GOVERNMENT OF SINDH
FINANCE & COOPERATION DEPARTMENT

REPORT ON IMPLEMENTATION OF SINDH PFC AWARD DURING 2002-03 AND 2003-04

August, 2004

LIST OF ABBREVIATION

ADP	Annual Development Program
DG	District Government
GoS	Government of Sindh
GP Fund	General Provident Fund
GST	General Sales Tax
HESCO	Hyderabad Electric Supply Corporation
KESC	Karachi Electric Supply Corporation
KPP	Khushaal Pakistan Program
KW&SB	Karachi Water and Sewerage Board
LG	Local Government
NFC	National Finance Commission
OZT	Octroi Zila Tax
PFC	Provincial Finance Commission
PHED	Public Health Engineering Department
PLA	Personal Ledger Account
POL	Petroleum
SLGO	Sindh Local Government Ordinance
SPDC	Social Policy Development Centre
TMA	Town Municipal Administration
UA	Union Administration
WAPDA	Water and Power Development Authority

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1. Introduction

The first Provincial Finance Commission (PFC) in Sindh was constituted in February 2002 under the chairmanship of the Minister for Finance through a notification of the Government of Sindh in February. At this time the finance chapters of the SLGO had not been finalized, however the PFC firmed up the fiscal Award 2002 with a view to move forward on certain basic requirements of fiscal decentralization. This Commission was given a broad set of terms of references which, included determination of the provincial divisible pool, preparation of revenue and expenditure benchmarks of both levels of Government and determination of Retained and Allocable amount and making recommendations for horizontal distribution of revenues amongst District Governments.

This Commission discussed at length various aspects pertaining to inter governmental fiscal relations in the country and internationally in order to evolve suitable revenue distribution criteria between the Provincial and District Governments. In this context the Commission held a detailed meeting with the Social Policy Development Center (SPDC) for assessing their research study pertaining to development ranking of districts in Sindh, undertaken with the support of UNICEF. Their report was extensively discussed and there was consensus that the backwardness index developed in the report would be used for resource distribution on the basis of backwardness.

2. Provincial Finances

The inter-governmental fiscal framework of the federal and provincial governments is defined under the constitution. The revenue sharing takes place on the basis of National Finance Commission's (NFC) awards announced very five years. The NFC last delivered an Award in 1996, allocating to the provinces 37.5% of the divisible pool with the distribution to the provinces by population (based on the 1981 Census of Population). This divisible pool is made up of the income tax, sales tax, revenues from customs and federal excises, wealth, and capital value taxes. In addition, various other tax transfers and grants are made by the federal government to the provinces. This includes some federally ceded taxes owned by the provinces and referred to as straight transfers, which are returned to the provinces on a derivation basis net of a 2% federal collection charge (e.g., royalty on oil and on natural gas, surcharges and excise on natural gas).

Provinces get more than 80% of their revenues through federal transfers, comprising of federal tax assignment and straight transfers on account of royalty on oil and gas, excise duty on gas and development surcharge on gas. In case of Sindh, the federal tax assignment constitutes 51%, the income from the straight transfers 32.2% and the provincial own revenue constitutes around 17% of the total general revenue receipts.

It is generally known that the provinces' own tax base is narrow and lack buoyancy. GoS's own taxes consist, mainly of Stamp duties, Motor vehicle tax, the Infrastructure Development Cess; the Agriculture Income Tax and land revenues, Registration fees, and other small taxes. Irrigation charges and various administrative fees, fines and sale proceeds of government land provide the bulk of non-tax revenues. Other than limited resources, the Government of Sindh's finances remain constrained on account of inflexible expenditures where salaries, pension, and debt servicing account for around 70% of current expenditures. The lack of fiscal space has caused the under-funding of vital human development and infrastructure expenditures and weakened future growth and poverty reduction prospects.

3. <u>Local Finances</u>

Since the discontinuation of Octroi and Zila tax (OZT) on the directive of the Federal Government, the local councils (now Local Governments) predominantly rely on federal-provincial transfers from the additional 2.5% GST levied with the objective of off setting the loss of OZT. The Taluka and Town Administrations depend on the inherited property tax and the grant they get in lieu of the foregone Octroi revenue. The OZT together accounted for more than 70% revenues of local councils and these were abolished on the agreement that the federal government would compensate the local councils for their losses through the additional 2.5% GST.

