

**LOCAL GOVERNMENT RESOURCE  
MOBILISATION**

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## **INTRODUCTION**

Local governments are a somewhat neglected tier of government in Pakistan despite the fact that they are responsible for the delivery of basic social services like water supply, sanitation, preventive health, etc. The enhanced priority for development of social sectors must, therefore, also imply a higher priority for development of the local government system in Pakistan.

However, prior to this a number of key issues will be need to be resolved relating primarily to the sharing of functions and fiscal powers between provincial and local governments. This will require an examination of the pros and cons of the decentralisation of different social services from provincial line departments to local councils and how such a decentralisation programme can be financed. It is the objective of this paper to examine the scope for expanding the role of local government either through self-financing by higher local resource mobilisation or by greater support from higher levels of government so as to enable a greater involvement of local governments in the delivery of basic social services.

Section 1 of the paper presents an overview of local fiscal powers and functional allocations. Section 2 briefly describes the composition of local revenue sources and expenditure patterns while section 3 identifies some of the key issues in local resource mobilisation. Finally, in

Section 4 we present the proposed overall strategy for local resource mobilisation alongwith detailed proposals for improvements in tax administration, rationalisation of the tax structure and development of new sources.

## **1. OVERVIEW**

The allocation of fiscal powers to local governments is specified in the Local Government Ordinances of the provinces (See Table 1 and 2). By and large, the distribution of fiscal powers is heavily influenced by the nature of the regional economy. As such, the main revenue source of the district council is a tax on goods 'exported' by the area while the most important revenue generating instrument for the urban councils is a tax, octroi, on goods 'imported' into the area. An examination of the tax structure of the local councils also reveals that some of the more buoyant taxes of a local nature have been pre-empted by the provincial government.

Local councils are responsible for the provision of some basic services in Pakistan. Table 3 presents a comparison of the legislative allocation of functions and functions actually performed by local councils. Some of the major local responsibilities include water supply, solid water disposal, drainage, fire fighting, roads and street lighting, primary education, health care, etc. However, the provincial government is either solely or partially involved in the provision of some of these services. The involvement of the local councils in the provision of the latter two services, for example, is currently limited because of financial and institutional constraints. As such, these services continue to be the principal responsibility of the provincial government. The actual participation of rural local councils in the development and maintenance of services is even more limited.

**TABLE 1**  
**FISCAL POWERS OF URBAN LOCAL COUNCILS**

	<b>Sindh</b>	<b>Punjab</b>	<b>NWFP</b>	<b>Balo- chistan</b>
1 Tax on the import of goods & animals for consumption or sale.	* <sup>a</sup>	*	*	*
2 Tax on the annual rental value of buildings and land.	*	*	*	*
3. Tax on cinemas and cinemas tickets	*	*	*	*
4. Entertainment tax on dramatical and theatrical shows.	*	*	*	*
5 Tax on the transfer of immovable property.	*	*	*	*
6. Water Rate	*	*	*	*
7. Drainage Rata.	*	*	*	*
8. Conservancy rate.	*	*	*	*
9. Tax on all kinds of vehicles.	* <sup>b</sup>	*	*	*
10. Lighting Rate.	* <sup>c</sup>	*	*	*
11. Fees for the erection and re-erection of buildings.	*	*	*	*
12. Marriage Tax.	*	*	*	* <sup>d</sup>
13. Fees for Licences, sanctions and permits granted by council.	*	*	*	*
14. Fees on the slaughter of animals.	*	*	*	*
15. Tax on professions, trades, callings and employment.	*	*	*	*
16. Market Fees.	*	*	*	*
17. Tax on Advertisements.	*	*	*	*
18. Tax on Feasts.	* <sup>e</sup>	*	*	*
19. Tax on animals and sale of animals.	* <sup>f</sup>	*	*	*
20. Toll tax on roads and bridges maintained by the council.	*	*	*	*
21. Fees at fairs, agricultural shows, industrial exhibitions, tournaments and other public gatherings.	*	*	*	*
22 Tax on the construction or maintenance of any work of public utility.	*	*	*	*
23. Fee for specific services rendered by council.	*	*	*	*
24. Parking fees.	-	*	*	*
25. Taxes on birth of children.	*	*	*	*
26. Hearth tax.	-	-	-	*
27. Rate for remuneration of village police.	-	-	-	*
28. Community tax on adult males for the construction of public works of general utility for the inhabitants of the town.	*	-	-	*
29. Surcharge on any of the taxes levied by Government.	*	-	-	-
30. Tax on the export of goods from the local area.	*	-	-	-
31. School fee in respect of schools established or maintained by council.	*	*	*	-
32. Tax on adoptions. '	*	-	-	-

\* = Tax can be levied.

Note: KMC an charge a drainage rate as well as impose a rate for bulk water supply.

a = Only on goods; b = Other than motor vehicles and boats; c = Also fire rate

d = On second marriage if first wife is alive; e = No qualification; f = On animals only.

SOURCE: Local Government Ordinances.

