers, a recreation system that makes the city more livable and attracts business, etc. Because these are general benefits, compensation in the form of a tax is more feasible than compensation in the form of a user charge. Business licenses therefore can meet the correspondence test, and depending on the rate of tax, can contribute a meaningful amount of revenue.

There are two major problems with business license taxes. The first is that they may impose compliance costs that are large enough to drive away would-be investors. The second is that they tend to be arbitrary in both design and administration and so they are too easily captured by corrupt administrators. Bird (1999) and McLure (1998) have argued that these are not good benefit charges, and that as taxes they are distortionary.

In fact, smaller local governments do make use of business license taxes and in some cases these have become revenue mainstays. In the Philippines, municipal governments levy a business license tax that is based on the estimated gross sales of the firm. It is a rough version of a presumptive tax, and yields about 10 percent of local government revenue[18]. An important local business tax in Fracophone Africa is the *patente*. These are fixed local taxes based on type of activity, number of employees, square meters of premises, inputs used, etc. (Vaillancourt, 1998). The idea is for this to be an easily administered local tax, but in practice it tends to be complicated and costly to administer correctly. An interesting approach to business licensing is in Kenya where a

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[18] Table 2 in UNESCAP, 2007.

single business permit has been introduced (Devas and Kelly, 2001). The idea is to minimize compliance costs on businesses by requiring only one license, and to generate revenue by applying a standard, graduated tariff schedule. In effect, it is a kind of presumptive tax on sales or profitability.

<u>Personal Taxes and Head Taxes.</u> Many smaller local governments (and some not so small governments) levy personal taxes. In its simplest form, it is a head tax. The appeal is that it does not require significant administrative skill, and it is a way to get the population involved in the culture of tax payment. This tax generates relatively small amounts of revenues.

A more sophisticated version of the head tax is the graduated personal tax (GPT) as has been levied in some east African countries. The Ugandan GPT has been an important source of revenue for both urban and rural local governments. The tax is levied according to a progressive rate schedule on incomes earned by adult males and adult working females. The assessment of income in the rural areas is notional. The assessment of the self-employed is on a notional basis. A committee is delegated to visit each village, and the members of the committee include the local chief and/or some elders. They visit each house, and fill out a form enumerating the wealth of the taxpayer. The local participation on the committee assures that the wealth is not under-declared. They use the assessment manual provided by MLG showing the notional value to be placed on a particular item of wealth, e.g., each head of a particular type of livestock translates into some level of income.

<u>Special Issues</u>

Some special issues have arisen with respect to local government taxation, and there is debate about how these should be viewed. These special issues include subnational government businesses, natural resource taxes and tax incentives.

<u>Local Government Businesses.</u> Particularly rural local governments sometimes generate revenues by operating commercial businesses. The idea is that the "profit", after covering all costs, can be viewed as a net contribution to the local government revenue stream. There are numerous examples of such enterprises ranging from game parks to hotels to commercial shops. Are local government enterprises a good option for local revenue mobilization? The answer here is that they probably are not[19].

A first question is whether these local government businesses actually generate revenue. While it might be true that they can show a net profit, it might not be true that this is net revenue to government. The problem is that some costs of operations might be hidden, and more properly ought to be netted out against this profit number. Among the possibilities for hidden or subsidized costs of operations are:

- overheads such as accounting services or personnel system support that might be provided by government, just as in the case of any other operating department,
- The provision of infrastructure on a preferential basis for government enterprises, and possibly even subsidized rents in the land that might be provided.
- Wage payments might be lower because of the greater job security that comes with a quasi-government position.

Another way to think about the revenue gain is in terms of the opportunity costs of a government business. It may crowd out private investment, thereby making the private

[19] For a more in-depth discussion, see Kitchen (2006).

tax base smaller than it would otherwise be. The absence of a level playing field in terms of competition – there may even be an implied subsidy to cover any losses of the government firm – will discourage private investors form entering this market.

Natural Resource Taxes. Should local governments be allowed to tax the extractive sector? The simple answer is that they should, but with significant constraints placed upon them. The basic methods of taxing the extractive sector – personal and corporate income taxes, VAT, trade taxes – should remain with central government, as dictated by basic tax administration considerations.

Local governments could participate by raising fees and charges from the extractive sector. However, this should be done within the general framework of allowable local government revenue-raising. Fees and charges should be general levies on all businesses, and should be aimed at recouping some of the cost of providing services. The targeting of one firm or one sector, for the purpose of exporting burdens, should be prohibited.

Some policy analysts have concentrated on identifying taxes that can be applied specifically to the natural resources sector. In an interesting analysis of the options for local taxation of mining activities, Otto (2001) suggests that good candidates might include royalties based on a unit assessment, licensing fees, surface rentals or land use fees, stamp duties, property tax and user fees. In terms of actual practice, he finds that property tax is the only levy on this list that is commonly used.

None of this is to say that subnational governments should be excluded from revenue sharing on natural resources. There are strong arguments to support this strategy (Bahl and Tumennasan, 2004). But a combination of the cyclical nature of the receipts, tax administration concerns and the possibility of tax exporting all point away from allocating broad based taxes on natural resources to subnational governments.

VI. Local Government Taxation in Pakistan: District Governments

District governments control the larger number of employees and incur the major fraction of local government expenditures. Important functions include elementary and secondary education, basic health, district roads, agriculture extension and social welfare. No comprehensive study has been carried out to document the extent to which districts can finance their own expenditures, but individual studies have shown that the gap between expenditures and locally raised revenue is very large. At the end of 1990s, it was around 97 percent (ADB/DfID/WB 2004). In recent years, the situation has not changed much. The districts continue to be largely dependent on provincial transfers for financing their services and the gap remains above 90 percent[20].

Our illustrative sample also shows that the transfers in all the four provinces make up the major source of revenue for the districts. The data in Table 14 provides a glimpse into the district revenues. The tax revenues finance less than 2 percent of expenditure for all districts except Karachi, which is a special case. Note that Lahore, Quetta and Peshawar city districts do not show the same pattern as Karachi. The non-tax revenue makes up another 0.2 to 5 percent of the district expenditure. The cases examined here indicate that the district governments in all the four provinces, with the exception of Karachi, have very little taxes.