The income from the 2.5% GST from the period 2000-01 till 2003-04 remained unpredictable due to continued disagreement amongst the federal and provincial governments regarding the formula of distribution and the respective shares of the provincial governments. So much so that after discontinuation of OZT, the actual transfers under 2.5% GST remained in the range of Rs. 6.3 billion, Rs. 4.5 billion and subsequently Rs. 4.1 billion in the years 1999-2000, 2000-01, and 2001-02 respectively. This amount was drastically less than the foregone OZT revenue, which was in the range of Rs.6.6 billion plus another 20 percent amount for meeting salaries of octroi collecting staff, which used to be borne by the contractors concerned. This fall in revenue impacted the overall fiscal position of all the Sindh local governments in the transition period.

The situation slightly improved subsequent to May 2002 meeting held under the Chief Executive of Pakistan where it was decided to transfer the entire proceeds of 2.5% GST to provinces. Resultantly the federal share of the 2.5% GST improved however, the issue of shares of the respective provincial governments remained disputed for next two years.

The issue is that both Octroi and Zila Tax were highly buoyant levies, which grew at an average growth rate ranging from 11 to 15 percent for different local councils. Subsequent to discontinuation of OZT and related unpredictability and cut in 2.5% GST compensatory funds, the fiscal health of the bulk of LGs deteriorated. While the fund flow declined the overall cost of expenditures kept on rising on account of pay increments, promotions, pay rises, increase in pension and other liabilities, and rise in cost of goods including electricity, POL etc. Of the 102 TMAs, only 40% were able to bear the cost of establishment and undertake some maintenance works. They were however unable to take on any development work and were also unable to meet the spiraling cost of electricity. The remaining 60% were in deficits and were unable to meet even the cost of their salary so much so that many TMAs were making payments on previous scales and had been unable to undertake any functions mandated to them.

Prior to devolution there were 268 octroi generating Union councils having sizeable development budgets. These were in surplus and many of them use to lend funds to other councils in deficits. After the doing away of OZT and the unfolding of new system, these UCs fell in fiscal stress as they continued having heavy establishments without having the means to sustain them.

4. Interim Award 2002

The basic features of the Award are that it was an Interim Award as provided under the amendments in SLGO 2002 in order to allow for any possible modification which may become necessitated due to certain contingent events such as finalization of NFC etc.

It may be mentioned that the PFC was primarily a technical commission comprising of 9 members with four ex-officio members including the chairman and five private members. The three ex-officio members other than the chairman were the Additional Chief Secretary Finance; the Additional Chief Secretary Development and Secretary Local Government. The private members were Mr. Jehangir Siddiqui, Mr. Sohail Wajahat Siddiqui, Syed Ashraf Wasti, Syed Sardar Ahmad and Mr. Nazar Mohammad Sheikh. Mr. Nazar Mohammad Sheikh unfortunately could not attend the PFC meetings.

Under the Interim-Award the shares of the provincial and district governments were estimated on the basis of benchmarks for recurrent expenditures. The provincial government was to retain 60% from the divisible pool, (consisting of federal tax assignment, straight transfers and provincial tax receipts) with 40% to be distributed among the district governments combined. The horizontal distribution amongst the District Governments was decided to be on the basis of population (50%), backwardness (17.5%, to be determined on the development Index prepared by SPDC), and tax collection (7.5%), with the remainder 25% earmarked for transitional transfer grants for bridging the gap between the expenditures of the district governments and transfers on the basis of the three criteria.

It may further be pointed that the provincial Finance Department by disaggregating the provincial budget into provincial and 16 DG budgets on the basis of functions devolved to each entity prepared the 2002-03 budgets of the DGs. Accordingly, the Commission took the budget estimates for FY 02-03 as benchmark for determining the expenditure requirements of the Provincial and the District Governments for both the current revenue as well as the development expenditure. The PHED portfolio had not been devolved to the TMAs by this time as such the PHED budget was maintained under the provincial budget and was subsequently transferred to TMAs after the devolution of various schemes and staff to TMAs at the end of the financial year.