**TABLE 2**  
**FISCAL POWERS OF RURAL LOCAL COUNCILS**

	Sindh	Punjab	NWFP	Balo- chistan
1. Tax on the import of goods and animals.	*	D	D	D
2. Tax on the import of goods and animals for consumption or sale.	U	U	U	U
3. Tax on the transfer of immovable property.	*	D	D	D
4. Fees for licences, sanctions and permission by the council.	*	*	*	*
5. Market fees.	*	*	*	D
6.. Rates on the services like water supply, drainage, lighting provided by the council.	*	*	*	D
7. Fees at fairs, agricultural shows, industrial exhibitions, tournaments and other public gatherings.	*	*	*	D
8. Fees for specific services rendered by council.	*	*	*	U
9. Fees on the slaughter of animals.	*	U	U	U
10. Tax on the annual rental value of buildings and lands.	*	U	D	-
11. Tools on roads and bridges maintained by the council.	*	*	*	D
12. Tax on the construction or maintenance of works of public utility.	*	*	*	U
13. Surcharge on any of taxes levied by Government.	-	U	U	D
14. Rate for the remuneration of village police.	-	-	U	U
15. Tax on vehicles other than motor vehicles, including cars, bicycles and tongas.	*	D	D	-
16. Tax on the profession, trades, callings and employment.	*	D	U	-
17. Tax on advertisement.	*	D	-	-
18. School fees in respect of schools established or maintained by the council.	*	D	-	-
19. Tax on lands not subject to local rate.	*	-	-	-
20. Tax on hearth.	*	U	U	U
21. Tax on births, marriages and feasts.	*	U	U	U
22. Tax on cinemas, dramatical and the atrical shows and other amusement.	*	U	U	-
23. Conservancy rate.	*	-	-	-
24. Fee on application for erection and re-erection of buildings.	*	U	U	U
25. Any other tax which is levied by Government.	*	-	*	-
26. Community tax on the adult males for the construction of any work of public utility.	*	U	U	-
27. Tax on animals.	*	U	U	U
28. Local Cess.	*	-	*	-
29. Fees on sale of cattle at fairs.	-	D	-	-

\* = Tax can be levied

U = Union Councils only

D = District Councils only

SOURCE: Local Government Ordinances.

## TABLES

### LEGISLATIVE AND ACTUAL ALLOCATION OF LOCAL FUNCTIONS

<b>Legislatively Local Functions</b>		<b>Actual Allocation of Functions</b>
Curative Health	?	
Land Development	?	Provincial Government
Primary Education	?	
	?	
FARM-to-Market Roads	?	
Rural Development	?	
Preventive Health	?	Provincial/Local Governments
Water Supply, Drainage and Sewerage	?	
	?	
Link Roads	?	
Intra-urban Roads	?	
Street-Lighting	?	
Solid Waste Management	?	Local Governments
Fire Fighting	?	
Parks, Playgrounds	?	
	?	

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SOURCE: Local Government Ordinances

By and large, there appears to be a direct relationship between the level and range of the functions performed by the local government agencies and city size. In large cities, considerable diversification is observed in role of local governments, which in addition to obligatory functions have also taken on some optional functions. The presence of specialised agencies, like development authorities and WASAs, has enhanced local development capacity. Municipal governments in small cities and rural areas have been relegated largely to performing only a few basic functions.

On the whole, there is a basic imbalance between the range of functions that local governments can perform and the fiscal powers granted to them. The former are very extensive, while the latter are very limited. Consequently, most local councils, especially those in the smaller cities and rural areas, discharge only few of the basic functions. This has necessitated continued involvement of provincial line departments, in the provision of 'local' services especially in the rural areas.

## **2. COMPOSITION OF REVENUES AND EXPENDITURES**

### **2.1 Sources of Revenue**

Local governments in Pakistan derive their income from various tax and non-tax sources. Bulk of the revenues, about 60 percent, are generated through taxes (see Table 4). In 1990-91, the estimated share of taxes in urban and rural areas was 63 and 52 percent respectively.

**Urban Councils:** Analysis of the composition of local council income reveals that octroi tax is the single largest source of revenue for urban local councils. In 1990-91, total national

**TABLE 4**  
**COMPOSITION OF LOCAL COUNCIL INCOME BY PROVINCE, 1990-91\***  
 [% Share in Total Receipts]

	URBAN AREAS					RURAL AREAS				
	Punjab	Sindh	NWFP	Balo- chistan	Pakis- tan	Punjab	Sindh	NWFP	Balo- chistan	Pakis- tan
<b>TOTAL REVENUE RECEIPTS</b>	<b>89</b>	<b>87</b>	<b>82</b>	<b>72</b>	<b>87</b>	<b>88</b>	<b>83</b>	<b>87</b>	<b>75</b>	<b>87</b>
<b>Tax Receipts</b>	<b>65</b>	<b>64</b>	<b>50</b>	<b>58</b>	<b>63</b>	<b>48</b>	<b>53</b>	<b>70</b>	<b>31</b>	<b>52</b>
Tax on the movement of goods [Octroi/export taxes]	49	53	38	55	50	13	39	46	6	24
Taxes on Property	8	7	5	n	7	24	2	12	6	16
Other Taxes	8	4	7	3	6	11	12	11	19	12
<b>Non Tax Receipts</b>	<b>24</b>	<b>22</b>	<b>32</b>	<b>14</b>	<b>23</b>	<b>40</b>	<b>30</b>	<b>18</b>	<b>44</b>	<b>34</b>
Licences and fees	10	2	10	2	6	15	4	9	6	11
Water Rates**	11	19	16	12	15	26	26	9	38	23
Other Non-Tax Receipts***	11	19	16	12	15	26	26	9	38	23
<b>Capital Receipts</b>	<b>11</b>	<b>13</b>	<b>18</b>	<b>28</b>	<b>13</b>	<b>12</b>	<b>17</b>	<b>13</b>	<b>25</b>	<b>13</b>
Development grants	2	2	4	8	2	1	3	1	6	1
Others	9	11	14	20	11	11	15	11	19	12
<b>Total Receipts</b> (Rs. in Million)	<b>4427</b>	<b>4646</b>	<b>784</b>	<b>467</b>	<b>10324</b>	<b>1268</b>	<b>538</b>	<b>317</b>	<b>32</b>	<b>2155</b>

\* Projected beyond 1985-86 (from the NCRD data base) on the basis of historical trends.

