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Options to support urban infrastructure delivery in Pakistan - a survey for the province of Punjab

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Abstract

Pakistan has more than 210 million inhabitants with a population that is increasing by 2 percent per annum. More than 60% of Pakistan's population currently lives in rural areas. However, the rural population is moving towards cities due to diminishing work opportunities in the agricultural sector. For this reason, a further investment in local infrastructure is essential. Moreover, in the last fifteen years, the economy of Pakistan has faced various domestic and external shocks such as the earthquake of 2005, the flood of 2010, the worldwide financial crisis of 2008 and the unsolved energy crisis. One of the richest part of Pakistan is the province of Punjab and in 2018 the minister of local bodies, Mr. Abdul Aleem Khan has announced that government of Punjab is going to introduce new local bodies system. Local body system of Punjab consists of 182 municipal committees, 10 metropolitans and 35 district councils and it is based on the Local Bodies' Act of 2001 and 2013. This paper provides an general overview of the different options of local public finance around the world as well review the draft Punjab local government act 2019from February 2019.

JEL Classification: H7; G20; R10

Keyword: Infrastructure financing, General regional economics, Taxes and grants, Pakistan

1 Introduction

Pakistan has more than 210 million inhabitants with a population that is increasing by 2 percent per annum. More than 60% of Pakistan's population currently lives in rural areas. However, the rural population is moving towards cities due to diminishing work opportunities in the agricultural sector. For this reason, a further investment in local infrastructure is essential.

Over the last fifteen years, the economy of Pakistan has faced various domestic and external shocks such as the earthquake of 2005, the flood of 2010, the worldwide financial crisis of 2008 and the unsolved energy crisis. The deterioration in the power sector, in particular, is one of the main constraints on growth since power cuts have shaved 2% off the annual GDP growth. The Pakistan economy has grown by 4.5 % in the last five years, while inflation has been overcome and is currently not a danger for the economic performance of Pakistan. Figure 1 below highlights the GDP per capita in US-Dollar in Pakistan and some neighbouring countries, while figure 2 presents the annual inflation rate in Pakistan from 2008 until 2018:

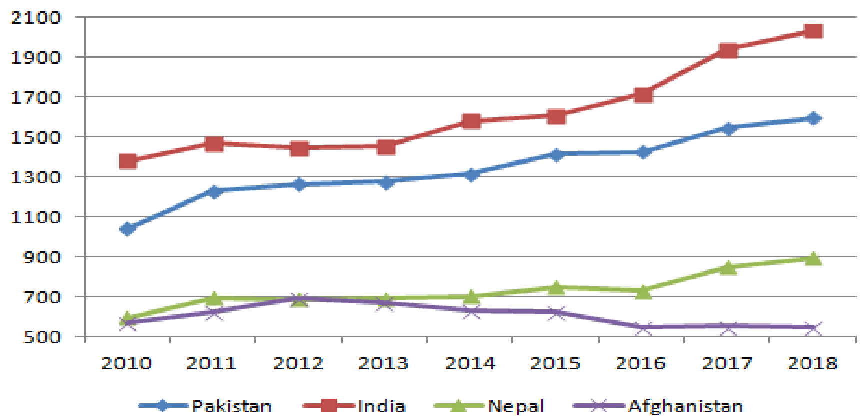

Figure 1: Development of GDP per capita in US-Dollar from 2010 until 2018

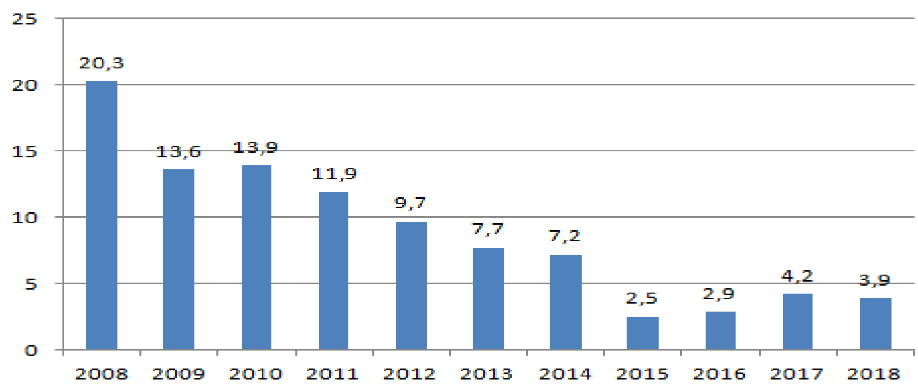

Figure 2: Development of inflation rate in % in Pakistan from 2008 until 2018

Pakistan is a federal country. Besides the central government in the capital Islamabad, the regional level of Pakistan consists of four provinces (Balochistan, Khyber Pakhtunkhwa, Punjab and Sindh) and the Islamabad Capital Territory. Moreover, Pakistan controls the areas of Azad Jammu and Kashmir (AJK) and Gilgit-Baltistan. These two areas are located on the Pakistan side of the demarcation line ("Line of control") of the divided Kashmir, which is claimed both by Pakistan and India. Both areas are not named explicitly in the constitution of Pakistan, but in 2009 the Pakistan central government signed the "Gilgit–Baltistan Empowerment and Self-Governance Order", which upgraded Gilgit-Baltistan to a semi-provincial status with partial autonomy, while Azad Jammu and Kashmir is still politically and fiscally dependent on the central government. The local governance system of Pakistan is divided into three tiers: districts, tehsils (sub-districts), and village / union councils. In total, there are approximately 154 districts, 588 tehsils, and several thousand union councils. The taxing powers in Pakistan were centralized in 1956 at the central level in order to achieve the goal of tax harmonization and to lower tax collection costs. The four provinces therefore voluntarily gave up the powers to collect sales taxes in favour of central government and were compensated by a tax sharing system.[1] However, the provincial spending and taxing power were constantly reduced from 1955 until 2010 and the 18th Constitutional Amendment in 2010 was the first sign of a reversal of this trend.[2] Table 1 below provides an overview of development of the revenue and expenditure share of the central, provincial and local governments of Pakistan from 1955 to 2015.

	1955	**1965**	**1985**	**1995**	**2005**	**2010**	**2011**	**2015**
Revenue share in %								
Central	70	85	90	90	93	94	93	92
Provincial	25	10	5	5	6	5	6	7
Local	5	5	5	5	1	1	1	1
Expenditure share in %								
Central	60	60	65	67	70	66	67	66
Provincial	35	30	30	29	20	25	28	28
Local	5	10	5	4	10	9	5	6

Table 1: Revenue and expenditure share in % in Pakistan from 1955 until 2015

Source: Werner, 2017

[1] The idea of tax sharing between the central government and the subnational entities is also used in Austria, Bolivia, Germany, Luxemburg and Poland.

[2] The provincial portion of the shared taxes increased from 45 % in 2009 to 57.5 % in 2015 and the provinces received the taxation right for VAT on services.

The institutional arrangements for intergovernmental transfers from the central government towards the four provinces are mainly organized by the National Finance Commission (NFC). The NFC is constituted under Article 160 of the Constitution of Pakistan and sets out the formula for distribution of revenues amongst the central and four provincial governments of Pakistan.[3] The fixed formula (Award) has a duration of five years and if the NFC is unable to agree on a new formula after the five year interval, the existing formula is used transitionally. Currently, the 7th NFC Award of 2009 is operative, because the 8th NFC was constituted on 21st July, 2010, but did not give any Award. The 9th NFC was constituted on April 24, 2015 and its first meeting was held on 28th April, 2015, but again the representatives of the central government and the provinces in the NFC did not agree on a new formula until April 2019.

In the fiscal year of 2014-2015, the 7th NFC Award means that the central tax administration collects the revenues from taxes on income[4], capital value tax, sales tax on goods[5], federal excise and customs duties in a common pool.[6] In order to cover tax collection costs, the central government receives a prior 1% of the divisible pool of taxes. Another one percent of the net proceeds of the divisible pool of taxes is assigned to the provincial Government of Khyber Pakhtunkhwa to meet the expenses of war on terror. The remaining amount is distributed, with 57.5 % going to the four provinces and the remaining 42.5% to the central government.