The size of the divisible pool for development programs was determined after reserving funds for counterpart funding of foreign aided projects and for compensating District Governments that may not have adequate funds on the basis of the distribution formula. The divisible pool so determined was then distributed between the Provincial and District Governments on the basis of a 30:70 ratio. The criteria driving the distribution between the districts is population (50%) and backwardness (30%); 10% of the pool to be shared equally and the balance 10% was set aside for financing the backlog of ongoing schemes.

To protect the base of district finances, as it existed at the time of the abolishment of the OZT, it was decided that 65% of the 2.5% of the GST to be awarded to the province would be distributed among the District Governments, TMAs and UAs on the basis of the historical collection of Octroi and Zila tax. It was also decided to maintain financial support to the Khushal Pakistan Program (KPP), funds from the residual 2.5% GST funds. The KPP funds were decided to be distributed on the basis of population (70%) and backwardness (30%).

5. <u>Implementation FY 2002-03</u>

5.1 Provincial Fiscal Receipts FY 2002-03

As against the budgeted Rs. 37.07 billion of federal tax Assignment (including divisible pool and GST on services) an amount of Rs. 38.3 billion was received by the end of June 03 showing a total collection of 103% of the budgeted estimates and 16% less than previous year's transfers. Bulk of the increase was due to higher income from Income tax, Custom duties, Sales tax and GST on Services (Central Excise mode) which showed growth of 9%, 41%, 14% and 39% respectively over 2001-02.

The full year income from the straight transfers (royalty on oil, gas and excise duty and surcharge on gas) was Rs. 19. 7 billion, recording 16% growth over previous year. The increase under royalty on oil was 24%, royalty on gas 27%, excise on gas was 19% and the surcharge on gas showed a decrease of 13%. In addition, Rs 1 billion were received on account of past years arrears of surcharge on gas. Thus the over all federal assignment for FY 2002-03 totaled to Rs. 52.503 billion (13% higher than 2001-02's receipt of Rs. 50.072 billion.

The net provincial own revenue collections as per June Accounts were Rs.10.5 billion (gross Rs. 11.84 billion) showing a slight increase of 3% compared to the gross provincial receipts of Rs. 11.52 billion collected by end of 2001-02. In FY 2002-03 the overall collection from the provincial taxes was Rs. 7.819 billion, which grew by 7% to Rs. 7.995 billion by June 2002-03. This was again gross tax collection including collections under the Property tax and Entertainment tax. The net tax collection in 2002-03 was therefore Rs. 7 billion.

5.2 Fiscal Transfers FY 2002-03

The 2002-03-revenue distribution was made on the basis of above formulae with certain variations. At Table-1 are the details of actual receipts and the vertical distribution of the provincial divisible pool receipts between the province and the districts combined. The district wise distribution of funds is at Table-2. The major features of the revenue distribution are;

* As against the estimated Rs. 20.87 billion for salaries, an amount of Rs. 17.3 billion net salary was released
* As against the estimated Rs. 5 billion for non-salary funds, an amount of Rs. 2.4 billion was released for non-salary
* An amount of Rs. 3.2 billion was released to the district governments against the development schemes. Against this Rs. 2.9 billion were utilized.

In order to assess the broad distribution it may be seen that the actual divisible revenue available to the Governments was as under (Rs. in billion)

* Federal assignment	Rs. 38.293
* Straight Transfers	Rs. 18.403
* Provincial tax net of property tax	Rs. 7.00
* **Total**	**Rs. 63.697**
* **District Share**	**Rs. 25.479**

As against their share of Rs. 25.479 billion, an amount of Rs. 22.76 billion were transferred to District Governments. This is around 89% of the due share and of this Rs. 17.3 billion were for salary, Rs. 2.4 billion for non-salary and Rs. 2.9 billion were spent on development. The salary and development expenditures were incurred through Account 1 of the provincial government. The non-salary funds were transferred to Account 4 on monthly basis. In addition to this, the government released Rs. 1 billion for the KPP schemes of the District Governments. The KPP funds were disbursed through Account 1 (through DCO's PLAs). In addition to above GoS financed the electricity payments of the local governments amounting to approximately Rs. 1.5 billion (Table-4).