\*\* Income only of the local councils and not of specialised agencies like the WASAs.

\*\*\* Including non-development grants.

SOURCE: National Centre for Rural Development (NCRD) Data Base.



collection from octroi was estimated at Rs 5.2 billion, accounting for half of total receipts of urban local councils. Other important taxes for urban areas include property related taxes, namely, urban immovable property tax and tax on transfer of property (TTP). The former is an annual tax on property rental values while the latter is charged on the total value of the property at the time of sale/transfer. These together account for about 7 percent of total urban receipts with higher revenue significance in bigger cities which have metropolitan/municipal corporation status.

The revenue contribution of non-tax sources is higher in smaller councils (municipal and town committees) where the tax base is relatively narrow and the tax structure relatively underdeveloped. Non tax receipts accounted for 23 percent, about Rs 2.3 billion, of total local council income in Pakistan in 1990-91. Revenue contribution of non-tax receipts is highest for town committees where almost 49 percent of total revenue receipts accrue from such sources.<sup>1</sup>

The generally low level of direct cost recovery of service provision is striking in the case of local councils. The concept of self-sustained provision of municipal services is, by and large, limited to only two services namely, water supply and solid waste. These user charges are generally low and restricted to the larger urban councils only. Water rate is perhaps the only user charge levied by most urban local councils.

In the case of larger cities the development capacity of the local council is supplemented by specialised agencies, namely, the development authorities (DAs) and the water and sanitation

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1. Does not include specialised agencies.

agencies (WASA). Bulk (75 to 90 percent) of the income of the former is generated through sale of land, which is the primary function performed by these agencies. Similarly, the primary source of income of WASAs is water rates charged for the provision of water supply. In recent years, water agencies in the country have been able to recover more than 60 percent of their recurring costs.

***Rural Councils:*** Among the important rural taxes are tax on transfer at property (TTP), export tax and local rate. TTP revenues accounted for 16 percent of total receipts of rural local councils in Pakistan. Its revenue contribution in 1990-91 was estimated at over Rs 340 million. Export tax yield was Rs 517 million, representing a share of 24 percent. Because of the current low export tax rates and limited coverage the revenue potential of these taxes is largely unexploited in Punjab. In other provinces, particularly Sindh, the export tax constitutes an important source of income to the local councils.

Non-tax revenues are also of significant importance to district councils with a share of about 34 percent. These revenues are generated from a multitude of smaller sources like licences and fees, grants in aid from higher levels of government, etc. Capital receipts account for about 13 percent of total revenues with development grants making only a marginal contribution to total revenues.

As a whole, major differences exist in per capita revenue among the different local councils of Pakistan. Urban local councils have over nine times the per capita revenue of rural local councils. Within the former, per capita revenue of metropolitan/municipal corporations is almost four times higher than that of municipal/town committees.

## **2.2 Expenditure Patterns**

Following a discussion on municipal revenues we turn now to the expenditure side of local councils. Total expenditure incurred by the local councils nationally is estimated at Rs 11.2 billion in 1990-91 (see Table 5), equivalent to 1.1 percent of the GDP and 13 percent of provincial expenditure in the country. Out of this Rs 7.1 billion or 63 percent was recurring in nature, indicating that a substantial proportion of total expenditure incurred by these governments is on operating and maintaining the existing network of services.

The pattern of recurring expenditure of local councils is also presented in Table 5. The table shows that a substantial share, 25 percent, of total recurring expenditure is on general administration. The most important sectors, as reflected by their share in total recurring expenditure, are sanitation and primary education, accounting for 24 and 9 percent of the total expenditure respectively. 'Others' sectors include services like social welfare, fire fighting, gardens, parks and playgrounds, animal husbandry, etc. These collectively account for about 24 percent of total recurring expenditure. Medical care sector accounts for 4 percent of recurring expenditure, mostly by the larger urban councils in the country.

Within development expenditure, the largest sector is roads and street lighting, with share approaching 37 percent. Next in importance are water supply and drainage and sanitation with share of 23 percent and 13 percent respectively. The involvement in development of primary education and curative health is limited, with a combined share of 9 percent.

**TABLE 5**  
**LEVEL AND PATTERN OF EXPENDITURE OF LOCAL COUNCILS BY PROVINCE, 1990-91\***  
*[% Share in Expenditure]*

SECTOR	RECURRING EXPENDITURE					DEVELOPMENT EXPENDITURE				
	Punjab	Sindh	NWFP	Balo-chistan	Pakis-tan	Punjab	Sindh	NWFP	Balo-chistan	Pakis-tan
General Administration	23	23	37	24	25	0	0	0	0	0
Primary Education	12	7	2	9	9	4	10	3	6	6
Medical Care	5	3	2	3	4	2	4	1	3	3
Sanitation	25	22	17	22	23	19	18	14	18	18
Water Supply & Drainage**	8	10	7	9	9	28	12	58	23	23
Roads & Street Lighting	8	4	14	7	7	42	35	21	37	37
Others	19	31	21	26	24	6	22	4	12	13
<b>Total (Rs. in Million)</b>	<b>3491</b>	<b>2564</b>	<b>651</b>	<b>393</b>	<b>7099</b>	<b>1926</b>	<b>1816</b>	<b>333</b>	<b>52</b>	<b>4127</b>

\* Based on extapolation of trends revealed by the NCRD data upto 1985-86.