The allocation criteria for horizontal distribution between the four provinces and the fiscal effect are presented in table 2 below. If the fiscal portion column is compared with the respective portion of the provincial government with regard to the national GDP, it is quite clear that the two provinces Balochistan and Khyber Pakhtunkhwa benefit from the tax sharing systems, while Punjab and Sindh receive relatively less than their individual economic strength.

[3] The concept of the National Finance Commission in Pakistan is similar to the regulation in Australia, India, South Africa and Uganda.

[4] Excluding income from agriculture, which is levied individually by the four provinces.

[5] Excluding the general sales tax / VAT on services, which is levied individually by the four provinces.

[6] In addition to the divisible pool of taxes, the four provinces also receive a minor share in the revenues from the royalties on crude oil, natural gas and excise duty on natural gas from the central government as a result of the tax sharing system. The tax sharing ratio is 98% for the central government and only 2 % for the four provinces. The four provincial government possess 100 % of the fiscal revenues from the natural gas development surcharge. These revenues are relatively small, because they only total 5.5% of the provincial share in federal taxes.

Factor	Weight		Province	Fiscal portion	GDP portion	Population portion
Population	82 %		Balochistan	9.7 %	6 %	5%
Poverty or backwardness	10.3 %		KP	16.1 %	12 %	13 %
Revenue collection or generation	5 %		Punjab	47.7 %	54 %	54 %
Inverse population density	2.7 %		Sindh	26.5 %	28 %	25 %
Total	100 %		Total	100 %	100 %	97 % [7]

Table 2: Horizontal distribution between the four provinces in the fiscal year 2014-2015

Source: Werner, 2017

The taxation autonomy of the four provinces is very limited and provincial revenues consist mainly of:

(1) VAT on service
(2) Zakat and Usher
(3) Agriculture income tax
(4) Motor vehicle tax
(5) Stump duty
(6) Property transfer tax / conveyance duty
(7) Property tax / urban immovable property tax
(8) Taxes on entertainment and hotels

The provinces are therefore extremely dependent on vertical grants and tax sharing with central government. However, the provinces and their local governments are responsible for education and health and this explains the huge % gap in the revenue and expenditure share in table 1.

In combination with the low fiscal autonomy of the provinces already presented, provincial expenditure is dependent on federal revenue transfers that leave little room for any fiscal policy freedom. Unfortunately, a low quality of education and health leads to low living standards and their improvement is the key to raising the economic prospects of the provinces in Pakistan. Only well educated people with a sound public service delivery are able and willing the pay the taxes, because both

[7] The FATA with 2 % and the Islamabad Capital Territory with 1 % is not included in the population portion.

tax morale and the tax ratio in relation to the GDP - only 12.4 % in 2017[8] - are extremely low in Pakistan.

2 Local public finance around the World

The decentralisation of expenditure and public functions is only "one side of the coin" of fiscal federalism. Just as well it has to be settled how this delegation is financed and how independent the subnational and local authorities are in their provision of public goods and services. A reasonable intergovernmental finance system has to consider the following principles:[9]

- Revenue autonomy, subsidiarity and connectivity (*local accountability*)
- Transparency of the tax system and direct impact of the tax burden (*benefit tax link*)
- Reference to local circumstances and neutrality of the taxes with regards to the private sector
- Tax bases, which are not affected by economic fluctuation and are also viable
- Simplicity of tax system

At first glance, these five principles seem to be trying to "square the circle" and even at second glance, it has to be admitted that no federal or unitary country in the world has implemented a public finance system that fulfils these five principles completely. Various countries have chosen different ways to reach these goals and thus the conception of how to finance subnational and local services differs significantly. The respective advantage and disadvantages of each method can best be assessed in a general comparison.

The Anglo-Saxon countries like Canada, the USA and the United Kingdom provide their local authorities with a very extensive system of property taxation. A local property tax has the advantage that a direct link between benefit and cost of the public goods can be established. This direct link between the preference of the citizens in local public goods and the policy makers, who have to provide the local public goods, cannot be created by grants or transfers.

Besides a local property tax, a group of European countries – namely Switzerland, Belgium, Croatia and the Scandinavian countries – give significant tax autonomy to their local authorities and therefore a local surcharge on the personal income tax is common.

