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Options to support urban infrastructure delivery in Pakistan – a survey for the province of Khyber Pakhtunkhwa

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Abstract:

Pakistan has 191.7 million inhabitants with a population that is increasing by 1.92 percent per annum. More than 60% of Pakistan's population currently lives in rural areas. However, the rural population is moving towards cities due to diminishing work opportunities in the agricultural sector. For this reason, a further investment in local infrastructure is essential. Moreover, in the last ten years, the economy of Pakistan has faced various domestic and external shocks such as the earthquake of 2005, the flood of 2010, the worldwide financial crisis of 2008 and the unsolved energy crisis. The deterioration in the power sector, in particular, is one of the main constraints on growth since power cuts have shaved 2% off the annual GDP growth and for this reason the Pakistan economy has annually grown by only 3.3 % in the last five years, while inflation has been overcome and is currently not a danger for the economic performance of Pakistan. One of the poorest part of Pakistan is the province of Khyber Pakhtunkhwa and this paper provides for the first time a detailed overview of the local public finance system in this province

JEL Classification: H7; G20; R10

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

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1 Introduction

Pakistan has 191.7 million inhabitants with a population that is increasing by 1.92 percent per annum.[2] More than 60% of Pakistan's population currently lives in rural areas. However, the rural population is moving towards cities due to diminishing work opportunities in the agricultural sector. For this reason, a further investment in local infrastructure is essential.

Over the last ten years, the economy of Pakistan has faced various domestic and external shocks such as the earthquake of 2005, the flood of 2010, the worldwide financial crisis of 2008 and the unsolved energy crisis. The deterioration in the power sector, in particular, is one of the main constraints on growth since power cuts have shaved 2% off the annual GDP growth. The Pakistan economy has grown by only 3.3 % in the last five years, while inflation has been overcome and is currently not a danger for the economic performance of Pakistan. Figure 1 below highlights the GDP per capita in US-Dollar in Pakistan and some neighbouring countries, while figure 2 presents the annual inflation rate in Pakistan from 2008 until 2015:

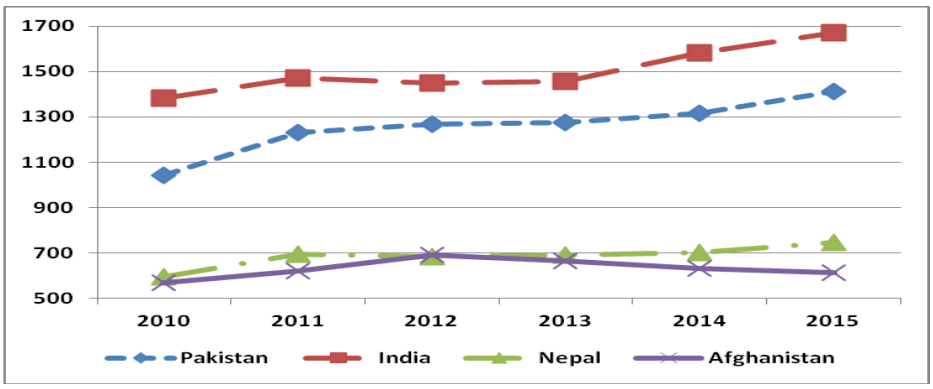

Figure 1: Development of GDP per capita in US-Dollar from 2010 until 2015

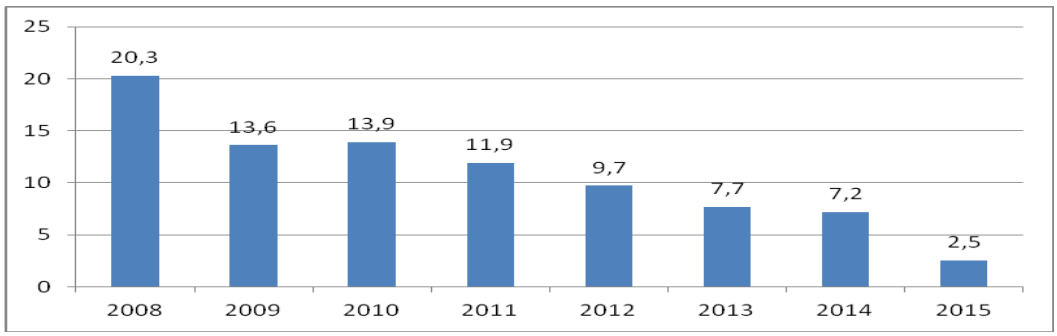

Figure 2: Development of inflation rate in % in Pakistan from 2008 until 2015

Pakistan is a federal country. Besides the central government in the capital Islamabad, the regional level of Pakistan consists of four provinces (Balochistan, Khyber Pakhtunkhwa, Punjab and Sindh), the Islamabad Capital Territory and the Federally

[2] see MoF, 2015, page 199-201, However, the last census in Pakistan was conducted in 1998 and for this reason the governments in Pakistan – national, regional and local – are not able to plan properly.