In the following paragraphs we discuss individual district taxes and sources of

[20] A rough figure given by Finance Department, Government of Punjab.

revenue.

Education tax

The schedule to Local Government Ordinances allows the districts to levy an education tax, but provides no description of the rate or base for this tax. The rationale for the creation of this levy was twofold: (i) The districts suffer from a great mismatch between expenditure responsibility and revenue assignments, and this tax has been created to provide a source of revenue to the districts. (ii) Failure of service delivery was a major cause for Pakistan's decentralization. Inclusion of an education tax, a tax to finance education, was presumably a political statement to emphasize the function in the new scheme.

The education tax has not been developed so far. Sporadic attempts have been made by some urban districts at levying it (more description below), but it does not appear as a source of revenue in any of the districts surveyed for this study.

Base and Rate of Tax. Since the Ordinance does not specify a tax base, local governments would appear to be free to determine one based on local preferences. In some urban districts, where an attempt to levy the tax has been made, the councils have used enrollments in private schools or revenues of private schools as the above. The rationale here is that private education is elitist and therefore a good target for taxation on equity grounds. Another view is that private schools are addressing the large scale failure of the public sector to provide adequate schooling. There are many types of private schools. Some charge high fees and putatively provide high quality education. Others charge low fees and provide education that is only marginally better than the public schools. A whole range of schools lies between these two extremes.

Quite predictably, the parents who send their children to private schools are from higher income percentiles than those whose children go to public schools. But this will not apply to all schools in the private category[21].

In 2007, City District Government Karachi considered levying an education tax on private schools to finance improvement of education in the city's public schools[22]. From the reports it seemed the intended tax base was the gross income of the private schools.

Other views expressed by government officials are that the education tax is not meant to be a tax on education. Therefore, private schools should not be taxed. Instead commercial units and industry in district jurisdictions should be taxed more heavily than at present with the revenues earmarked for education.

Private school income is taxed under the federal income tax. Collection is low and reportedly there is large scale evasion in the federal income tax, similar to other sectors[23].

Since the tax has not yet developed, statutory rates have not been documented for the cases where it has been attempted. In Karachi the rates being discussed 1 percent of the fee per enrolled student.

<u>Tax Administration</u>. The identification of those liable for payment of the education tax will depend on the tax base that is chosen.

If the tax is levied on private schools then identification of tax paying units will be carried out by the district education departments.

This will raise the question of record keeping and determination of liability. As

[21] I need to add a reference here; possibly give numbers from a WB study
[22] "New Tax on Education, Health Prior to Budget", The Daily Times, Lahore, June , 2007.
[23] It is not specific to private schools.

discussed above, the district level does not have a well developed tax collection department. The record keeping of private schools is done by the district education department which exercises a loose supervision. It is not clear if the liability will be determined on the basis of school records. Enrolment is not always accurately reported. If the tax is instead levied on commercial units and industry then E&T department will be a better choice, since it administers the provincial excise and property tax. Assignment of this responsibility to the Zila Council staff also has been discussed.

No mechanism for collection has been proposed. The likelihood is that it will be patterned after business license fee collections. Tax liability notices could be sent to the tax payers once a year and tax could be collected by field inspectors of the E&T or Zila Council staff.

Health tax

The health tax is a second proposed new instrument in the local government law. It would be assigned to district governments. As in the case of the education tax, the health tax has not been developed by the provincial government or by local practice. The choices discussed so far include a tax on the receipts of private hospitals. Due to the low quality service in general in the public sector hospitals, people from higher income groups seek medical attention from private clinics and hospitals. At the same time, for tertiary care, people from lower income groups also seek consultation at private clinics for want of another choice when public sector facility is not available or is performing at a very low level. The equity case for taxing privately produced medical services is not at all clear.

The present tax on services -- levied by provincial governments -- does not include charges levied by private clinics. Physician's income is income is taxed under the federal personal income tax, though coverage might be expected. Doctors are also taxed under the provincial tax on professions and callings, through the rates are very low. In short, the health tax, much like the education tax, appears to be little more than an idea. It is not even clear if it is meant to be a tax on health services or a tax to benefit health services. Until the intent of the ordinance is fleshed out, little can be said about rate, base or administration.

Local rate on land assessable to land revenue

A local rate is levied on agricultural land. Agricultural plots below the size of 12 - 1/2 acres are exempt from paying land revenue. But the local rate is payable on all such lands as well as the larger farms. The actual cultivation of land does not matter for this levy.

Base Rate: Farms owned by individuals or legal persons form the base for this tax. The tax is levied on a per acre basis.

The tax is levied at a flat rate of 2 rupees per acre. The rate has not been revised in the last many years. The rate is set at the provincial level. Local governments do not have any discretion in setting the rate. It is not clear that if this is due to a legal provision or because the local governments have never exercised their discretion. This is an important pint because if the local government has no rate-setting power, this levy is effectively an intergovernmental transfer from the provincial government.

Administration. Land records for rural land are maintained by the patwari using an archaic system of measurement and record keeping. For every village, records are prepared through a process called '*settlement*'. During *settlement* each parcel of land is measured, its soil quality assessed and it is given a unique number. At the same time ownership, occupancy and usufruct rights are recorded. Under the law *settlement* should be carried out every 25 years but in practice it happens at much longer intervals. The communal land in the villages is given separate numbers. It is jointly owned by the land owners in the village. Parcels of land are identified in the patwari registers, specially the four yearly *jamabandi* and *khasra girdawari*. The *khasra* is updated every six months by field inspections.

Between *settlements*, the records are updated every four years in the form of new editions of records of rights or *jamabandi*, incorporating changes in ownership and occupancy, taking place on account of inheritance or sale. Each four yearly edition of the records is formally maintained, with copies placed at more than one location, including special purpose record rooms, to protect its authenticity. The records keep up to date information of ownership and occupancy. Patwari maintains the records.

Tax liability is determined according to the ownership in the record of rights by the patwari. The tax is payable by the land owners. The Patwari calculates the liability when preparing the *dhal bhach*, or the tax demand for other land taxes.

The field officers of the land revenue department, patwaris, carry out the collection. Collection is made twice a year, at the end of each cropping season. A demand notice is handed over to the owners, mostly through personal service. It lists the amounts due on account of different land taxes. The collection is made by the patwari by receiving cash payments from the land owners and depositing it in the government accounts.