\*\* Excluding development authorities and water and sanitation agencies.

SOURCE: NCRD Data Base.

### **3. ISSUES IN LOCAL RESOURCE MOBILISATION**

A number of important issues arise in the context of local government finances. These include:

#### **3.1 The Role of Local Government**

During the last two decades there has been a growing centralization in the performance of government functions in Pakistan. This has largely been caused by an imbalance between the legislative allocation of functions and fiscal powers, as a consequence of which lower (provincial, local) levels of government have not had the financial resources to discharge all their responsibilities. While the provincial governments have abdicated some of their responsibilities in the Concurrent List of the Constitution to the federal government, a whole range of municipal functions in practice are being performed by provincial governments, especially in the rural areas and smaller towns. This includes functions like preventive and curative health, primary and secondary education, land development, farm-to-market roads, water supply, drainage and sewerage.

The NFC Award of 1991 has, however, removed some of the imbalance between the federal and provincial governments in the allocation of revenues. This has been achieved by the large once-and-for-all expansion in the divisible pool of taxes. Therefore, it is now an appropriate time for reversing the process of centralization that has occurred. Provincial governments could begin to play a more active role in discharging Concurrent List functions and hand over the essentially municipal functions to local governments. However, a number of key issues need to be resolved: Which are the prime candidate services for decentralisation? How will resources be augmented at the local level to enable such a process of decentralisation?

Do the local councils have the institutional capability to perform more functions? How responsive will different levels of government be to a programme of decentralisation?

As noted above, the urban local councils have been charged by the LGOs with the performance of large number of regulatory and service provision functions, most of which are in the nature of compulsory functions. However, while the larger local councils have made an attempt to perform most of the prescribed functions, smaller councils have had difficulty even in discharging the basic compulsory functions, because of resource and institutional constraints. Therefore, as a starting point any program of decentralisation must be designed to ensure that local councils can at least perform adequately their compulsory functions according to the LGOs.

Decentralisation is justified if it can be demonstrated that there is an increase in efficiency in the provision of a service either by cost reductions or by enhancements in the quality of service, through greater accountability and more effective administration or if there is greater beneficiary involvement in financing. One of the strongest arguments in the favor of decentralisation of the provision of urban physical infrastructure is that local councils are ultimately responsible for maintenance of such infrastructure even if the initial development is by a provincial line department or a specialized agency. Therefore, if the local councils are also involved in the stages of project design, financing and execution, the prospects of a smooth transition from the development to the maintenance stage is likely to be greater. Moreover, local councils are likely to have a better knowledge of the needs and preferences of citizens. As such, their involvement is likely to ensure that development schemes more accurately reflect effective demand. This will increase the willingness to pay on the part of

beneficiaries for both capital and recurring costs and, wherever necessary, provide greater scope for community participation.

On the basis of these considerations, the strongest case for decentralisation in the context of service-related functions appears to be in the areas of water supply, sewerage and sanitation, primary education and basic health as these are typically the most important services which are currently handled by the provincial line departments on behalf of the local bodies. However, for the success of such a program there is clearly a need to enhance the financial resources of the local councils. This will require not only a higher level of resource mobilisation from existing sources but also new methods of increasing the resource availability to these government units through revenue sharing transfers, matching grants etc. This takes us into issues in resource mobilisation.

### **3.2 Limitation of Fiscal Powers**

As mentioned earlier some of relatively more broad-based and buoyant taxes of a local nature, like motor vehicle tax, property tax, tax on professions, trades and calling and entertainment tax, are either not included in the local bodies' fiscal powers or have been preempted by the provincial governments. However, local governments have been vested with considerable powers to levy user charges like drainage rate, conservancy rate, lighting rate, parking fees and betterment tax. In addition, there exists the option to levy a surcharge on any tax levied by provincial government. Local councils have not yet seriously explored and exploited this option.

### **3.3 Fiscal Autonomy**

Local taxes can only be levied or enhanced/reduced if prior sanction has been obtained from the provincial government, which has the power to decrease, suspend or abolish any tax. Also, proposed changes in tax rates or structure have to be published to invite public comments. Objection to the proposed tax measures are heard by the Finance Sub-committee of the council in public. This procedure is not followed by other levels of government. Given that local taxation proposals are also legislated by elected representatives at the local level the case for greater fiscal autonomy is strong. Basically, the approach of the provincial government should not be one of the physical control but of bringing about desired changes in behaviour of local councils through incentive schemes like matching grants, etc.

### **3.4 Inter-governmental Fiscal Relations**

Local governments, unlike other tiers of government in the country, are, by and large, self-financing entities. While the higher tier of government (the provincial governments) largely rely on federal revenue transfers, local councils, more or less, completely self-finance their expenditures. This is a reflection of the pattern of inter-governmental fiscal relations in the country whereby local governments have been largely excluded from revenue-sharing arrangements (except in the case of property tax) and from access to grants and borrowing either from higher levels of government or from domestic capital market. This has avoided any degree of financial profligacy but has limited investment to the level attainable by self-financing. The consequence is that expansion and improvements in the level of service provision are largely undertaken by the financially stronger metropolitan and municipal corporations which are in a better position to exploit the limited fiscal powers. Smaller



councils, especially in the rural areas, which have narrow tax bases and limited fiscal capacity are in general forced to spend less and undertake only minor development works.