Administered Tribal Areas (FATA), which is administered by the central government.

Moreover, Pakistan controls the areas of Azad Jammu and Kashmir (AJK) and Gilgit-Baltistan. These two areas are located on the Pakistan side of the demarcation line ("Line of control") of the divided Kashmir, which is claimed both by Pakistan and India. Both areas are not named explicitly in the constitution of Pakistan, but in 2009 the Pakistan central government signed the "Gilgit–Baltistan Empowerment and Self-Governance Order", which upgraded Gilgit-Baltistan to a semi-provincial status with partial autonomy, while Azad Jammu and Kashmir is still politically and fiscally dependent on the central government.

The local governance system of Pakistan is divided into three tiers: districts, tehsils (sub-districts), and village / union councils. In total, there are approximately 149 districts, 588 tehsils, and several thousand union councils.

The taxing powers in Pakistan were centralized in 1956 at the central level in order to achieve the goal of tax harmonization and to lower tax collection costs. The four provinces therefore voluntarily gave up the powers to collect sales taxes in favour of central government and were compensated by a tax sharing system.[3] However, the provincial spending and taxing power were constantly reduced from 1955 until 2010 and the 18th Constitutional Amendment in 2010 was the first sign of a reversal of this trend.[4] Table 1 below provides an overview of development of the revenue and expenditure share of the central, provincial and local governments of Pakistan from 1955 to 2015.

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

Table 1: Revenue and expenditure share in % in Pakistan from 1955 until 2015
Source: Shah, 2012, page 7 and Werner, 2016

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

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

The institutional arrangements for intergovernmental transfers from the central government towards the four provinces are mainly organized by the National Finance Commission (NFC). The NFC is constituted under Article 160 of the Constitution of Pakistan and sets out the formula for distribution of revenues amongst the central and four provincial governments of Pakistan.[5] The fixed formula (Award) has a duration of five years and if the NFC is unable to agree on a new formula after the five year interval, the existing formula is used transitionally. Currently, the 7th NFC Award of 2009 is operative, because the 8th NFC was constituted on 21st July, 2010, but did not give any Award. The 9th NFC was constituted on April 24, 2015 and its first meeting was held on 28th April, 2015, but again the representatives of the central government and the provinces in the NFC did not agree on a new formula.

In the fiscal year of 2014-2015, the 7th NFC Award means that the central tax administration collects the revenues from taxes on income[6], capital value tax, sales tax on goods[7], federal excise and customs duties in a common pool.[8] In order to cover tax collection costs, the central government receives a prior 1% of the divisible pool of taxes. Another one percent of the net proceeds of the divisible pool of taxes is assigned to the provincial Government of Khyber Pakhtunkhwa to meet the expenses of war on terror. The remaining amount is distributed, with 57.5 % going to the four provinces and the remaining 42.5% to the central government.

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

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

6 Excluding income from agriculture, which is levied individually by the four provinces.

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

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

Factor	Weight		Province	Fiscal portion	GDP portion	Population portion
Population	82 %		Balochistan	9.7 %	6 %	5%
Poverty or backwardness	10.3 %		KP	16.1 %	12 %	13 %
Revenue collection or generation	5 %		Punjab	47.7 %	54 %	54 %
Inverse population density	2.7 %		Sindh	26.5 %	28 %	25 %
Total	100 %		Total	100 %	100 %	97 % [9]

Table 2: Horizontal distribution between the four provinces in the fiscal year 2014-2015
Source: Werner, 2016

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

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

The provinces are therefore extremely dependent on vertical grants and tax sharing with central government. Figure 3 below presents the sources of revenues of the province of Khyber Pakhtunkhwa from 2000 until 2015:

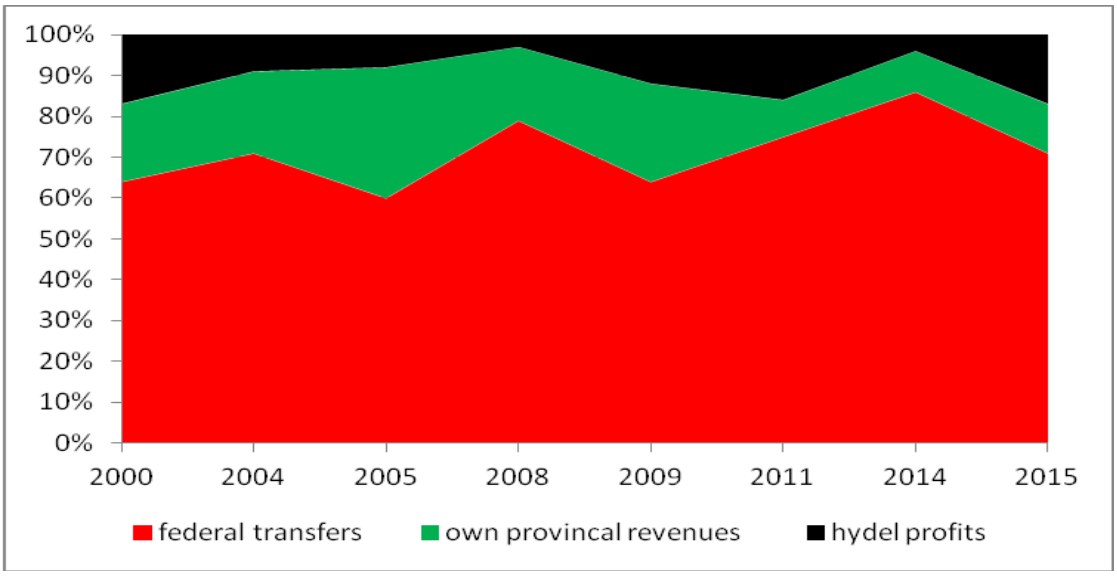

Figure 3: Revenues sources of Khyber Pakhtunkhwa from 2000 until 2015
Source: World Bank 2013 and own calculation

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

A tax sharing system also exists between the provinces and the local governments and for this reason the local entities receive 85 % of property transfer tax and property tax, although tax collection is the responsibility of the provincial tax administration. Moreover, the local entities can levy a piggy pack tax on various, small provincial taxes such as the tax on entertainment and hotels, for example.

The provinces and their local governments are responsible for education and health and this explains the huge % gap in the revenue and expenditure share in table 1. In combination with the low fiscal autonomy of the provinces already presented, provincial expenditure is dependent on federal revenue transfers that leave little room for any fiscal policy freedom. Unfortunately, a low quality of education and health leads to low living standards and their improvement is the key to raising the economic prospects of the provinces in Pakistan. Only well educated people with a sound public service delivery are able and willing the pay the taxes, because both tax morale and the tax ratio in relation to the GDP - only 10.2 % in 2015 - are extremely low in Pakistan.[10]

2 Local public finance in Khyber Pakhtunkhwa

The province of Khyber Pakhtunkhwa has a population of around 28.3 million people. Figure 4 below summarizes the different tiers of governments[11] in the province of Khyber Pakhtunkhwa (KP):