Patwari calculates the amount which he has collected on account of the local rate and deposits the local rate in designated accountsly. Currently the revenue is deposited in the provincial account from where it is transferred to the district.

Business license tax

Under the local government ordinances, districts have been allowed to levy tax in the form of a business license fee. The district governments charge this fee to allow the privilege of conducting business in its jurisdiction. A similar fee is also levied by the TMA. After 2001, initially it was not clear which business will be taxed by each tier and whether the same business could be taxed by both. In 2003 Punjab Local Government Taxation Rules have specified the businesses separately for each tier.

Base and Rate. The business licence tax is levied on a unit basis.comprehensive data are not available on rates, but the rates are generally low and are rarely above Rs.300 per annum. Some large industrial units are taxed at a higher rate, though in some case provincial governments have disallowed high rates.

Administration. Systematic surveys of business activity are not carried out. The staff assigned to the tax administration compiles information progressively and periodically makes addition to the records. These are kept manually in the form of a register.

Tax liability is determined on an annual basis. A notice is sent to the business owner. Field inspectors, generally one or two for the entire jurisdiction in a typical rural district, collect the amounts by personal visits. The business owners can deposit the fee at the tax collection office as well. Compliance is ensured by requiring display of a business licence on the premises. Default is prosecuted in the court. Evidence suggests that prosecutions have been attempted in some districts. But pursuing prosecution is costly. Since 2001, after the abolition of executive magistrates the ordinary civil and criminal courts do no assign priority to the cases entailing minor liability. Cases remain pending for long durations as result. In many cases, local governments have not taken this course.

It is a difficult tax to administer for the local governments. Identification and record keeping are not systematic and estimates for the base are not available.

Tolls

Districts have been allowed to collect tolls on roads and bridges constructed and maintained by them. They do not collect tolls on important roads or bridges that are maintained by the province. Districts like Faisalabad levied tolls in the first three years after the new system was put in place. But in some cases, the tolls were disallowed by the provincial government later on. They are a small source of revenue for the districts where they are levied. Collection is generally through contractors. The districts do not have accurate estimates of the potential collections based on traffic counts on any point. The reserve price for the bids is set keeping the historical collections in view. In many cases, complaints are received against the contractors for overcharging.

User charges

User charges are mainly collected from school and health facilities, where they are applicable. Provincial governments have made primary education free for all residents, hence no fee is charged in secondary and higher schools. Health institutions charge a basic fee. The rates are generally low. Higher rates apply to diagnostic facilities and tertiary health care. A large number of charges are recovered from services provided by agriculture, land revenue, roads and forestry departments. The total amount collected from these departments is not a major fraction of the district revenue.

VII. Local Government Taxation in Pakistan: Tehsil Municipal Administrations

Fiscal decentralization reform has assigned new revenues to TMAs as well as retained taxes and other revenue items from the earlier belonged to the urban local governments. Table 15 shows two illustrative cases. The two cases in Table 15 show that most of the TMA in Sukhar revenue comes in the form of grants from the province (83 percent). The major component of this revenue is the replacement grant for octroi. This is generated from the collection of GST at the federal level. One-sixth of the GST on goods is placed in separate pool. The pool is distributed among the provinces according to their shares in the baseline collection of octroi and zila tax in 1998. The shares determined in 2006 through the interim NFC are given in Table 16.

Own revenue for TMAs varies with the ratio of urbanization and other tax base endowments. In the illustrative cases is it 60 percent in Sialkot, which is a highly urbanized thriving industrial city. This is an important pint because if the local government has no rate-setting power, this levy is effectively an intergovernmental transfer from the provincial government. But in Sukhar in rural Sindh it is close to 17 percent of total revenue. In another study the share of own revenue varies between 10 and 88 percent of the TMA revenue[24]. Similar variations are present among TMAs in other provinces and within Sindh and Punjab. The grant system presently does not take into

[24] Table 7 in Shah et al 2006.

account these differences.

Most of the TMA tax bases are located in urban areas. Property tax has been extended to rural areas but it is not levied on agricultural land. Other taxes and fees are collected in the urban areas. Most TMA services are provided to the urban residents within the TMA. TMA taxes are sometimes set up with an intra-jurisdictional correspondence. In TMAs with large rural populations, since 2001 the new capital investments now are gravitating toward rural areas. This imbalance between expenditure demands and revenues generated has raised concerns for maintaining adequate investment in urban infrastructure.

Some of the TMA tax bases are volatile e.g., cattle markets. It is the major source of own revenue for TMA Attock. But these can vary between seasons and at times from year to year.

Property tax

Property tax is levied on immovable property. In 2001 local government laws assigned the tax to the TMA but in practice it is shared between the province, district and TMA (Cyan, 2007). The TMA receives the major share of collection. This is an important source of revenue for the TMAs. But due to administrative issues it is yet to achieve its full potential for the TMAs. In the 12 illustrative cases in Table 17, it accounts for 0.1 to 28 percent of the total TMA revenue. It is predictably a low percentage in rural TMAs (Bhalwal, Sukhar, Barshore, Qilla Abdullah, Charsadda and Nowshera) and a higher percentage in urban TMAs (Attock, Gulberg Town, Sialkot, Liaqatabad Town, Zarghoon Town and Mardan). Even within the rural and urban groups, however, there is considerable variation.

Rate and Base. In all the four provinces, the tax is levied on urban immovable property and it does not include agricultural land. Specifically, the definition includes only urban property in the base. The local government laws now include all rural housing estates in the base as zero rated areas. Annual rental value is used for tax base computation. Property is classified into different categories and then size of plot and covered area are used to determine the annual rental value. The calculation of the base varies across provinces.

The tax rates vary across provinces but not among TMAs in a province. In some TMAs however only certain bands of rates apply.

Administration. The District Excise & Taxation Department carries out five yearly surveys to document each parcel of land in the tax rated areas (earlier these areas were called ‘urban areas’). The surveys comprise physical visits to property units as well as desk assessment. Property characteristics such as covered area, quality of construction, number of bath rooms are documented by interviewing the owners or occupants. Sometimes historical records are used. The details of each unit are recorded in registers. The department identifies each unit with a distinct number.