To negate the affects of differences in local fiscal capacity for provision of services across jurisdictions, inter-governmental fiscal transfers are widely used internationally. Table 6 shows that inter-governmental transfers (which may include revenue-sharing transfers or grants) account for a significant proportion of local revenues internationally. In the case of some of the major cities in the region like Calcutta (India), Chittagong (Bangladesh), Tehran (Iran), and Colombo (Sri Lanka), flow of funds from higher levels of government are over 40 percent of local government revenues. As compared to this provincial transfer to local councils in Pakistan is only 13 percent of local receipts. Therefore, a case can perhaps be made for enhancing the magnitude of flow of funds from higher levels of government to local councils in the country. In fact, the case for higher revenue sharing flows to local councils can further be strengthened on the grounds that, as already mentioned, the provincial governments have pre-empted some taxes which are either local in nature or fall in local fiscal powers.

### **3.5 Incidence of Existing Taxes**

One of the basic issues in the context of existing taxes is that of incidence. The incidence of urban local taxes by income groups is presented in Table 7. The table shows that the burden of local taxes as a proportion of income is somewhat progressive in Punjab while it is clearly regressive in NWFP. This implies that in Punjab and Sindh the proportionate burden of municipal taxes increases nominally for higher income households, being the highest for the upper middle income households, while the opposite holds true in the case of NWFP.

**TABLE 6****INTERNATIONAL COMPARISON OF THE  
SIGNIFICANCE OF INTERGOVERNMENTAL TRANSFERS\*  
IN LOCAL GOVERNMENT FINANCES**

	<b>City/Country</b>	<b>Year</b>	<b>Intergovernmental Transfer as % of Local Government Revenue</b>
1.	Chittagong, Bangladesh	1983	41.7
2.	Dhaka, Bangladesh	1983	34.6
3.	Jakarta, Indonesia	1981	39.1
4.	Tehran, Iran	1974	45.2
5.	Colombo, Sri Lanka	1982	42.6
6.	Manila, Philippines	1975	30.0
7.	Mexico City, Mexico	1982	26.3
8.	Nairobi, Kenya	1982	24.7
9.	Bangkok, Thailand	1977	39.6
10.	Seoul, Republic of Korea	1983	22.0
11.	Madras, India	1979	13.7
12.	Calcutta, India	1982	54.9
13.	Faisalabad, Pakistan	1986-87	6.5
14.	Lahore, Pakistan	1986-87	22.1
15.	Pakistan	1985-86	12.0

\* Includes revenue-sharing, grants (both development and non-development) and Loans.

**SOURCES:**

1. Roy W. Bahl and Johannes F. Linn, 1992, "Urban Public Finance in Developing Countries" A World Bank, Published by Oxford University Press.
2. National Centre for Rural Development (NCRD) Data Base.
3. Metropolitan Corporation Lahore and Municipal Corporation, Faisalabad, Budgets.

The lack of progressivity of local tax burden is primarily because of the distribution of octroi revenues across income groups. The table shows that octroi is clearly regressive in Punjab and NWFP, while its incidence is almost neutral in Sindh (due to dependence on taxation of international imports). The regressivity of octroi revenues can be attributed to the rate structure of octroi tax on the one hand, and the commodity-wise composition on the other. The burden of octroi is relatively high on basic commodity groups like food and clothing as compared to non-essential items like consumer durables which are typically subject to very low rates. For example, as shown in Table 8 in the case of motor cars the average effective octroi, as a percentage of the wholesale price of the commodity, is only 0.04 percent whereas for basic items like rice and chillies, it is 0.4 percent and 0.8 percent respectively. Also, substantial variation in effective rates exists among items within a particular commodity group, and there is a tendency for rates to be higher for items consumed by the lower income groups.

Moreover, studies of commodity-wise composition (from the [jinswar](#)) of octroi revenues shows that, particularly in the case of smaller cities, the largest contribution to octroi revenues is by food items. This makes the octroi tax generally regressive and perhaps more so in the smaller cities and towns. Potentially, of course, the local tax structure could be more balanced in terms of incidence if the share of property tax in revenues could be increased significantly. However, the scope for achieving this is limited in the smaller cities.

In case of rural taxes, perhaps the most controversial tax, as far as incidence is concerned, is the export tax. It is argued that since the tax is at the point of exit, its burden is exported to other districts. It is further argued that because of this phenomenon the local council has

**TABLE 7****INCIDENCE OF URBAN LOCAL TAXES BY INCOME GROUPS, 1985-86**

	<b>Octroi Revenues as percent of Income</b>	<b>Property Tax as percent of Income</b>	<b>Total Taxes* as percent of Income</b>
<b>PUNJAB</b>	<b>1.63</b>	<b>0.26</b>	<b>1.89</b>
Lower	1.78	0.00	1.78
Lower Middle	1.66	0.12	1.78
Upper Middle	1.69	0.49	2.18
Upper	1.49	0.48	1.94
<b>SINDH</b>	<b>2.24</b>	<b>0.34</b>	<b>2.58</b>
Lower	2.30	0.00	2.30
Lower Middle	2.29	0.21	2.50
Upper Middle	2.29	0.63	2.92
Upper	2.24	0.44	2.68
<b>N.W.F.P.</b>	<b>1.42</b>	<b>0.14</b>	<b>1.56</b>
Lower	2.15	0.00	2.15
Lower Middle	1.42	0.98	2.15
Upper Middle	1.55	0.09	1.64
Upper	1.13	0.26	1.39

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\* Include octroi and property tax revenues which account for more than 90 percent of total urban tax revenues.