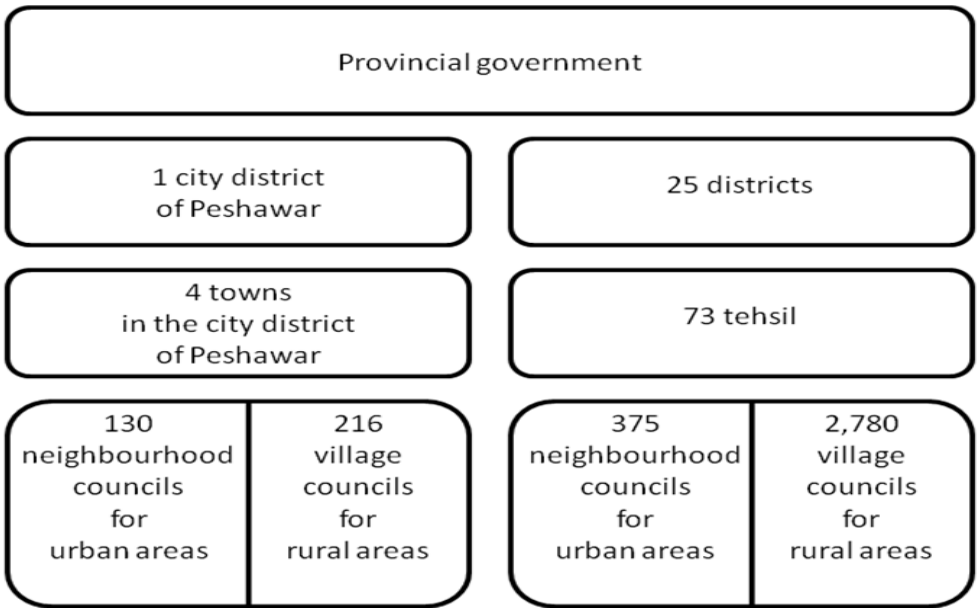

Figure 4: Different tiers of government in the province of Khyber Pakhtunkhwa

The 26 districts and 77 tehsils (73 "real" tehsils and the 4 towns of Peshawar) are the most important sub-provincial entities in KP, because their main expenditure areas

[10] Regarding tax morale and decentralsation see, for example, Torgler and Werner, 2005

[11] The latest change in the government structure was in 2014, when the district of Kohistan was bifurcated into Upper Kohistan and Lower Kohistan.

are health and education, while the 3,501 neighbourhood and village councils play a minor role in providing public services.

The fiscal structure of the tehsils can be summarized as follows:

(1) Vertical grants from the provincial government

- Grant for octrai

  In the past, the local authorities in Pakistan levied various smaller taxes for consumption goods - mainly in the area of agriculture -, for goods entering the local area. The octrai were abolished in 1997 but the tehsils still receive grants from the provinces today based on these outdated consumption taxation data.

- Grant for aid

  The tehsils can apply for grants for aid at the provincial level, if they have any problems with tax collection in a current fiscal year or if they have unplanned, additional expenditure. However, there is no clear decision mechanism for these grants and therefore political pork barrelling is possible.

- Grant for development

  30 % of the provincial budget for development is fixed for the subnational entities and it is distributed according to a formula which is currently under revision by the provincial Ministry of Finance. The author of this report considers this grant to be a classic example of political marshalling, because, this grant, like the two other grants, is unconditional and not linked directly to the expenditures for development. For example, the tehsil of Haripur listed the repair of a bath room for their own employees as development investment, although it is actually a current running cost factor and not an investment in development.

(2) Tax on transfer of property / conveyance duty

The tehsils receive 2 % of the selling price of property. The majority of the interviewed stakeholders in the administration and politicians at the tehsil level were very satisfied with this revenue source, but selling property is not a stable and constant revenue flow for local units. The interview partners in Peshawar town III and Haripur, in particular, were quite surprised at the negative effect that dependence on solely one-off payments can have on a budget.

(3) Urban property tax / Urban immovable property tax (UIP tax)

Pursuant to the urban immovable property tax act of 1958, the tehsils receive revenues from an urban tax. This urban tax is mainly administered by the provincial government and for this reason the provincial government receives 15 % of the total tax revenues and the remaining 85 % goes to the tehsils. In the province of Khyber Pakhtunkhwa the taxation procedure differs slightly from that of other provinces, because the tax base is not

> *"The annual value of any land or building shall be ascertained by estimating the gross annual rent at which such land or building together with its appurtenances and any furniture that may be let for use or enjoyment with such building might reasonably be expected to be let from year to year"*

In the provinces of Khyber Pakhtunkhwa private houses are classified depending on the size of the property - based on marlas[12] - and a value classification of A, B and C allocated with C as the highest value. Moreover, there is a district distinction within the provinces, in which the city districts of Peshawar have the highest tax burden. Based on this tax schedule 1 - which is located in the annex 1- the private owners who live in their own house are taxed. Housing property which is let out on rent, lease or by other arrangements and is not used by their registered owners will bear a double tax burden based on the afore-mentioned tax schedule 1, except for category 1 with a size of 5 marlas.

The taxation of commercial property by the urban immovable property tax is located in the annex 2.

The urban immovable property tax has some major weaknesses in its current conception:

- The tehsils have no taxation autonomy, because the tax schedule / tax rate is fixed by the provincial government and the tehsils cannot influence their own revenue flow.
- Per definition only urban property is taxed, while rural property is tax exempted.
- Even within the urban areas in the province of Khyber Pakhtunkhwa the rating areas are not updated very regularly and the tax schedule 1 is not indexed to inflation.
- The tax burden for both the poor and rich is equally very moderate. The tax reduction for poor people with a property smaller than 5 marlas could possibly be explained as a vote-winning measure or as a distribution factor to reduce the gap between poor and rich. However, why rich people pay only a maximum amount of 30,000 PKR or 250 € per year is more than questionable. It has to be considered that on the one hand the tax burden is only 30,000 PKR per year, but on the other hand 301 properties in Peshawar with a selling price of more than 30,000,000 PKR and 23 properties in Haripur with a selling price of more than 3,000,000 PKR can already be found on the website www.zameen.com