Manual records are maintained by the departments. In most cases the registers are maintained in iron cabinets. Punjab is now considering computerization of the departmental records.

Tax payers deposit a tax amount in the bank and receive two copies of the payment receipt. One is mailed to the department while the other is kept by the tax payer.

Tax on transfer of property

Two departments deal with transfer of property: the registrar and the land revenue department. The registrar attests the transfer deeds and collects the provincial registration fee in urban areas. He can register any kind of immovable property transaction, but generally the registration pertains to urban property. In urban areas there is no formal mechanism for maintaining property records except in planned jurisdictions developed by municipal authorities or regional development authorities. In the absence of organized records, registration provides security to transactions and acquisition of title. In rural areas the land revenue department maintains land records, with details of title and rights in land and records mutations under the Land Revenue Act 1967 and rules framed under the statute. The TMA tax on transfer of property is levied in addition to the provincial taxes which are registration or mutation fee and stamp duty. At the same time federal capital value tax is also collected. The TMA collection is the smaller item in the total collection made at the registrar's office or by the patwari.

The TMA collection is carried out through contractors. Contracts are annually awarded through competitive bidding. The process is formal but the information asymmetry works against the TMA. The contractors have better information of the market; the TMAs do not have experts with knowledge of land transactions.

Base and Rate. The tax is applied to all immovable property transactions. The value of the transaction forms the base for the tax. The value is determined by the registrar in urban areas and patwari in the rural areas. For urban areas a committee under the District Collector formulates and notifies a valuation table. This table is updated every few years. Although the committee takes different market transactions into account the valuation tables have been under discussion and many view them to be undervaluing the transaction taking place in the market. The TMA does not have a say in the assigning value to any transaction. In the rural areas, value is determined to the satisfaction of the patwari. Again the TMA does not have a role in valuation.

The rates vary across provinces and jurisdictions but generally fall in the range of 0.5 to 1 percent of the value of the transaction. Table 17 shows the current tax rates in the provinces.

The tax rate is set by the province and applies to the whole province. TMA does not have any discretion in setting the rate. The rates have not been revised in the provinces since 2001.

Administration

The tax collection contractor deputes personnel at the registrar's office. The transaction value is determined by the registrar using valuation tables notified by the district collector. In many cases the tables are not updated frequently enough to keep up with the market. The registrar collects the provincial registration fee. Stamp duty is collected through the sale of stamp paper. The value determined for the provincial levy becomes the base for the local tax. The contractor does not have a say in determining the value of the property.

Records are kept by the contractor. They are in the form of payment receipts. The registrar keeps a copy of the deed. As such there is no record of transactions other than these documents. Organized records for transfers do not exist for urban areas. For rural areas, patwari maintains a mutations register.

The contractor determines the liability on the basis of value affixed by the registrar. In rural areas, the patwari determines the value of the transaction. He also calculates the local transfer tax.

Tax payers make the payment in the form of cash to the contractor. The contractors keeps the collection in his account. At the end of each month he deposits the agreed monthly instalment in the TMA accounts. In general the total contract is divided in thirteen instalments. He is asked to deposit the first instalment at the signing of the contract and the remaining twelve instalments are due at the end of each calendar month. The amount deposited in the TMA account at the end of each month may or may not have any connection with the actual collection. Complaints about collection by contractor are addressed by the TO Finance.

Administration of transfer of property tax is problematic. The collection suffers from several weaknesses:

(i) The TMAs award annual contracts based on a competitive biddingprocess. The reserve price that they announce is generally an incremental increase in the previous year’s price. They do not conduct valuation surveys or market research to compute a more realistic reserve price.

(ii) The staff deputed to the task is inadequate in more than one ways. The in house expertise of TMAs is weak. They do not have experts on the staff rolls who have experience of the property market.

(iii) Collusion among the contractors is not an unknown happening. Therefore, it seems that generally the contracts are awarded for much lower amounts than they should be.

(iv) The contractors depute their personnel for collection to sit outside the registrar’s office. The registrar out of courtesy or due to government instructions will insist on seeing a receipt for transfer of property tax before his attestation. The valuation of the property is however carried out by the registrar. He will do so by reviewing the reported value of transaction. The incentives to under invoice the value of property are there. But at the same time provincial governments have not placed any system to ensure that under invoicing could be prevented. A low valuation of the transaction for the provincial registration fee will also result in a low collection of the local government's transfer tax.

(v) The contractor's representative at the collection does not have clear incentives to collect revenue for the municipality. If the parties offer to settle for a sufficiently low valuation resulting in a lower liability, they can still save after paying to the contractor. The only case where the contractor will exert to collect a higher amount is if his contract amount is not too low.

(vi) The contractor's representative collects the revenues and deposits the amount according to the payment schedule, not necessarily according to the receipts.

(viii) The penalty clauses in the contract are seldom invoked forcefully when the contractor does not pay a full amount. In case where they are invoked, the default cases drag on in courts for long periods of time. In many cases a lesser cost solution is to arrive at a settlement with the contractor rather than spending on legal fees. Overall it creates perverse incentives for the contractors.

(ix) The contract is designed as a lump sum amount payable to the TMA. In early years this type of contract was probably a good instrument to hedge against the unpredictability of the base, specially when the TMAs had low expertise in the area. With time there is sufficient evidence of the level of transaction and value of property in the markets. In some rural jurisdictions it might be less so.

<u>Water rate</u>

Water rate is a major source of revenue for TMAs. In the illustrative cases it is …to… percent of TMA revenue. Water is collected for both the water supply schemes in urban areas and rural areas. Historically local governments as well as provincial PHE have not been able to recover sufficient amount to meet the costs of supply or carry out due maintenance of systems. This has occurred due to low tariffs, collection inefficiency and the trend to subsidize drinking water supply.

<u>Issues</u>. Water supply is mostly piped water. Nearly all TMAs use supply tankers

also. Capital investment in many cases is dependent on provincial grants. A large number of TMAs do not have the finances to invest in upgradation or expansion. Gujranwala city, one of the large urban TMAs in Punjab negotiated a grant from the province for a major upgradation of its water supply. Operating costs are also high. In 2004 88 out of 144 Punjab TMAs had accumulated arrears on electricity bills. At various occasions provinces have carried out at source deductions to settle the electricity dues. This practice has been discontinued as it created unpredictability for the TMA revenues. The gap between water rate revenue and operating cost however remains. Table 18 illustrates the case for five TMAs, including both urban and rural jurisdictions.