SOURCE: Ghaus, A. and Hafiz A. Pasha [1991].

an incentive to enhance export tax rates and, therefore, there exists the rationale and the need for provincial regulation and model tax schedules. These arguments are perhaps true for commodities where the prices are not fixed and the burden of taxation is shifted forward to the consumers. However, in the case of goods like agricultural commodities, where the prices are fixed by the government, it is unlikely that the incidence of the tax is transferred to districts other than the one where the tax is levied. It is important that this tax be developed in such a way that the burden of the tax is largely localized.

### **3.6 Tax Administration**

Three mechanisms are being used currently for collection of municipal taxes. The first is the provincial tax machinery consisting essentially of the Excise and Taxation Department (ETD) and the registrar of Stamp Duties in urban areas and the Board of Revenue (BOR) in the rural areas. The property tax and tax on transfer of property are collected by the first two while responsibility for the collection of local rate rests with BOR. The second collection mechanism is a more conventional one in which the municipal governments' own taxation department has the responsibility of collection of smaller taxes like advertisement tax, vehicle tax, cinema tax, etc. Non-tax sources like water rate, rents from properties etc., are also collected directly by municipal tax departments. The third mechanism that is unique to local governments is private contractors. Much of the revenue collection including that of octroi, export tax, most licenses and fees, has been auctioned to private contractors by local councils.

The justifications generally offered for provincial collection (with revenue sharing) of municipal taxes are, first, that sophisticated procedures are involved in the assessment of

liabilities of some taxes. These procedures are perhaps beyond the capabilities of local taxation departments, especially in the smaller jurisdictions. This is the justification given for assumption of the responsibility for property tax collection by the provincial governments, which retains 15 percent of the proceeds (net of collection charges) before transferring revenues to the local governments. Second, there is a perception that local fiscal effort is limited by greater vulnerability to local political influences.

However, property tax continues to be one of the most underdeveloped taxes in Pakistan. Estimates show that currently only about one fourths of the potential tax base is exploited. This can largely be attributed to the problems/issues that arise in the context of property tax administration. These include, first, the lack of extension of rating areas. Property tax is generally collected from those cities/towns which are declared as rating areas by the provincial excise and taxation department. Currently, most of the municipal corporations and municipal committees have been declared as rating areas, while most town committees remain exempt. In the latter, given the smallness of the jurisdictions, it is felt that revenues would not be adequate to justify the costs of collection. It is not surprising, therefore, that town committees account for only 3 percent of the national tax collection while their share in urban population is 16 percent.

Over time, as population grows, it can be expected that smaller jurisdictions will get declared as rating areas and new residential neighborhoods in existing rating areas included in the tax net. Municipal governments frequently voice the complaint that provincial governments are slow in extension of rating areas, implying significant foregone revenues. Clearly, an effort must be made by the latter, first, to extend the rating area within a city, more or less,

simultaneously with an expansion in municipal limits and, second, to identify an explicit cut off point of population beyond which all cities/towns would be declared as rating areas, without exception.

Second, there is the problem of inadequate assessment methods and low frequency. The buoyancy and revenue raising potential of the property tax depends primarily on the frequency of reassessments of rental values and on the level of efficiency of assessment formulae in capturing market values of properties. Rules specify that reassessments should take place at least once every five years. In some provinces, there has been an attempt to maintain this frequency but the measurements have not been market-based and instead relied primarily on ad-hoc enhancements. The assessment formula for imputed property rental values, in particular, fails to capture true market values. Furthermore, there is a ceiling on the maximum enhancement in assessed values of owner-occupied properties. The above factors alongwith various exemptions currently allowed have lead to significant leakages in the potential tax revenues.

Estimates show that about half of the leakage in property tax is due to underassessment of rental values, 29 percent due to the inability of the provincial government to extend rating areas while another 17 percent is due to various exemptions currently allowed [Ghaus, et al., (1991)].

The reluctance of the provincial governments to adequately develop the tax raises the fundamental issue whether the responsibility for collection of property tax should continue to rest with this level of government or should this function be decentralized down to the

municipal level once again. The basic reason generally given for lack of development of the property tax is that given the high revenue share (85 percent) handed over to the local councils, provincial governments have very little incentive to collect higher revenues as the net gain to them is very small in relation to the high political costs. Another option which needs to be examined is the scope for privatisation of at least part of the tax collection process, especially in the area of valuation.

The other important issue in the context of municipal tax administration relates to privatisation of revenue collection. As already mentioned, much of the revenue collection, including octroi and most licences and fees has been auctioned to private contractors by local councils. In this arrangement supervision responsibilities for collection are privatized while the staff continues generally to be of the local council. The contractor is appointed on the basis of a competitive auction whereby the council gets a commitment for revenue from the tax in advance. Contracting of revenue collection has contributed to higher revenues and ensured a greater certainty of municipal income.