(4) Fees

The distinction between local taxes and local fees is not clearly defined in the province of Khyber Pakhtunkhwa. Even Khyber Pakhtunkhwa Local Government Act 2013 define taxes as

> *"taxes includes any cess, fee, rate, toll or other charge leviable under this act"*

Under international standards of public finance it makes a huge different whether a local government can levy a tax or a fee. A fee or toll always relates to a direct ser-

[12] The marla is a traditional unit of area that is used in Pakistan, India and Bangladesh. A Pakistani marla equals roughly 21 square meters.

vice provided by the local government, such as a fee for school, a slaughter house, a market or road. A tax is not linked to any public services and is not collected on the assumption "pay as you use".

Moreover, the Khyber Pakhtunkhwa Local Government Act 2013 already includes an option for the districts to collect a "tax for education and health" and for tehsils to levy a local tax on services, but this option is a toothless paper tiger as it is not used by the tehsils.

In contrast, the tehsils pursue a great many purely private economic activities to increase their revenues. For example, the tehsils run their own hotels, build and rent their own shopping malls, collect production cess from a cement factory and excavates minerals.

Finally, it has to be considered that not all the tehsils observed were able to spend their fiscal resources within the budget year and they sometimes start a year with an opening balance of more than one third of the complete budget volume. One reason for these huge residual amounts are delays in bank transfers of vertical grants from the provinces and other reasons are problems of the tehsils with finalizing tenders with the private sector due to "administration capacity".

Due to the opening balances and the strict regulation from the provincial government, the tehsils do not generate any public debt and attract no fiscal revenues from the capital market.

The following figure 5 summarizes the revenue structure of six tehsils in the fiscal year of 2015

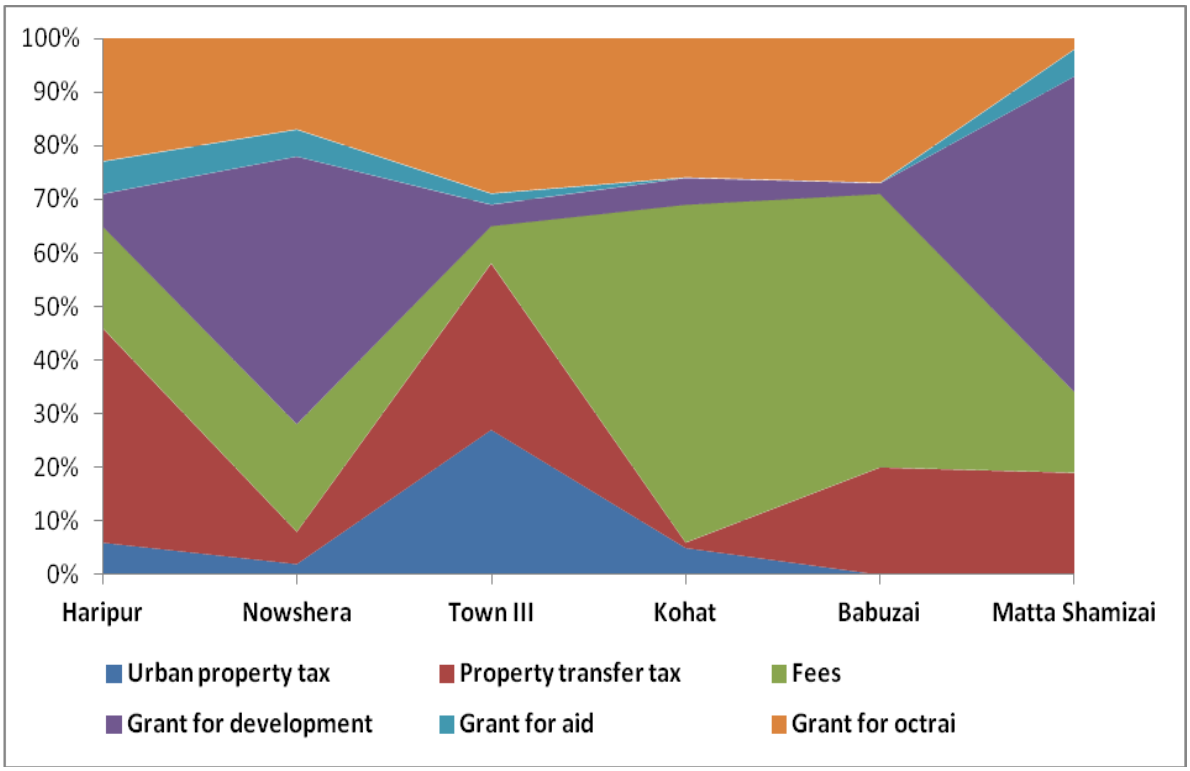

Figure 5: Revenue structure of the tehsils of Babuzai, Haripur, Kohat, Matta Shamizai, Nowshera and town III of Peshawar in the fiscal year 2015, Source: own calculation