Sialkot is the only case where the revenue is greater than the operating cost. A detailed inquiry may reveal how this has been achieved. In the other four TMAs, Attock and Sukhar have large urban centers whereas Qilla Abdullah is largely rural. In all three the gap is more than 50 percent of the operating expenditure. Zarghoon Town shows a different case. It is a Town under a city district and collection has been centralized to the city's Water and Sanitation Agency (WASA). All major cities have their WASA which many times operate independently of the local government. In Lahore a share of property tax is being given to WASA as a subsidy. WASA shows it as a revenue in their budget, which is not a good practice in the long run. Provinces have achieved various milestones in handing WASAs to the respective cities. In Karachi it is most advanced with the City Nazim chairing the Karachi Water and Sanitation Board (KWSB). The chief operating officer reports to the city district government. Last month the provincial government, using the legal provision in the KWSB Act, centralized the organization.

Rate. Rates are set by local councils in each case. We do not have data to analyze the rates in detail. Interviews with officials indicated that rates are very low, often ranging between Rs.100 to 300. But a comprehensive picture may be different. Reportedly rates are not increased to keep up with the increases in operating costs or to generate funds for capital investment in the supply systems.

<u>Administration</u>. Municipal administrations keep manual records of all connections. Meters are seldom used. Mostly connections are classified as domestic and commercial, with the commercial having a higher tariff. Many ‘illegal’ connections are also reported. These connections are taken by individuals from the water lines on their own.

Municipal authorities send notice by post to the water users. In some cases, service is achieved by inspectors or municipal staff delivering the notices personally. Collection practice also vary. Payment can be in the form of cash to the inspectors, deposit in the office or through a form in the designated branch of a bank.

<u>Tax on vehicles other than motor vehicles</u>

This tax is levied on tongas, animal driven carts, bicycles and other modes of transport using animals. These vehicles do no pay the provincial motor vehicles tax. There is no requirement for registration with the Excise & Taxation department. The vehicles in this category are registered with the TMA. Registration is carried out by entry in the records. But registration does not cover all such vehicles in most jurisdictions. Most of the tax base is not captured. In the rural parts of a TMA there is no mechanism to register vehicles or enforce the requirement.

<u>Base and Rate</u>. All animal driven and human pedalled vehicles are the base. The

municipal authorities cannot add other category of vehicle to their base. The definitions are prescribed by the provincial law. They have the discretion to set the rate. We do not have data to do a detailed analysis of the rate.

Administration. The municipal staff identifies vehicles. This is carried out through random checks in the urban areas. Records are maintained in registers. In many cases the record keeping is not up to date. Liability is determined according to the type of the vehicle. Municipal staff collects the tax from the owners mostly as cash. Voluntary deposits take place but are not the rule. In most cases, random checks are used to recover the tax.

Business licenses

Similar to the district business license, TMAs have the authority to require licenses from businesses operating in their jurisdictions. TMAs typically send out inspectors to document various types of shops and imposes a fixed annual fee for the right to carry out business in its jurisdiction. Earlier licenses to all types of local business were with the TMAs. In 2005 some of the business have been given to districts to increase their tax base.

Tax Base. The TMAs issue licenses to shops, vendors and small operations like tailors, painters, meat shops and other sales operations. Districts license larger operations like poultry farms, timber processing etc. Each unit is treated as a tax payer. Differences in the size of business do not account for difference in the category of business. The rates vary among jurisdictions but generally are low within the range of Rs.50 to a 300 hundred rupees per annum.

Administration. TMA staff from the taxation office carry out periodic physical surveys and document shops and business according to their type. After this identification they serve notices upon the business informing them of their tax liability. Collection is mostly through personal visits of the staff to the business offices or shops. Records are not kept in a systematic manner. Attempts to levy these taxes are not popular. Therefore TMAs have mostly relied on a mix of voluntary compliance and creation of sufficient pressure through moral suasion and personal efforts of the taxation staff. In some cases defaulters are given notices and cases for recovery are taken to court. The cost of pursuing court cases is high for both parties, but the marginal cost decreases for the TMA as the number of cases increases: the result of court cases is expeditious payment and withdrawal of the case in a large number of cases.

Special charges and fees

Special charges and fees are levied by TMAs for specific services. A wide range of services are used for collecting charges or fees. Table 17 shows some items on which charges are fees are levied. Individual items do not make a substantial share of TMA revenue. But fees and charges together add up to an important fraction. Table 15 above shows that fees add up to 27 percent of TMA revenue in Sialkot but form only 2 percent of the same in Sukhar.

Union Administration

Unions do not have any taxation power. They receive a lump sum grant from the province for staff salary and utilities. They are not allowed to incur capital expenditure or create recurrent liabilities. They are planning bodies for the TMA and district and linked through the Naib-Nazim and Nazim.

VIII. Conclusions and Options for Reform

Pakistan's system of local government taxation in its infancy. How it develops will be determined by the type of fiscal decentralization that the country wants. And how local government tax policy develops will play a role in determining the success of the fiscal decentralization program. Fiscal decentralization is a key component of development policy. It can enhance accountability of local service providers and promote efficiency.

If local government finance becomes an important agenda item for the Government, it might consider two proposals. First, the central and provincial governments need to develop a strategy for fiscal decentralization to the local government level, i.e., an underlying policy structure. Second, this analysis of Pakistan's situation and the international practice suggest that there are good options for strengthening local government taxation. But these need to be thought through in detail, and need to be based on empirical evidence that presently does not exist. The leadership in this effort must rest with the central and provincial levels.

Strategy and Structure

There are a number of structural issues that the government might consider in developing its program for local government taxation. These should be considered before specific proposals for local taxes are evaluated and moved toward legislation.