[8] However, the tax ratio increased from 9.1 % in 2009 to 12.4 % in 2017, see MoF, 2018,page 51.
[9] For detailed description see for example Spahn, 1995 as well as Werner, 2006.

Furthermore, a third possibility to finance local authorities has been chosen by Austria, Bolivia, Germany and Poland, which developed a local tax system with its own revenues as well as tax-sharing.

The following four figures summaries the different local taxation concept as well as the pros and cons of tax sharing and the local tax structure around the world

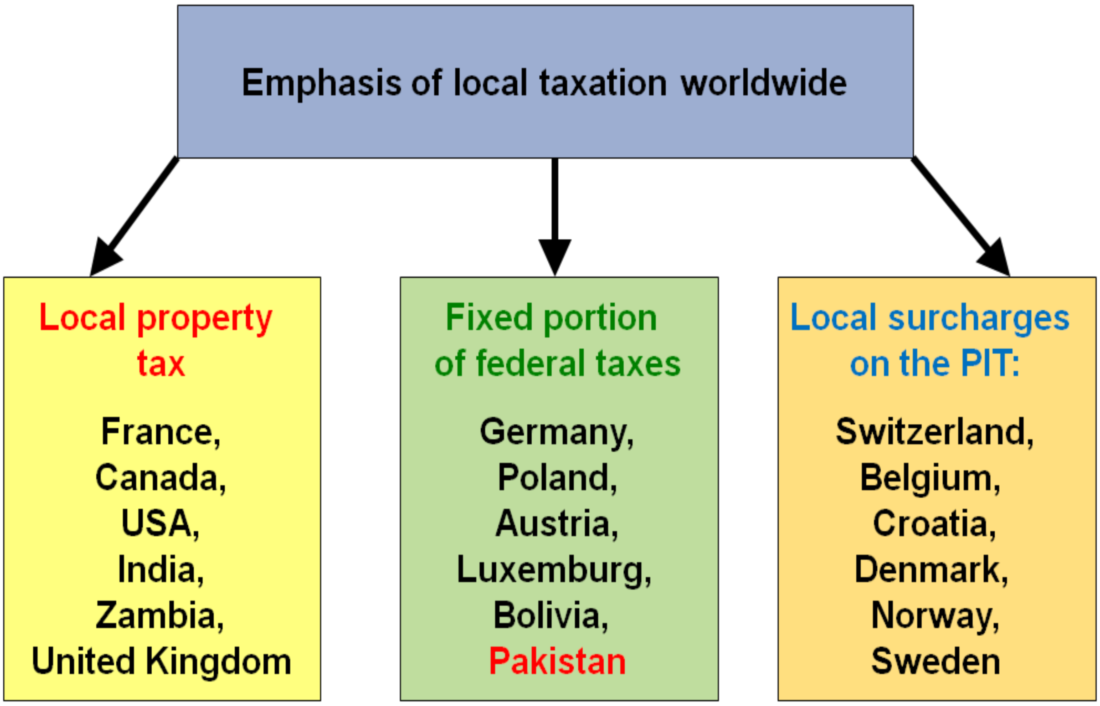

Figure 3: Options for local taxation

	Tax sharing	Own revenues
Pro	❖Stable revenues, because the taxes are not strongly affected by economic fluctuation ❖Common tax for all tiers of government	❖High revenue autonomy and direct link to the local accountability ❖No political pork barrelling possible
Con	❖No revenue autonomy and for this reason a low local accountability ❖ lower transparency	❖No stable revenues flow ❖Administration issue