Based on an observation of these six tehsils, the entire vertical grants from the provincial government account for a minimum of one third of the budget volume and for the two tehsils Kohat and Nowshera as much as two thirds of the complete budget volume. The extremely high portion of vertical grants in Kohat and Nowshera s mainly results from the development grant.

With the exclusion of Peshawar town III, the urban immovable property tax plays a minor role in the budget of the six tehsils, even being outperformed by the tax on transfer of property.

The most important revenue source is fees - again with the exclusion of Peshawar town III.

3 Recommendation for the tehsils in KP

The **first recommendation** for revenue enhancement to increase the local fiscal autonomy is an update of the existing urban property tax to a new, real property tax with the following features:

- tax administration and tax collection is handled by the provincial administration with the provinces receiving 15 % of the total tax revenues as a refund for administration costs. This feature can be compared to a tax sharing system.
- the tax rate is fixed independently by every tehsil and the provincial government only sets a minimum tax rate. This feature guarantees high revenue autonomy for the tehsils.
- the rating areas are not only limited to urban areas but extend to rural areas. This feature expands the tax base and leads to a higher revenue flow.
- in the province of Khyber Pakhtunkhwa no cadastre exists for the province as a whole and since not all properties have been sold in the last ten years, it is not possible to evaluate property based on sales prices. Therefore, a tailor-made property tax system for Khyber Pakhtunkhwa should use the following concept. The assessment of the property has to be handled by the provincial government along the following general guidelines:
  - Three benchmark indicators could be used to determine the tax assessment base for real property:
    - (a) maximum ground space,
    - (b) maximum floor number,
    - and (c) size of property.[13] All three figures would be multiplied and, in order to attract incentives for an optimal land use, it would be irrelevant whether the property is fully constructed or undeveloped.

[13] Indicator c is measured in square meters, whereas the two indicators a and b are measured in decimal numbers and calculated in relation to the total size of the property. For example, if a property has a size of 400 square meters and the building on this property has two floors, with a ground space of 240 square meters, the respective benchmark indicators are a = 0.6, b = 2.0, and c = 400.

- The tehsils would divide individual building sections into special building zones, to which they allocate individual building zone factors. The tehsils themselves would decide not only how high this building zone factor should be but also how big the zone should be.
- The tehsils would also set the local real property tax rates with all zones being subject to the same municipal assessment rate.
- All properties - private property, commercial property, property for agricultural and forestry use, and public property - would be subject to local real property tax. However, for public properties[14], the zone factor would be 1.0.

Hence, the new local real property tax would be calculated in the following manner:

Ground space * Floor number * Size of property * Zone factor * Local tax rate = Tax liability

Such a new system of a property tax could be installed within the next three years (long term).

Prior to the new property tax system, the provincial government has to increase the tax schedule 1 for private property in the next year by 100 % (short term).

Within two years, the provincial government has to increase the tax areas to all urban areas in the province of Khyber Pakhtunkhwa (medium term).

The **second recommendation** for revenue enhancement is to use the local tax on services in the province of Khyber Pakhtunkhwa. The Khyber Pakhtunkhwa Local Government Act, 2013, section 42, third schedule, Part III Tehsil municipal administration itemises fifteen points with different taxes and fees. Point 1 reads

"Local tax on services."

Moreover, the Local Government Taxation Rules 2016 issued on July 13th, 2016 summarize the schedule to introduce a new tax for all local units in KP. The full version of this bylaw can be found in the appendix under annex 3.

Another possible option for increasing local fiscal autonomy in KP - apart from collecting more revenues from already existing taxes and fees, the introduction of a new, real property tax and land value capture - is to introduce a local tax on services. On the one hand, such a new tax would have to fulfill the goal of being stable over time and not being affected by any economic fluctuation and on the other hand it should be easy to administer.