First is the question of expenditure assignment. The "right" level of local government revenue-raising cannot be identified until it is decided what level of expenditure responsibility local governments will have. This is a decision that rests with provincial governments. The more important the functional assignments, the more significant the revenue raising powers to be shifted to the local governments. At present, there is an expenditure list for local governments in each province, but as noted above, it remains murky. Only with a transparent set of expenditure assignments can the costing out be done to determine how much revenue access is needed by local governments. At present, neither the provincial nor the local governments have much access to productive revenue bases. Provincial and local government taxation in total probably accounts for less than – percent of total national tax revenues.

The second structural issue is that the government needs to determine what kind of fiscal decentralization program it wants. There are two versions. One is the assignment of functions to local governments, together with some autonomy in budget allocations and in service delivery. This could be financed by intergovernmental transfers, with minimal or no local government taxing powers. This is a quite viable arrangement, and is more or less followed in most developing countries. This is the system favored by most local government elected administrations – it puts them in the safe place of spending the money of a higher level government. In turn it creates weak accountability of the local executive to its electorate. The alternative is a local financing system that places more emphasis on stronger accountability of elected local officials to voters. In this case, a significant local tax component is a necessary part of the structure.

Third, the strategy for implementing fiscal decentralization and local taxation might involve an asymmetric approach. In particular, the urban local governments could be moved first toward heavier reliance on local government taxes. The justification is that they have the strongest tax bases and potentially the strongest tax administrations. The government might even go so far as to set targets for the fiscal self reliance of urban local governments. Smaller and rural local governments under this strategy would remain heavily dependent on transfers. The goal under such a system would be to reduce the reliance of urban local governments on transfers, use this money to fund services in rural areas, and increase the overall level of revenue mobilization. For the asymmetric approach to work, the current uniform treatment of local governments will need to give way to a more capacity based tax assignment.

Finally, the strategy might include structuring the provincial-local transfer system to provide an incentive for increased local government tax effort. This strategy will require some careful design, but it might work along the following lines. A revenue sharing pool specifically for tax effort would be established, and would be distributed among urban local governments according to how they made use of their newfound taxing powers. The rural local governments will continue to have a heavier dependence on transfers. PFC awards would be restructured to align incentive correctly with the tax assignment scheme.

Before a new structure can be designed and put in place, the government needs a better capability to monitor and evaluate its local tax system. At present, there is no information system for local government finance in Pakistan. In fact, neither the federal nor the provincial governments can report how much is spent by local governments, or how much revenue they raise, or how much disparity there is in either of these series. Only anecdotal evidence or small surveys are available. The design and implementation of a fiscal information system for local government finance is an essential early step.

The way forward for Pakistan might be to have these questions vetted before a blue ribbon commission on intergovernmental fiscal relations.

Specific Tax Proposals

If the focus of local government tax reform is on urban local governments, there is no shortage of options for increased revenue mobilization. In some cases, this involves an upgrading of tax levies that are already in play in Pakistan. In other cases, it could involve new taxes.

<u>Districts: Education and Health Tax.</u>

These two new taxes were suggested by ordinance, but the rate or base was not specified in either case. Consequently, they have not been implemented. Therefore, the next step is for the provincial governments to think through the intent of these new taxes, e.g., are they meant to be taxes on education and health activities, or are they meant to be new taxes or higher tax rates on some existing base that are earmarked for education and health expenditure. Or, is the idea really to enhance local government revenues, and then allow the local elected body decide if it will spend more on health and education? The blue ribbon commission on local government tax reform can make this a priority decision item.

<u>Urban Districts: Piggyback Income Tax</u>

The larger urban districts have significant sized formal sector payrolls with a great deal of revenue potential. A local government payroll tax would fit the norm for a good local tax in that the burdens would remain local, and the yield could be substantial enough to fund increased local services. The problem of administration would be the big obstacle, as even the largest urban government would probably not have the wherewithal to assess and collect a payroll tax. However, the local governments could piggyback on federal collections. If local government rate setting were allowed (within limits), this could become a true "local" tax, where elected politicians would be transparently responsible for the higher taxes imposed on local residents. Whether a piggyback version as is described here would violate the constitution is another question.

Urban Districts: Motor Vehicle Taxes

Urban districts could impose motor vehicle license fees, at significantly higher rates than at present. These could be in addition to the provincial taxes, or as a replacement for them. The tax could be revenue productive, easily administered, and local governments would have the power of rate setting. This might be viewed as being competitive with provincial motor vehicle taxes, but this need not be the case. Provincial governments could reduce the amount of grants to the local governments to compensate, or it could allow this local tax as an add-on to provincial rates which are presently quite low.

TMA's: Urban Immovable Property Tax

The main source of revenue for the TMA could become the urban immovable property tax. The TMA could be empowered to set the property tax rate and would receive the revenues. The administration of the property tax would be shared by the province (valuation), the district (collection and identification of the tax roll) and the

TMA (setting rates). This has been discussed above, and is a longstanding proposal for property tax reform in Pakistan.

TMA's: Land Value Increment Taxes

TMA's could tax a portion of the land value increments due to public investments in urban areas. The administration of such value capture taxes would be combined with the urban immovable property tax.

TMA's: Professions tax

The tax on professions could be transferred to the local governments along with the power set the tax rate and the tax base.

Some more considerations

There has been some discussion in the country on assigning retail level sales tax to local government. Due to administrative difficulties this proposal will need to be evaluated carefully.

There is a case for assigning natural resource royalties to local government. This can be an important source of revenue for rural districts. However, it will need to be structured appropriately.

Endnote

This report is a working draft rather than a polished finished product. The basic elements of the study are here, but there is much to do to flesh out some of the analysis and to more fully develop the policy recommendations offered for consideration. A major problem that we encountered in doing this work is that there are very little data to examine the present practices of local government finance in Pakistan. We have brought whatever anecdotal data we could find to this study, and think we developed a rough picture of what is going on, but it still is very impressionistic.