Figure 4: Pros and cons of tax sharing and own revenues

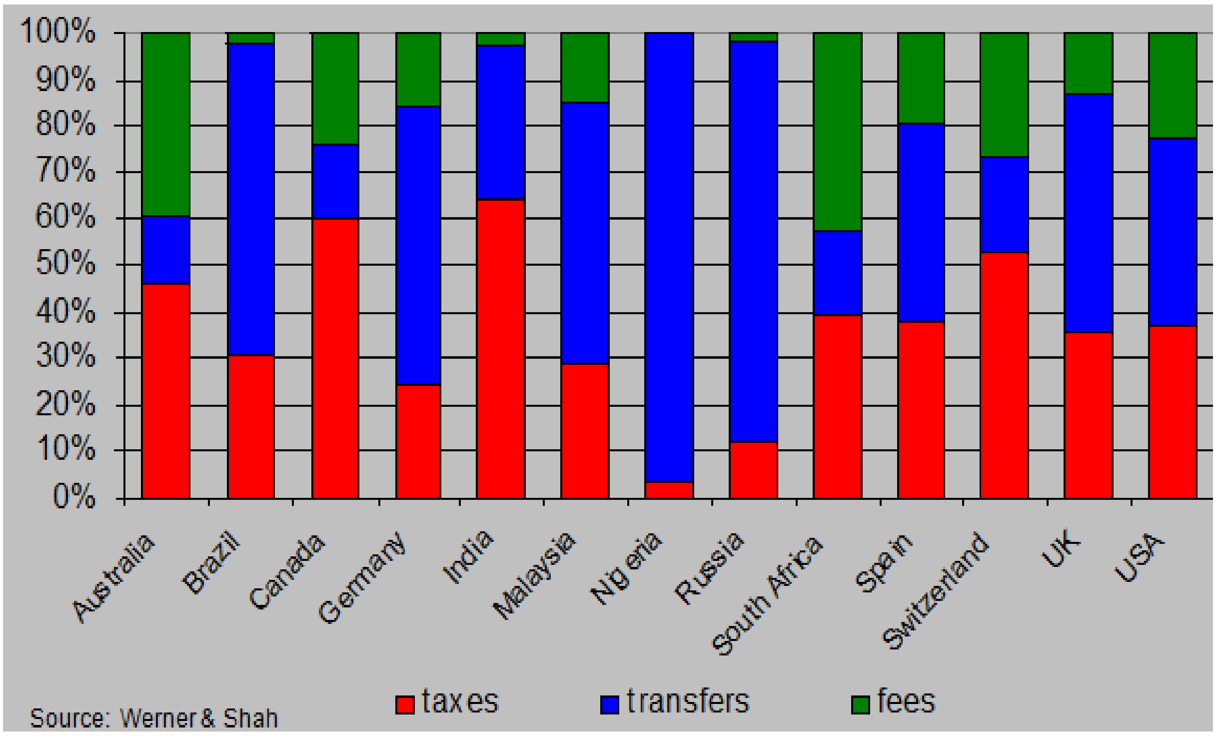

Figure 5: Local public finance structure around the world

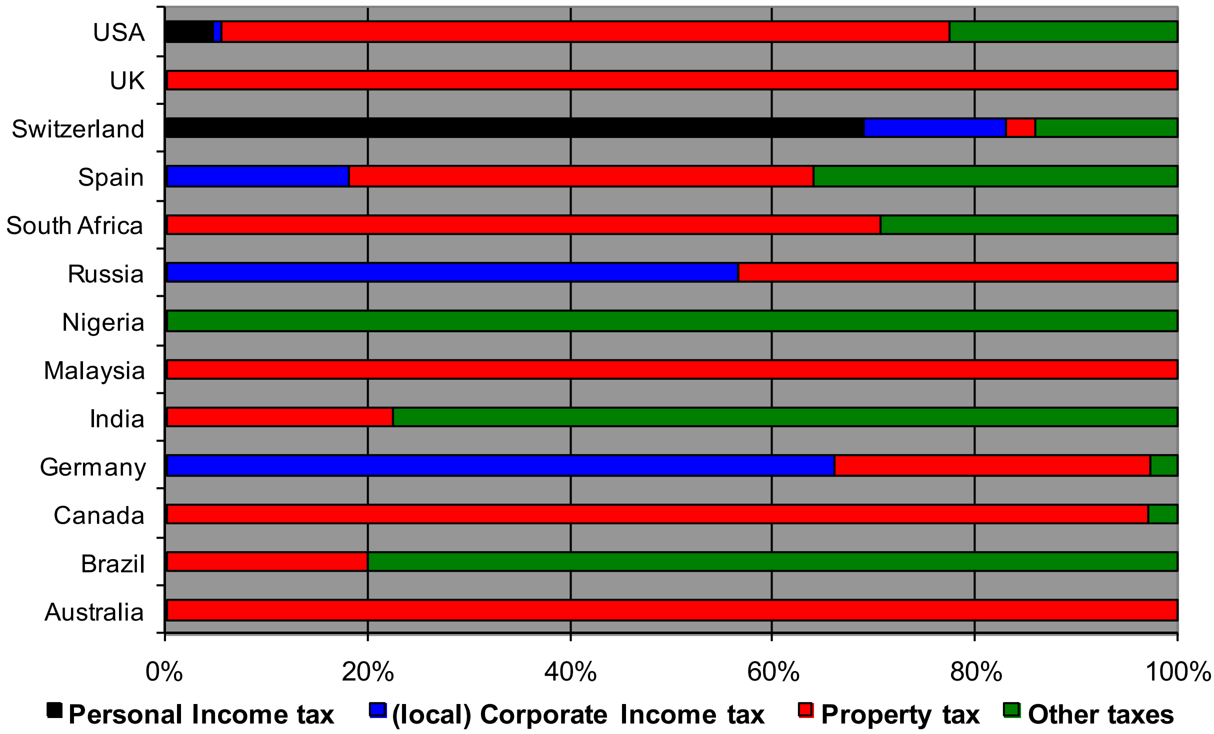

Figure 6: Local tax structure around the world

Nevertheless, vertical grants are also needed in the Anglo-Saxon model and the Scandinavian model and the German model. Grants and transfers avoid external effects and spillovers; for example a local jurisdiction benefits from services of other local authorities without participating in the cost. This situation often exists in the relationship between a metropolitan city and its suburbs. A reasonable solution of this problem is the FOCJ (*functional, overlapping, and competing jurisdiction*) concept (see Frey / Eichenberger, 1995), but for developing countries the FOCJ concept is not realisable. Moreover, the school communities of the Swiss canton of Zurich and the North American special districts are the only successful examples of the FOCJ concept.

Sometimes a country restricts the local accountability, because it substitutes local taxation for vertical grants. These negative scenarios can be found in the Netherlands, Wales, Ireland and Scotland. In the case that local authorities cannot generate sufficient finances from taxes and grants, municipalities will use charges and fees to fill the financial gap. These developments do not only occur in China (see World Bank, 2002) but also in such a rich country as Norway, where "since 1980 user charges have been the fastest growing revenue component of Norwegian local and county governments" (Borge, 2000, page 703).

3 Review of Draft Punjab Local Government Act 2019, Version February 2019

The **first recommendation** is to delete section # 129, clause 1c and section # 164 completely, because sometimes the respective draft version of the Punjab local government act undermines local accountability.