[14] Public property also creates a fiscal burden for a local unit. For example, a military base also relies on local infrastructure since the children of the army personnel attend the local elementary school or trucks with equipment for the military base use the local roads and wear down the asphalt of the road. On the other hand, the *ceiling* of zone factor prevents the local units from burdening the central government or the provincial level with an extreme tax burden ("tax exporting")

The only option for such tax is - beside a property tax - a poll tax.[15] A poll tax or a head tax is a tax of a uniform, fixed amount applied to an individual person. A poll tax, however, also has the two disadvantages that the tax violates the goal of income redistribution[16] and is politically very unpopular[17].

Excluding extremely poor people completely from the tax burden can overcome this undesirable effect of equal income distribution. Moreover, if the entire tax revenues from a local tax on services are linked to a special expenditure item, for example to local education institutions, the public acceptance could be strengthened. A better level of education is a key factor for more economic growth in Pakistan and especially in KP. In 2000, 6 million pupils were taught in private schools in Pakistan, and this number of pupils has now increased to 14 million young people or 37 % of all enrolled pupils in Pakistan.[18] Such a high portion of private institutions shows that the public schools have a poor reputation and if they can afford it, parents try to send their children to private institutions. However, this is surely a greater negative income redistribution than a moderate poll tax with tax exemptions for the poorest people.

The **third recommendation** for revenue enhancement is land value capture in the province of Khyber Pakhtunkhwa. The degree of urbanisation is increasing at a rapid pace all over the world. In 2007, for the first time in history, the urban population of the world was bigger than the rural population. Furthermore, two thirds of the world's population is projected to live in cities by the year 2050.

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[15] Moreover, some people could come up with the idea that the tehsils should benefit from the already existing sales tax on services, which is collected by provincial authorities. However, this is not a reasonable suggestion, because both possible options - a classical tax sharing between the tehsils and the provincial government or a local surcharge to the provincial sales tax - have both some major weaknesses. A common tax sharing at the sales tax on services does not generate any local revenue autonomy for the tehsils and leads consequently to a low accountability for them, because they cannot influence the tax rate per definition at a tax sharing system. A local surcharge at the provincial sales or even an own local sales tax has to rejected also and due to the negative experiences in Bosnia and Herzegovina as well Brazil with the concept of local surcharges or own local sales taxes. Until 2005, the two Entities and the District of Brcko in Bosnia had three separate and non-harmonised laws regulating the sales taxes. The differences between the three laws were significant and included different rates, numbers of reduced rates as well as tax bases to which these rates were applied. These differences naturally induced arbitrage and produced market distortions. Furthermore, very little cooperation existed between the individual tax administrations, which resulted in massive tax evasion and substantial revenue losses. Importers and retailers from the Republika Srpska in Bosnia often declared fictitious sales in the BiH Federation of Croats and Bosnian Moslems and vice versa while selling goods tax-free on the black market. Such evasion schemes were especially attractive for importers and retailers of heavily taxed excisable goods such as oil. The ability to make high profit margins from selling oil on the black market has led to the phenomenon of abundant petrol stations in BiH. For example, in 2006 there were more than 20 petrol stations operating on the 60km road from Banja Luka to Gradiska. In Brazil the three different sales tax - which are consist with the Imposto sobre produtos industrializados ("Tax on industrialized goods") of the central government, with the Imposto sobre circulação e serviços ("Tax on circulation of goods and services") of the 26 federal states and with the Imposto sobre serviços ("Tax on selected services") of the local units - lead even to the famous fiscal wars within a nation.

[16] A poll tax favours rich people, because the rich and the poor both pay the same amount and the individual income is not considered.

[17] The poll tax riots in the United Kingdom did much to contribute to the downfall of the British Prime Minister Margaret Thatcher in 1990.

[18] See Centre for Governance and Public Accountability, 2015b, page 10.

The following two graphs show the projected development of the urban and rural population in Pakistan up to 2050 and it is obvious that the province of Khyber Pakhtunkhwa will be effected by a similar development, because KP has the highest population growth rate in Pakistan and the province has the youngest population in Pakistan, with about 30% of the male population between the ages of 15 and 29.[19]

