THE NEWS

Repairing provincial finance

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Most of the discussion and discourse on public finances has remained focused on the federal government and FBR. The analysis of provincial finances has been sketchy and shallow, although it should occupy a salient place in the aftermath of the 18th Amendment and 7th National Finance Commission Award.

It has been a decade now since the provincial governments have enjoyed both administrative, legal, and political autonomy and a large dose of injection of financial resources out of the divisible tax pool.

As compared to the pre 2009-10 period when the provinces were entitled to a relatively small share and the federal government a larger share, the new arrangements gave a big bump in the share of the provinces, which went up to almost 60 per cent (57.5 per cent out of the divisible pool and the remaining amount in form of straight transfers on various accounts and recurring and development grants). This situation has favoured the provinces – and rightly so, because the main services that the citizens expect from the state are all provided by the local and provincial governments. It is another story that the local governments have in fact been weakened and the devolved functions and responsibilities along with the requisite financial resources that were given in 2001 were withdrawn.

There are many compelling reasons as to why the present devolution should be taken to its logical end point – to the third tier of the government. It is interesting to inquire how the increased quantum of resources available to the provinces in the last decade have been used and what impact they have created on human capital formation, infrastructure development and connectivity and production sectors. And what repercussions this had on the

general state of public finances at the national level, particularly on the fiscal condition of the federal government.

In 2009-10, the four provincial governments collectively employed 1.8 million individuals and their wage and salary bill was Rs340 billion – an average salary of Rs189000 annually. The same year, the federal government employed 928,000 persons and paid them Rs89 billion or an average of Rs96,000.

By 2019-20 – a decade later – the number of employees in the provincial government had risen by 28 per cent to 2.3 million and the annual wage bill had reached Rs1548 billion. The average salary had gone up to Rs673,000. The federal government employment roll was 981,000 with a wage bill of Rs260 billion. The average wage was Rs265,000 in the same period.

Not only was there a net addition of half a million new employees or 28 per cent increase in the provincial governments' staff, but the average wage also rose by multiples of 3.6 times. In contrast, the federal government employment increase was limited to six per cent and the average wage rose by a multiple of 2.8 times. Annual inflation rate during the period averaged about 8-9 percent and thus there was significant real wage increase in case of both the federal and provincial government employees.

The total wage bill of the provincial governments expanded by a factor of 4.2 times during this decade while that of the federal government 2.8 times, signifying that the rising share of the divisible tax pool from the federal governments was used mainly to benefit the employees of the provincial governments. In the provinces, three departments – education, health and police – employ 75 per cent of the total workforce, with education and health's share being more than one half of the total employees. The same formula applies to the distribution of the wage bill.

Education and health expenditures in the provincial budgets have remained in the range of 35-39 per cent but the impact on outcomes – enrolment rates, adult literacy rate, average year of schooling, out-of-school children, learning ability, and health indicators – has been minimal. The governance and management of these sectors has been below par; most of the money is spent

on poorly trained teachers and basic infrastructure facilities in schools are lacking. Therefore, those who argue for an increase in the allocation for social sectors in the absence of governance and teaching quality improvement may be throwing good money after bad.

One of the pernicious side effects of a large dose of the federal divisible tax pool, injected into the provincial finances, has been the provinces being slack in mobilizing their own revenues. The provinces contribute only one per cent of GDP to national taxes. Indian state governments contribute 35 per cent to the total tax revenues or 6-7 per cent of GDP. Provinces in Pakistan together spend 40 per cent of the total consolidated expenditures while raising only 10 per cent of total national tax revenues.

When flushed with such windfall liquidity, political will and bureaucratic effort to tap GST on services, property tax and agriculture income tax have been found missing irrespective of the party in power. Our elected leaders consider that imposing and collecting taxes is an unpopular task while their spending needs can be met easily from the federal transfers. They do not feel much pressure to go for digitized cadastral surveys of property; revaluation of existing properties aligning them with market prices; removing exemptions, concessions and discretionary prices fixed by the tax officials; introducing electronic record-keeping and an automatic billing system; updating the record through GIS system mapping, including newly urbanized areas in the tax base.

The ratio of property tax is 0.03 per cent of GDP while the average for developing countries is 0.6 per cent. The total collection from all cities of Pakistan is Rs20 billion while the Mumbai Municipal Corporation collects Rs120 billion. Pakistan's real-estate market is estimated to have an asset value of $400–700 billion. Studies have shown that Pakistan can raise at least Rs400 billion annually from property tax if the reforms mentioned above are implemented and the responsibility for assessment, collection and enforcement of property tax is shifted solely to the metropolitan corporations and the municipal corporation.

Agriculture income tax yields an insignificant amount of Rs3 billion annually while agriculture gross value added in 2020-21 was Rs15 trillion. Non-agriculture income tax collection is Rs1.7 trillion. Of the total farm area of 21.4 million hectares in Pakistan, land holding of 10 hectares and above by the top four percent of the farmers constitutes 35 per cent (the top one per cent have 22 per cent). If one quarter of agriculture GVA can be attributed to this top category of four per cent landlords their contribution would be at least Rs3.75 trillion. Applying an average tax rate of 10 per cent (with progressive sliding scale), we should expect agriculture income tax to yield Rs375 billion or 0.5 per cent of GDP.

This enforcement of agriculture income tax would also stop evasion of non-agriculture income tax as the federal Income Tax Ordinance 2001 exempts agriculture income from the federal income tax. Taking advantage of this loophole, federal income tax filers inflate their true agriculture incomes by including sources of income from other non-exempt sectors of the economy. Thus, the FBR suffers losses in collection of income tax also.

All the provinces have made strenuous efforts to collect GST on services which used to be in the domain of the FBR. In fact, this has become the single largest source of provincial tax revenues – Rs293 billion or 58 per cent of the provincial tax revenues. However, the gross value added in the services sector that can potentially contribute to GST is estimated at Rs3.8 trillion. An average tax rate of 16 per cent should generate Rs600 billion annually, twice as much as it is being collected at present. The new organizations – provincial revenue authorities – set up for this purpose have the capacity to achieve this target.

There are a number of other revenue heads in the provincial budgets which can also be streamlined but these have not been included in this analysis. By repairing provincial finances, it is shown that at least 1.6 per cent of GDP in the form of additional taxes can be generated, pushing up the national tax-to-GDP ratio to 12 per cent, reducing the fiscal and primary deficits by that extent and repaying and thus lowering the national debt burden. For this, the scope of the local government finances has to be enlarged.

The writer is the author of 'Governing the ungovernable'.