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Table 1

Local Governments in Pakistan

	DG	TMA	Unions
Balochistan	28	77	567
NWFP	24	54	986
Punjab	35	144	3464
Sindh	23	121	1114
Total	110	396	6131

Source: NRB, Government of Pakistan

Table 2

Source of Local Revenue[25]

District Councils	Tehsil and Town Councils	Union administrations
• Education tax. • Health tax. • Tax on vehicles other than motor vehicles. • Local rate on lands assessable to land revenue. • Fees in respect of schools, colleges, and health facilities established or maintained by the district government. • Fees for licenses granted by the district government. • Fees for specific services rendered by a district government. • Collection charges for recovery of tax on behalf of the government as prescribed. • Toll on new roads, bridges, within the limits of a district, other than national and provincial highways and roads.	• Local tax on services. • Tax on the transfer of immovable property. • Property tax on annual rental value of buildings and lands. • Fee on advertisement, other than on radio and television, and billboards. • Fee for fairs, agricultural shows, cattle fairs, industrial exhibitions, tournaments and other public events. • Fee for approval of building plans and erection and re-erection of buildings. • Fee for licenses or permits and penalties or fines for violation of the licensing rules. • Charges for execution and maintenance of works of public utility like lighting of public places, drainage, conservancy, and water supply. • Fee on cinemas, theatrical shows and tickets thereof, and other entertainment. • Collection charges for recovery of any tax on behalf of the Government, District Government, Union Administration or any statutory authority as prescribed.	• Fees for licensing of professions and vocations. • Fee on sale of animals in cattle markets. • Market fees. • Fees for certification of births, marriages and deaths. • Charges for specific services rendered by the union council. • Rate for the remuneration of village and neighborhood guards. • Rate for the execution or maintenance of any work of public utility like lighting of public places, drainage, conservancy and water supply.

[25] *Devolution in Pakistan*, ADB/DfID/WB 2004

Table 3

District Population Variation

Province	Population Estimates 2004		
	Min	Max	Mean
Punjab	945,000	7,171,000	2,457,559
Sindh	760,000	11,296,000	2,052,412
NWFP	275,000	2,328,000	852,333
Balochistan	39,000	879,000	292,192

Source: Pakistan Population Data Sheet, National Institute of Population Studies, Islamabad, Pakistan, January 2007.

Table 4

Two Types of Districts

	Districts	
	City	Ordinary
Punjab	5	30
Sindh	1	22
NWFP	1	23
Balochistan	1	27

Source: ADB Decentralization Support Program

Table 5

Districts: Revenue by source (percent of total income) [a]

	District	Tax	Non-tax	Transfers	Capital Income[b]
Punjab					
1	Attock	0	1	85	14
2	Chakwal	1	0	91	8
3	Faisalabad	0	2	76	22
4	Lahore	2	5	82	13
6	Sialkot	1	0	85	14
Sindh					
7	Karachi	20	7	70	3
Balochistan[c]					
8	Pishin	0	0	93	7
9	Qilla Abdullah	0	0	54	46
10	Quetta	2	0	89	9
11	Sibi	0	0	94	6
NWFP					
12	Mardan	1	2	84	13
13	Peshawar	0	4	91	5

Source: ADB Decentralization Support Program

Notes
[a] *The data are based on revised budget estimates collected by ADB Decentralization Support Program for the study.*
[b] *Capital income includes opening balance in some cases. Local governments apparently do not follow a uniform classification.*
[c] *Some of the zeros may be classification errors.*

Table 6

TMA Revenue by source (percent of total revenue) [a]

	TMA	Tax	Non-Tax	Transfers	Capital/Op Balance [b]	Unclassified
Punjab						
1	Attock	27.8	41.0	30.6	0.3	0.3
2	Gulberg Town	46.2	9.7	20.2	0.0	23.8
3	Bhalwal	6.8	29.8	58.3	3.7	1.4
4	Sialkot	29.3	35.5	34.6	0.6	0.0
Sindh						
5	Liaqatabad Town					
6	Sukkur	36.1	6.9	19.0	32.8	5.2
Balochistan [c]						
7	Barshore (Pishin)	0.0	0.0	63.0	29.3	7.6
8	Qilla Abdullah (Chaman)	0.0	0.0	77.8	16.3	5.8
9	Zarghoon Town (Quetta)	12.8	0.0	79.7	1.0	6.5
NWFP [c]						
10	Charsadda	4.2	0.0	34.6	2.9	58.4
11	Mardan	19.9	0.0	10.9	6.5	62.7
12	Nowshera	0.0	0.0	100.0	0.0	0.0

Source: ADB Decentralization Support Program

Notes
[a] *The data are based on revised budget estimates collected by ADB Decentralization Support Program for the study.*
[b] *Capital income includes opening balance in some cases. Local governments apparently do not follow a uniform classification.*
[c] *Some of the zeros may be classification errors.*

Table 7

Assignment of Functions

Province		Local
Education	→	**Education**
Colleges		**Secondary education**
Technical and vocational education		**Elementary education**
Health		**Health**
Secondary health	→	**Primary health care**
Tertiary health		
Criminal justice and public order		
Highways and inter district roads	→	**Small roads, streets**
Agriculture	- - - →	**Agricultural extension**
Industrial development		**Industrial promotion (city district only)**
Transport	- - - →	
Irrigation		
Water supply and sanitation	- - - →	**Water supply and sanitation**
Mineral development		
Power development		
Land administration	→	**Land administration**
Social welfare	- - - →	**Community development**
Environment	→	**Environment**
Local government (for framing laws)		
		Municipal services
Urban development and building control	- - - →	**Building control**
Regulation		**Municipal regulation**

Notes

a) *Dashed lines show that the function has been partially decentralized. There is a co-occupation of mandate is these cases.*

b) *Regular lines show that the function has no provincial office in the district after decentralization. But there may be vertical programs in these sectors for provincial priorities.*

Table 8

Revenue Structure of Provincial Governments 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]	22,180	74.97	2,762	59.27

Source: Calculations are based on provincial revenue time series data provided by the World Bank, Islamabad.

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.

The total does not add to 100 percent because non-tax receipts are not included. The total for NWFP is based on actual collections in 2005-2006 and does not use the calculation for others described in note ‘c’.