However, it should be noted that the contracting system can only function properly, if there is adequate market transparency. Privatization of octroi (or any other tax) works effectively only as long as the bidding process for appointment of contractors remains competitive. There is some evidence that cartels of contractors have been formed and jurisdictions are being allocated among members of these cartels. This is reflected in the significant slowing down in the growth rate of octroi revenues and the difficulty that some local councils are having in achieving the minimum growth target through the auctioning process.



### **3.7 User Charges**

An efficient pricing policy is generally a prerequisite for an adequate provision of service. However, the concept of self-sustained provision of municipal services is yet to be fully developed in Pakistan. By and large, user charges are limited to a few services the most important of these being water supply. However, water rates do not really operate as an user charge because payment by metering of sales, except to bulk consumers, is largely nonexistent in Pakistan. Instead water rates are charged on a flat rate basis or are linked to some proxy for the level of consumption like ferrule size, plot size or property rental value.

It appears that the complexity in water rate assessments tends to increase with city size. The smaller local councils i.e., the municipal and town committees, have gone in for the most simplified assessment procedure, namely a monthly water rate per connection. Water rates in larger cities, with municipal corporation status, on the other hand, are primarily linked to ferrule size. In some metropolitan areas like Lahore, water rates are charged on the basis of the annual rental value of properties. Water rates in rural areas are primarily collected on a flat rate basis. Water tariffs are generally low especially in smaller councils and are not frequently revised. As a consequence the operation and maintenance cost recovered generally is low, being about 60 percent. On the whole, the current coverage of user charges and the cost recovery rates in the country are limited and significant scope currently exists for enhancements in these.

## **4. STRATEGY FOR RESOURCE MOBILISATION**

### **4.1 Strategy for Resource Mobilisation**

Resource mobilisation proposals for the municipal governments must emphasize, first, diversification of and broadening of revenue base, in view of the skewness in the present revenue structure, second, make the taxation structure more progressive by tapping the upper income tax payers in the rural areas and the middle-to-upper income group tax payers in the urban areas. Given the present taxation structure, this can be achieved by rationalizing the octroi rate structure, which has been indicated to be regressive at least in the smaller cities/towns, and developing property-related taxes, in particular the property tax. This tax has considerable untapped revenue potential. It is likely to be progressive in incidence and if properly administered, constitute a buoyant source of revenue.

Third, one of the cornerstones of the resource mobilisation strategy should be to introduce the concept of cost recovery, to the extent feasible, in the pricing of municipal services. In fact, in the larger cities land, in particular, should be priced (particularly for the rich) not only to finance direct development costs but also to generate surpluses than can be used for reinvestment in basic social and physical infrastructure by the local agencies.

Development of property related taxes and user charges are probably the limits of the options available in the short run to municipal governments to augment their resources. Beyond this, new arrangements will be required which go beyond the boundaries of current fiscal powers especially if it is proposed to implement a programme of decentralisation of municipal services from the provincial to local governments. These will include, first, establishment of more elaborate revenue-sharing schemes initially of taxes which fall within the ambit of

common fiscal powers but which have been pre-empted by provincial governments. Second, to the extent that large differentials continue to exist in the per capita revenues of local councils, grants will have to be used to act as a fiscal equalization device.

## **EXISTING LOCAL SOURCES**

### **4.2 Octroi**

As highlighted earlier, a decline in the growth rate of octroi in the 80's, has partially been attributed to the formation of cartels among octroi contractors. To check this tendency it is essential that local councils must exercise the option of reverting back to departmental collection. Octroi collection should be departmentalised if the target growth rate is not achieved in the auction. A stimulus may be provided to departmental collection through an incentive scheme which offers a sizeable bonus to the taxation department staff in the event the target level of revenues is attained. Such a scheme may mitigate against corruption or lack of motivation on the part of the department staff.

Also, to enhance the buoyancy of octroi revenues and to maintain the effective octroi rates even in the absence of periodic rate escalations, it is suggested that a switch over from specific to ad valorem rates should be introduced in the case of imports through dry ports and a partial switchover of land dues in the case of the bigger cities on experimental basis. The high buoyancy of octroi in Karachi is largely attributable to the ad valorem octroi rate structure. It is suggested that the use of a similar structure in the case of imports through dry ports will not only increase the buoyancy of revenues but will also mitigate against possible distortions, resulting from different octroi rates in Karachi port and other dry ports in the country.

In the case of land dues a switchover is recommended only in the case of commodities which are non-food manufactured items with no seasonal fluctuation in prices, which are likely to be shipped in full truck loads and the incidence of which is largely on the upper income groups. This will help in preserving the simplicity and equity of the tax structure. In the case of such commodities a standard price list [which may be referred to as domestic trade prices (DTP)]<sup>2</sup> should be prepared (with the help of trade and industry) at the beginning of each year and used for the valuation of consignments throughout the year. Also, a concious effort should be made to keep these prices low to minimise complaints of overcharging.

As indicated earlier, the average effective rates (AER) tax rate as a percentage of the price of the octroi particularly on non-food items are very low. Moreover, analysis shows that AER are frequently higher for basic goods than luxury goods. There is need, therefore, for rate escalation on non-food items, and rationalization of other rates, aimed at the removal of rate structure anomalies. It is therefore, suggested that rates on non-food items (excluding commodity groups I and II of the schedule) should be enhanced in such a way that escalations are the highest for luxury items. This will not only increase revenues of the local governments but also more importantly make the incidence of the tax progressive.