As against a receipt of Rs. 7 billion on account of Federal share of 2.5% of GST during 2002-03, GoS released an amount of Rs. 6.6 billion (94%) to the LGs on the basis of their historical collection share (Table-3). The GoS share of the 2.5% GST which was included in the Sales tax was distributed on the basis of PFC formula

6. Implementation FY 2003-04

In the meanwhile based on the guidelines provided by the NRB, the Government of Sindh moved ahead on amending the SLGO 2001 for incorporating the covenants pertaining to the establishment of a Provincial Finance Commission empowered to make recommendations on the distribution of revenues between provincial and district governments and amongst the district governments. The PFC was reconstituted and its terms of references were revised to bring these in conformity with the new law. The details of membership and revised terms of reference are in the Report's Annexes.

6.1 Provincial Fiscal Receipts FY 2003-04

The During FY the total provincial resources were projected are Rs. 90 billion as under

- Federal Tax transfer Rs. 41.8
- Straight transfers Rs. 24.0
- 2.5% GST Rs. 10.9
- **Total** **Rs. 90.7**
- **Provincial Revenue** **Rs. 14.1**

The Federal divisible pool revised budget for 2003-04 (including GST on services central excise mode) was estimated at Rs. 41.82 billion with an increase of 8% over actual transfers in 2002-03 (Rs. 38.2 billion). As against these estimates Rs.38.054 billion was received by the end of June 2004, which is 91% of budget and is almost at the same level as that of 2002-03. The twelve-month transfers show the highest growth of 84% under the GST (central excise mode), followed by 25% in Custom duties 5% in Sales Tax, whereas the Federal Excise and Income tax are considerably lower than previous year by 19% and 14% respectively.

The straight transfers were budgeted at Rs. 24.08 billion for FY 2003-04, with 27% growth over FY 2002-03 (Rs. 18.85 billion) and 29% over FY 2002-03 actual revenue. The income during 2003-04 from the straight transfers is Rs. 24.568 billion, recording 24% growth over previous year’s income of Rs. 19.749 billion. There is an increase under all the heads of revenue with Royalty on Gas showing a growth of 54%, Surcharge on Gas 24% and Excise on Gas 20%. The GST on Services (provincial) however, shows a big decrease of 34% over previous year and similarly the Royalty on Oil is lower by 10% over last year.

The over all federal transfers including the straight transfers for FY 2003-04 totals to Rs. 62.622 billion, which is 95% of the budget and is 8% higher than previous year’s total transfers of Rs. 57.944 billion. This performance is however primarily on account of more than hundred percent transfers under the straight transfers as the federal divisible pool transfers are 91% of revised budget estimates.

The Government of Sindh had budgeted the Federal share of 2.5% GST at Rs. 10.87 billion. As against this an amount of Rs. 10.814 billion have been transferred by the Federal Government by end FY 2004. This amount however includes arrears of 2002-03 and the exact bifurcation of previous year’s arrears is not available as yet.

The revised Provincial revenue budget for 2003-04 was estimated at Rs. 14.135 billion, against previous year’s actual receipts of Rs. 10.38 billion. The revenue collection during FY 2003-04 stood at Rs. 12.47 billion, which is 88% of budget and 20% higher than 2002-03 collection of Rs. 10.38 billion. As against a tax receipt of Rs. 7 billion (net of the devolved taxes of Property tax and Entertainment tax) by the end of June 2002-03, the FY 2003-04 tax budget was pitched at Rs. 9.3 billion (net of the devolved taxes of Property tax and Entertainment tax). As against this target, the overall collection by the end of 2004 is Rs. 9.61 billion, showing a 103% budget collection and a growth of 37% over 2002-03 tax revenue.

Other than the revenue decline under AIT (-38%), Tax on Hotels (-48%); Cotton Fees (-18%); as compared to the corresponding period previous year, all other taxes show revenue growth over previous year's collection. The most impressive performance in 2003-04 has been under the Stamp duties where the collection is Rs. 3.4 billion, which is 129% of the budget target and 67% higher than last year's collection. This is in continuation of 2002-03 trends where the overall collection was 19% higher than previous fiscal year. The revenue collected under the Registration of Property for FY 2003-04 is Rs. 529.495 million showing a growth of 63% over previous year.