❖ Section # 129, Application of the local fund, clause 1c indicates

"Thirdly, in meeting expenditure declared by the government to be an appropriate charge on local governments"

❖ Section # 164, Power of the Finance Commission in case of unfair local taxes etc., indicates

"... The Finance commission requires ... measures to remove this

objection."

The **second recommendation** is that the selection criteria of the members of the local government finance commission could be more well-defined.

❖ Section # 178, Establishment of the Local Government Finance commission indicates
  - That the commission consists of 13 members
    - 5 representatives from the provincial level
    - 4 representatives from the local level and
    - 4 local experts

❖ Section # 181, Eligibility for appointment of experts and certain other members indicates in clause 1d the requirement that

- *"he is not a member of a political party"*

The suggestion is

(1) to include in Section # 178, Clause 2 an additional sub-clause that says that at least three of the thirteen members have to be female.

(2) to include in Section # 178, Clause 2 that the respective 4 representatives from the local level will be independently selected by one of the Punjab local government associations,e.g. the Local Councils Association of the Punjab (LCAP).

(3) to delete Section # 181, Clause 1d completely.

The **third recommendation** to increase transparency for normal people by using the internet as an instrument.

- Section # 196, General function of the finance commission, clause 1 f mentions a report on the fiscal performance of local government.

And for this reason define in Section # 196 that this report **and** all relevant data have to be published on the internet.