Table 9

PFC Transfers to Local Government

	PCF	PA	GST	LG Share	
		Rupees			Percent
Balochistan	182783	42753	14000	56753	31
NWFP	49747	19648	1683	21331	43
Sindh	36016.89	14468.86	2787.016	17255.88	48

Notes

a) *The data are based on revised estimates for 2006-2007 reported in the provincial Annual Budget Statements for 2007-2008.*

b) *LG Share is the sum of PA, provincial allocable and GST, General Sales Tax grant for local governments. PCF is the provincial consolidated fund.*

c) *The horizontal shares formulas are as follows:*
   a. *Balochistan weighs population and area equally.*
   b. *NWFP calculates the share using population and an underdevelopment index which in turn comprises development ranking based on service delivery coverage and outcomes in health, education and drinking water and sanitation.*
   c. *Punjab allocates funds on an index developed from population, urbanization and underdevelopment.*
   d. *Sindh allocates shares on population, underdevelopment and revenue raising capacity. The latter rewards districts with higher tax bases.*

Table 10

Urban Local Government Taxes

Country	Tax	Percent of Local Revenues	Administration	Autonomy Arrangements	Source
South Africa	Payroll and Turnover[a]		Metropolitan and Muncipal Governments	Tax rates set locally, but frozen since 1996	Bahl and Solomon (2003)
Colombia	Gross Receipts	40	Municipal Governments		Acosta and Bird (2005)
Brazil	Sales Tax On Services	10	Local	Tax rates set locally	Alfonso and Araújo (forthcoming)
Uganda	Graduated personal tax[a]	---	Local	Tax rate set Centrally	

[a] The RSC levy is abolished effective FY07, and replaced by a compensatory grant.
[b] Combination of a poll tax and a presumptive income tax

Table 11

Property Taxation in Selected Countries

Country (Year)	Property Tax Base	Percent of Local Govt. Revenue	Local Rate Setting Power	Administration	Percent of Revenue to Local Govt.	Source
Colombia (1999)	Market Value of Property	35	Municipal Gvt. may choose within a range	Local in large cities, otherwise central	100	Chaparro, Swart and Zapata
Poland (2004)	Area-based	15	Rates are centrally set	Local Government	100	Swianiewia (forthcoming)
Argentina (2004)	A combination of market value and economic activity	34	Rates locally set within limits	Local	100	Asensio (forthcoming)
Brazil (2004)	Capital value, indexed	7	Rates are locally set	Local	100	Afonso and Arajo (forthcoming)

Table 12

Property Tax Revenues in Selected Cities

City	Year	Property Tax Base	Share of Local Government Revenues (in Percent)	Source
Bangkok	1997	12.5 percent of the annual rental value of non residential and residential premises (excluding those that are owner-occupied).	7.2	The World Bank (2000)
Rio de Janeiro	1998	Capital value, indexed for inflation	15.9	The World Bank (1999)
Mumbai	2002	Annual rental value[b]	5.1[a]	The World Bank (2004)
Bangalore	2005	Area Based	5.1[a]	The World Bank (2004)

[a] FY 2000

[b] There are twelve different rate categories.

Table 13
Local Taxes in Rural Local Governments

Country (Year)	Tax	Base	Percent of Revenues	Local Rate Setting Power	Administration	Source
Poland (2004)	Property	Area	13.1	None	Local	Swianiewicz (forthcoming)
Uganda (2004)	Personal Tax (Head Tax)	Presumptive Tax on Income	……	None	Local	
India (Panchayats	Property Tax	Annual Value Area	…….	Yes	Local	Sethi (2005)

Table 14

District Government Expenditure. Percent Distribution of the Financing

	Tax	Non-tax	Transfers
Punjab			
Attock	0.000	0.509	85
Chakwal	1.380	0.201	91
Faisalabad	0.046	2.292	76
Lahore	0.025	5.135	82
Sialkot		0.200	79
Sindh			
Karachi	21.858	7.122	74
Balochistan			
Pishin			92
Qilla Abdullah			91
Quetta	1.758		87
Sibi			93
NWFP			
Mardan	1.423	0.786	83
Peshawar	0.106	1.770	37

Source: ADB Decentralization Support Program.
The data are for 2006-2007.The blanks indicate that no reliable estimates were available for the item.

Table 15

	TMA Sialkot		TMA Sukhar	
	Rupees	Percent of total revenue	Rupees	Percent of total revenue
Total Revenue	587,002,256	100.0	219,685,079	100.0
Fees	156,522,876	26.7	4,338,200	2.0
Rent	3,500,000	0.6	6,960,300	3.2
Business taxes	12,050,000	2.1	35,000	0.0
Tax on non motorized vehicles	1,500,000	0.3	3,000	0.0
UIPT Share	33,461,380	5.7	13,000,000	5.9
Transfer of property tax	100,000,000	17.0	1,300,000	0.6
Tax on advertisements	1,000,000	0.2	600,000	0.3
Water rate	38,500,000	6.6	10,510,000	4.8
Cattle market/fairs	2,510,000	0.4	103,000	0.0
Total OSR	349,044,256	59.5	36,849,500	16.8
Grants and other income	237,958,000	40.5	182,835,579	83.2

Source: ADB Decentralization Support Program.

Table 16

Provincial Shares in One-Sixth of GST

Province	**Share in Local Government GST Pool**
Balochistan	5.22
NWFP	9.93
Punjab	50.00
Sindh	34.85

Source: Pakistan, Government of (2006a) (Inter-governmental Fiscal Relation),
http://www.mng.gov.pk/icfd/presentations/default.asp

Table 17

Revenue (major items)

(Percent of total)

	TMA	UIPT	Water Rate	OSR (minus WR)
1	Attock	19	6	69
2	Gulberg Town Lahore	28		80
3	Bhalwal (Sargodha)	2		38
4	Sialkot	13	6	65
5	Karachi (Liaqatabad Town)			
6	Sukkur	5	3	48
7	Barshore (Pishin)	8		8
8	Qilla Abdullah (Chaman)	0.1	0.2	6
9	Zarghoon Town (Quetta)	13		19
10	Charsadda	4	3	63
11	Mardan	6	2	83
12	Nowshera	9	8	

Table 18

Water & Sanitation Cost and Revenue (Rupees)

	Water rate revenue	Current Budget	Gap (precent of expenditure)
Attock	6,000,000	38,099,000	(84)
Sialkot	38,500,000	20,500,000	88
Sukhar	10,500,000	25,212,500	(58)
Qilla Abdullah (Chaman)	52,000	2,063,025	(97)
Zarghoon Town (Quetta)	-	120,472,584	(100)

Source: TMA Annual Budget Statements, 2007-2008. The data are the revised estimates for 2006-2007.