The revenue collection under various taxes managed by the E&T department also shows a similar trend of growth over 2002-03 collections. The Motor Vehicle Tax, Infrastructure Development Cess, Provincial Excise and Professional tax, show a growth of 42%; 42%; 10% and 2% respectively over the previous year. The receipts under the Electricity duty too show a better performance compared to a persistent trend of last many years where due to lack of adjustment, the overall revenue from this levy used to be much lower than the estimated target. The out-going year's figures show an income of Rs. 351.195 million from Electricity duty, which is 80% of the budget and dramatically higher than previous year's revenue of only Rs.44.210 million.

The Property tax and the Entertainment tax were devolved to the Local Governments in March 2004 and in July 2004, with instructions for its collection in respective District Government Accounts. The issue of devolution of these taxes remained held up on account of administrative reasons.

6.2 Fiscal Transfers FY 2003-04

The 2003-04-revenue distribution was made on the basis of Interim Award 2002 extended to cover 2003-04. At Table-6 and 7 are the monthly and district –wise transfers of funds to the DGs during 2003-04. For FY 2003-04 the total resources projected were Rs..90 billion and the divisible pool was projected at Rs. 75.2 billion. As against this projection the total provincial divisible pool funds available with the provincial government on the basis of actual receipts including arrears were Rs. 75.5 billion. On the basis of 40% share, the due Allocable amount was Rs. 29 billion. As against this a total amount of Rs. 26.675 billion or 92% of the Allocable amount share was transferred to the DGs combined for salary, non-salary and development expenditure.

- The projected Allocable amount was Rs. 30.08 billion having a component of Rs. 24.74 billion for salaries and Rs. 5.34 billion for non-salary.
- Of the total provincial ADP of Rs. 11 billion Rs. 4.53 billion were earmarked for district governments over and above the Allocable amount. As against this the revised allocation was Rs. 5.29 billion. GoS transferred Rs. 4.63 billion to DGs and TMAs under 2003-04 ADP and the expenditure incurred by LGs till end June was Rs. 4.35 billion (94% of releases)
- As against the estimated Rs. 24.74 billion for salaries, an amount of Rs. 19.21 billion salary was released.

* As against the estimated Rs. 5.34 billion for non-salary funds, an amount of Rs. 2.296 billion was released.

The reason for bifurcating the DGs unconditional grants into salary, non-salary and development is primarily on account of the existing system of transfer of funds where the salary and development funds are being disbursed through the provincial Account 1 and the non-salary funds are moving through the Account 4. This system continues to be in vogue due to multiple reasons including cash constraints. The provincial government has remained under heavy deficits for more than a decade and a half and all along the development portfolio was financed through domestic and foreign borrowings. Subsequent to discontinuation of the Cash development Loans, the provincial government financed the provincial ADP from various savings mostly on account of vacant posts. Further the Award 2002 treats the Current expenditure and development expenditure separately with separate formulas for distribution. As the provincial and district ADP has to financed from salary savings, the subject can only be managed when both these releases are through same Account.

Another major constraint in transferring funds to Account 4 has been non-availability of district Accounts. This again is partly on account of inability of AG Sindh to disaggregate the provincial civil accounts into provincial and district Accounts for both the financial years. Non-availability of district civil Accounts has thus again hindered the Finance Department's ability to manage transfer of actual salaries to districts on monthly basis.

Alike 2002-03, GoS also financed the electricity cost of LGs. It can be seen from Table-9 that the Government financed Rs. 1.246 billion on account of various LGs liabilities towards KESC and WAPDA. The liabilities of the TMAs of Karachi towards KESC were subsequently adjusted against their Property tax dues. Bulk of the payments made to KESC during 2003-04 amounting to Rs. 597.293 million pertained to liabilities of KW&SB, which stands devolved to the City District Government Karachi (CDGK). The Rs. 677.1 million payments made to HESCO relate to electricity dues of TMAs. Of this amount Rs. 28.32 million was adjusted against their Property tax and remaining adjustment is pending due to reconciliation of their Property tax receipts. Other than this GoS has paid electricity payments on account of essential connections, which includes some establishments of DGs as well.