The **fourth recommendation** for revenue enhancement is pooled financing in the province of Punjab**.** Besides taxes, fees and vertical transfers, the concept of local borrowing also has a huge effect on delivery of infrastructure. Possible options for the local government borrowing system are:

(1) Severe restriction and generally no independent local borrowing

- Ethiopia, China (until 2015) and the current system in Punjab (article 109)

(2) Pooled municipal government debt in a provincial government agency

- Canada and India

(3) A municipal bond system

- USA, Mexico, Poland, Czech Republic, Slovakia, Hungary and South Africa

(4) Commercial and private bank

- France, Belgium (Dexia)

(5) Public "saving banks"

- Austria, Germany

Because of the limited capital market in Pakistan, options three and four are not possible and the example of South Africa proves that the municipal bond system is not always a silver bullet.[10]

However, instead of unregulated access to the capital market, the province of Punjab should combine the concept of pool financing and its own public bank. Including rural entities in a common pooled financing system is almost certainly cheaper for the urban areas in the province of Punjab in the long run, because if the infrastructure delivery gap between rural and urban entities increases, then rural depopulation will also increase, putting pressure on the infrastructure for the urban authorities. The following box 1 explains the concept of pooled financing in India.

Box 1: Pooled financing like the Tamil Nadu Urban Development Fund in India

The Tamil Nadu Urban Development Fund (TNUDF) was established in 1996 and is mainly financed by the regional government of Tamil Nadu as well as the World Bank.

The fund manager of the TNUDF is Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL). The regional government holds 49 % shares of the TNUIFSL and remaining 51 % shares belongs to three national banks. The daily management responsibility of this fund belongs to the ICICI Bank, which holds with 21 % the biggest share of all three Indian banks.

Eligible Borrowers for the Tamil Nadu Urban Development Fund in India are on the one hand urban local bodies in India and on the other hand any private institutions that creates urban infrastructures in India.

Moreover, the TNUDF uses - besides capacity development also the concept of polled financing for the infrastructure financing. The idea of polled financing means that several projects are pooled and lumped together in a bond issuance and this can provide a significantly reducing transaction costs and improving pricing. Especially for smaller and less creditworthy local authorities is this concept reasonable.

Currently, a sum of ₹ 3510.19 crores is available with TNUDF for providing financial assistance for the implementation of urban infrastructure projects.[11]

[10] The city of Johannesburg is the only one of the eight urban areas in South Africa, which has been able to attract various municipal bonds quite easily since 2004. As a matter of course, the US-American rating agencies always profit from a municipal bond system, because every local government needs an adequate rating for entry into the capital market and such rating is always expected from foreign rating agencies. Moreover, it has to be considered that the "success story" of the US municipal bond market is based on a savings and loan crisis and that municipal bonds are tax empted.

[11] Tamil Nadu Urban Development Fund, 2019, page 2

The lesson to be learned from the Tamil Nadu Urban Development Fund in India for the stakeholders in the province of Khyber Pakhtunkhwa is that the local units should use the idea of polled financing as much as possible to reduce their financing costs. Moreover, the urban areas should not be blinkered as to the financial situation of their surrounding rural entities. To include those rural entities in a common polled financing is in the long run surely cheaper for the urban areas in in the province of Khyber Pakhtunkhwa, because if the infrastructure delivery gap between rural and urban entities is increasing, then the rural depopulation will also increase and the urban authorities have pressure on their own infrastructure.

Furthermore, the aspect of capacity development should be not underestimated, as financial institutions like commercial banks or pension funds from abroad expect very qualified dialogue partners.

4 Conclusion

Local public finance and fiscal transfers are a highly technical as well as political issue.

Institutional arrangements can reduce or increase fiscal conflicts and, for this reason, please do not underestimate the selection criteria of the members of the local government finance commission in Punjab

It is important to keep in mind the administration capacity of the provincial MoF as well as the amount of available data in Punjab, if a new equalisation system is to be implemented. For this reason keep it simple and transparent and use the data of the new census from 2017as an indicator

The suggested concept of pool financing issued by a publicly-owned Bank offers the subnational entities another option for long term investments and fulfils the "Golden rule of fiscal policy". This rule means that the local government - under the supervision of their own public bank - will borrow only to invest for the benefit of future generations and not to fund current spending.

Moreover, even for the best taxation system together with an integer tax administration it is impossible to improve a tax collection rate without any political willpower.

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