### **4.3 Property Tax**

Currently bulk of the net property tax revenues collected are transferred to the local authorities by the Provincial E&T department. As such, the provincial governments have not

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2 The Customs Department of the Central Board of Revenue operates a similar system called International Trade Prices (ITPs) for valuation of imports. These ITP's are adjusted quarterly.

had the incentive to fully develop the tax which is reflected both in the low assessed to market values and also the reluctance to expand rating areas both within and across cities.

It is, therefore, recommended that decentralisation of the collection of property tax should be attempted at least in cities, with a metropolitan corporation status. If this increases the buoyancy of property tax revenues then municipal corporations may also be asked to take over this function. Given the potential importance of this tax, local councils are likely to have a strong incentive to develop this tax.

Further, it is suggested that assessment methods be refined to include other indicators like plot size, independent bungalow or flat, corner plot, age of the housing unit, etc. It may be stated that these measures are easy to quantify and should not complicate the assessment process significantly. The differential treatment given in favour of owner-occupied properties in the assessment process must be removed. Also, efforts must be made by the E&T departments, first, to extend the rating area within a city, more or less, simultaneously with an expansion in municipal limits and, second, to identify an explicit cutoff point of population (say 10000) beyond which all cities/towns would be declared as rating areas, without exception. The interference of political factors would thus be minimized.

#### **4.4 Export Tax**

Since the problems in the administration of export tax are similar to those of octroi, albeit at a smaller scale, the recommendations made for the latter also apply to export tax. Further, effective rates of export tax are generally low compared to its urban counterpart, octroi. Therefore, a case can be made for a selective rate escalation, with the rate enhancement

higher for commodities on which the incidence will not be on lower income groups and which are largely local in character. This will imply higher tax rates on items like fruits, sugarcane, tobacco, etc. Also, the export tax can be used as a kind of a royalty by levy of higher rates on minerals.

#### **4.5 Water Rates**

To make the water tariff structure progressive and to introduce an in-built buoyancy in revenues we recommend that water rates be linked to plot size (also a better proxy for consumption) in the small cities. In cities where property tax exists and regular assessment of ARVs takes place water rates should be linked to the ARVs. Also, in some cities, on a trial basis privatization of water rate collection may be attempted.

Given the present water tariff rate only part of recurring costs of water supply are currently recovered through water rates. A case, therefore, exists for water rate escalation. This should be implemented in combination with the change recommended earlier in rate bases. The objective must be to recover full costs of water supply, especially in the large cities of the province.

#### **4.6 Local Rate**

Local rates are have been shown to be generally very low. It is suggested that for larger land holdings, in particular, the rate should be increased and delinked from land revenue (which has been eroded following the levy of Ushr). This measure will specifically tap the large land-owning class in the rural areas, without imposing significant burden or creating any major distortionary effects.

#### **4.7 Licences and Fees**

The bulk of the revenues from licences and fees accrue from a few sources. Rates of those have, by and large, remained the same over the past decade or so. It is, therefore, recommended that selective rate escalation in major licences and fees like fees on fairs, vehicles and markets, etc. be resorted to. Simultaneously, some of the smaller fees, the revenue contribution of which is small should be phased out.

#### **NEW LOCAL SOURCES**

The resource mobilisation strategy discussed above has highlighted the need for broadening of municipal tax base. Also, it has been indicated that this will have to be achieved not only through tapping of sources currently in local government fiscal powers but also introduction of sources which are local in nature but are presently not contained in the fiscal powers of local government. Suggestions for development of new local sources are presented below.

#### **4.8 Presumptive Property Tax**

Keeping in view the need to make the taxation structure progressive in the smaller cities/towns and to broaden their tax base (beyond octroi) it is suggested that a simple presumptive property tax be introduced in jurisdictions which have not been declared as rating areas for property tax and collected along with the water rate. The tax rate may be linked to plot size (with exemption) and construction type (pucca / kaccha) and the collection responsibility rest with the local council.

## **4.9 Levy of Rates**

The need for orienting the revenue structure of local governments towards collection of user charges has been highlighted earlier. In line with this and in view of the untapped provisions in the LGO regarding user charges it is suggested that conservancy, drainage and lighting rates which are currently levied in only a few jurisdictions should be levied by other local councils also.

## **4.10 Parking Fees**

Inadequacy of parking spaces leading to congestion is a prominent feature in some of the bigger cities. To generate funds for proper development of parking lots it is suggested that a parking fees be levied in the bigger cities, provision for which already exists in the ordinance.

## **4.11 Revenue Impact of Proposals**

Quantification of the revenue impact of the resource mobilisation proposals presented reveals that it is possible to double municipal revenues over projected levels in the next five years. It is of importance to note that the base-broadening of municipal revenue structure is consequence of a multifarious package consisting of improvements in tax administration, removal of exemptions and new sources. Also, the package proposed does not draw upon the revenues of higher levels of government in a major way, implying that bulk of the additional resources are generated through local sources, either existing or new.

On the whole, significant revenue raising potential exists in local sources, especially in property-related taxes and user charges. As such, if priority is attached to feasible



improvements in tax administration and justifiable enhancements in rates then a significantly higher level of local resource mobilisation can be achieved. In addition, the establishment of more elaborate intergovernmental fiscal arrangements with provincial governments as part of a decentralisation programme could expand significantly the role of local governments without adversely affecting the budgetary position of the provincial governments significantly.

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