7. Issues and Challenges

Implementation of the fiscal Award 2002 in last two years must be appraised in view of multiple constraints ranging from issues of fiscal constraints, problems of weak staffing at LGs and a wide range of issues relating to Accounting and Audit. There continues to be a huge mismatch between the functional responsibilities of district governments and the financial resources available to them, too much having been devolved in substantive terms in relation to their fiscal powers. On the one hand, they are excessively dependent upon provincial transfers and, on the other hand, they have a narrow tax base from which they are required to generate revenues for discharging their functional obligations. There are further legislative restrictions on them to mobilize resources through borrowings.

In this perspective, the Finance department had placed the issue of possibility of transferring the powers to levy and collect a potentially buoyant tax like the Agriculture Income Tax (AIT) to the district governments before the PFC. Other than the positive impact that it could have on the incentive structures for district governments to exploit the full potential of such a tax, it would also reduce their overwhelming reliance on transfers from the provincial divisible pool to finance operations. The distribution criteria governing the PFC Award could be appropriately modified to account for the revenues that would be retained by such district governments and to compensate non-agricultural districts, or those with limited potential for raising substantial revenues from other sources. PFC deliberated this subject however it was decided to defer this till further technical work on AIT institutional reform is done at the provincial level.

The criteria of Transition transfer was added as a large number of districts were not getting enough funds on the basis of first three criteria namely population, backwardness and tax collection. In order to ensure that the districts got their minimum expenditure benchmarks the transition transfer component was added. At this point this criterion continues to be criteria for meeting the minimum needs of many districts in Sindh such as Hyderabad, Dadu, Sukkur, Khairpur, Larkana, and Jacobabad and N'Feroze etc.

Sindh is a dual economy in the sense that Karachi is highly developed and compared to it even Hyderabad is listed at number 25 in overall ranking of districts in Pakistan. Again the population of Karachi (33%) is predominantly higher whereas Hyderabad, the second largest city, is only 9.5%. Hence these criteria of distribution need to very carefully worked out for districts like Hyderabad, Sukkur, Dadu, Larkana and Khairpur which do not get even the bare minimum resources on any of the four PFC Award criteria because of their placement in the mid range districts.

The common compliant received by the local elected leadership is the non-cooperative attitude of the DCO's/ DPO's as still their transfer and postings are with the provincial government. This is the main challenge in the area of administrative decentralization. Some concrete steps must be taken to eliminate provincial interventions particularly in transfers/postings and highest local government officials must be hold accountable to local leadership given their recommendations that would help improve administrative efficiency. Also local governments at present have no or little authority to recruit local staff.

It is still premature to see the impact of devolution on service delivery improvement due to lack of reliable data and difficulty in measuring intermediate and outcome indicators

The devolution proposes various reforms to enhance citizen participation in decision-making process. The public participation through Citizen Community Boards (CCB's) is still in its infancy and its effectiveness has yet to be seen. There is very limited progress in utilization of budgets allocated for CCB's schemes in most of the districts. Largely the funds are unutilized due to lack in identification of appropriate schemes coupled with lack of clarity in understanding rules for allocations/prioritization of schemes. Although

SMC's has been formed at number of places but their role and effectiveness is yet to be determined in improving service delivery

The allocations of funds to MNA's MPA's and their spending on local services is seen to be a little at variance with the devolution as it may lead to conflicts and contribute in creating inefficacies due to lack of its spending in a real local priority areas. Further the vertical programs are also likely to weaken the planning and budgeting process at the local level and give greater central control and impression of lack of adequate confidence on local governance.

In the PFC Award 2002-03, the intra local government fiscal transfer arrangements were not identified. The transfer of funds was left on the discretion of district governments that enhanced uncertainness in transfers' receipts to TMAs and UAs. This aspect was partly rectified when Finance department begun direct transfers of OZT shares to TMAs from March 2004 onwards. Finally, the Award 2002 did not entail any criteria relating to incentive for improving performance in either, expenditure management; service delivery or fiscal effort. This remained difficulty on account of the fixed establishment costs of many districts, which needed to be met prior to inclusion of additional funds under incentive.