

# Reforms in Sub-Provincial Finances

By

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# Format of Presentation

1. Review of Process of Devolution after 2001
2. Lessons from International Experience
3. Allocation of Functions
4. Allocation of Fiscal Powers
5. Resource Mobilization Strategy
6. Intergovernmental Revenue Transfers

# Review of the Process of Devolution After 2001

- Significant fiscal decentralization, doubling of LG expenditure to 2.5% of GDP
- Transfers of large number of functions to LGs, but limited capacity to absorb, lack of vertical integration among LGs
- Restricted administrative and financial autonomy
- Inadequate attention to capacity building and setting up of monitoring and supervision bodies

- Within LG budgets, largest share (over 60%) on education (primary, secondary) and on development side to roads
- Limited fiscal powers and fiscal effort
- Fiscal equalization through transfers by PFCs has been limited
- Impact on social Indicators – improvement in literacy and coverage of water supply and sanitation. Little change in health, gender equality & regional disparities.

# Lessons from International Experience

## Local Resource Mobilization

- Own revenues must be large enough to ensure accountability, ownership, efficiency and legitimacy of the decentralized system
- Harmonizing of tax rates of mobile tax bases not of immobile tax bases
- Significant Imbalance in fiscal powers, case for 'piggy backing'
- If higher level of government collect and reverts back revenues, little incentive to develop own sources
- Avoid multitude of small taxes, and increase focus on promising sources

# Lessons from International Experience

## Transfers

- Too large transfers can reduce fiscal effort and create dependency
- Performance-linked incentives in grants can lead to significant improvements
- Inter- jurisdictional fiscal equalization in grants needs more attention
- Use of gap filling approach to grants creates a tendency for LGs to raise expenditure and reduce fiscal effort
- Specific matching grants offered for development schemes are distortionary and inequitable

# Allocation of Functions

- The basis of allocation is essentially the principle of subsidiarity in Devolution Plan 2001 – Education (primary, secondary) and health (preventive, curative) were devolved to the LGs.
- As per the draft Punjab LGA 2010, reversion of secondary education and hospitals to the provincial governments does not appear to be consistent with the principle of subsidiarity.
- However, some economic services like agricultural development and law and order (police) is better managed at Provincial level.

# Allocation of Fiscal Powers

- The principal source of revenue in LGA 2010 will be tax on annual value of buildings and land which remains grossly underexploited. By giving flexibility to vary tax rate, the tax can become the budget balancing device.
- Collection and rate-setting authority of property tax is not clear. Case for devolution to Metropolitan Councils
- An important omission in draft PLGA 2010 is of Local Rate on land, assessable to land revenue
- Non-tax revenue sources are largely unchanged and include water, drainage, conservancy etc.



# Proposals for Local Resource Mobilization

- Development of urban immovable property tax. Devolution of collection and rate setting to metropolitan governments
- Fixed tax on establishments below RGST threshold level
- Reintroduction of local rate on agricultural land
- ‘Piggybacking’ on provincial tax like
  - ~ GST on retail trade
- Move towards full O&M cost recovery in water supply, sanitation, etc
- Market based land pricing

# Types of Revenue Transfers to LGs in Punjab

Type of Grant	Purpose	Share in Total Transfer
General Purpose Grant	To meet current expenditures needs	71.2%
Equalization Grant	To remove any shortfall in benchmark expenditure	9.3%
Development Grant	To meet development needs	11.3%
Tied Grant	To provide additional finances to social sectors under protocols agreed with donors	8.2%

# PFC Formula of Current Transfers by Province

Provinces	Formula
Punjab	General Purpose Grant (89%) and Equalization Grant (11%): <b>General Purpose Grant:</b> shared on the basis of population <b>Equalization Grant:</b> shared on the basis of the fiscal gap between baseline expenditure and the general purpose grant
Sindh	Current transfers distributed according to multiple criterion: Population (40%); service infrastructure (35%), development needs (10%); area (5%) and performance (10%). Transitional grants given only to districts with relatively high levels of expenditure.
Khyber-Pukhtunkhwa	Salary transfers as per needs. Non salary transfers are formula-based: 90% distributed on the basis of population (50%), backwardness (25%) and lag in infrastructure (25%). 10% set aside for equalization grants.
Balochistan	Allocated on the basis of shares in total expenditure in 2001-02, the first year of devolution.

# Revenue Sharing Observations in the PFC Award of Punjab

- Fairly complex system – 4 types of grants
- Share of development grants is relatively low
- No criterion reflecting local fiscal effort. No explicit consideration of fiscal equalization in current transfers



Transfer mechanisms will need to consider:

- Enhancement in the share of development grant
- Explicit provision for fiscal equalization between rural and urban areas
- Incentive for higher fiscal effort at the local level
- Conditional grants for some devolved functions in order to achieve a minimum standard of provision throughout the province

# Conclusions

- Major move towards devolution should not stop at the provincial level but proceed also to the local level
- Currently, the draft of Punjab LGA, 2010 is closer to LGO of 1979 in terms of structure but allows some expansion in the list of functions