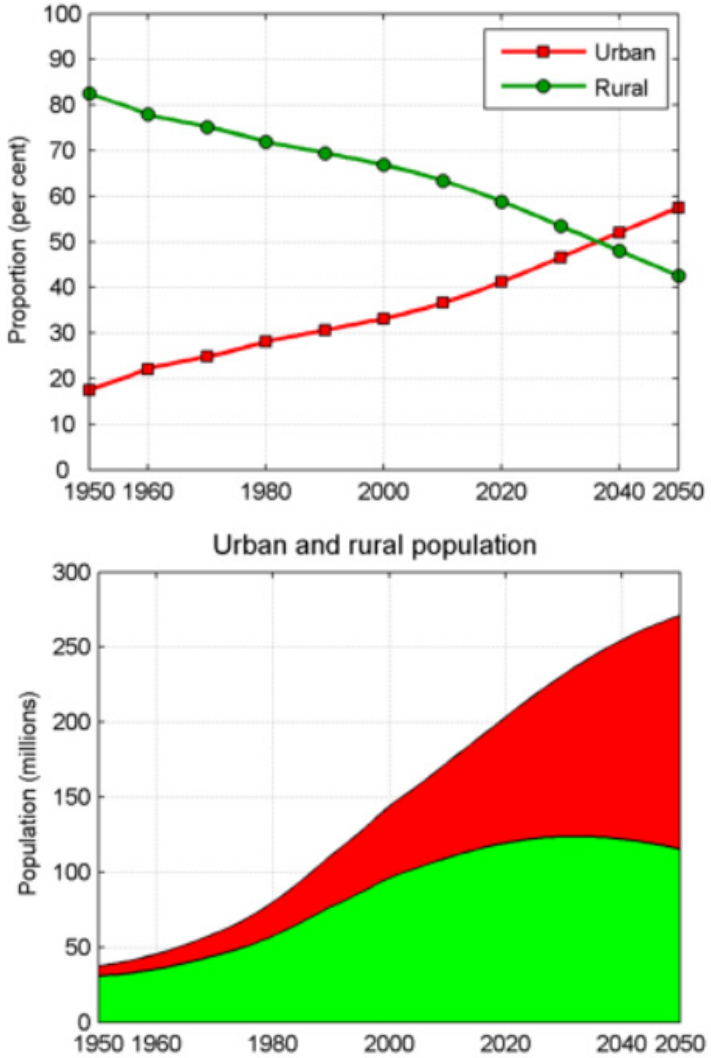

Figure 6: Development of the urban and rural population in Pakistan up to 2050
Source: United Nations, Department of Economic and Social Affairs, Population Division (2014): World Urbanization Prospects: The 2014 Revision.

The urban centers in the province of KP have to deliver various forms of local infrastructure and another option for generating some fiscal funds for the investments is land value capture. Land value capture is a method of funding infrastructure improvements that is based on recovering all or some part of the increase in property value generated by public infrastructure investment.

Land value capture in Germany is a local fee, which is divided into technical development costs and traffic-related development costs.

[19] See Centre for Governance and Public Accountability, 2015a, page 30.

Technical development costs are costs incurred for the connection of land to supply and disposal networks. This includes electricity, gas, public water supply and sewage connection. Traffic-related development costs are costs for roads, sidewalks and lighting, public parks, children's playgrounds, noise protection walls, telephone and cable television network.

A building permit in Germany will only be granted if the development costs for the property are secured or even paid. Private landowners pay in Germany a maximum of 90 % of the development costs and the remaining 10 % are covered by the municipality.

Development costs are distributed between private landowners on the basis of

- the nature and extent of building / numbers of the floor, e.g. for a noise protection wall
- the size of the land, e.g. for a local road
- the land width, e.g. for a sidewalk

The lesson from Germany for the local units in KP is that they have to shift virtually **all** development costs directly onto the private landowners. In some of the tehsils observed there is already a "fee of approval of building / construction plan" (Haripur) or a "building plan fee" (Nowshera), but these fees do not cover the complete cost of the land development.

It is very important for the tehsil to collect land value capture in the future, because otherwise they will be subsidising private landlords when they convert agricultural land into building area for commercial or private property, for example (the society as a whole pays the development cost, but a small minority can enjoy the benefit of it through an increase in the value of the property).

Land value capture should also be used in the future in KP for public transportation, because it is clear that property near a bus station will benefit relatively more. For example, Don Riley calculated the total land value that arose within a radius of only 1,000 yards of each of the new metro stations of the Jubilee Line Extension in the city of London in the United Kingdom. He concluded that these land values have increased by 13 billion British pounds, while the construction costs of the metro were 3.5 billion British pounds.[20] Another independent study carried out for Transport for London estimated that between 1992 and 2002, near two of the 11 new stations, namely Southwark and Canary Wharf, the Jubilee Line Extension caused land values to rise by 2.8 billion British pounds. This means that the public sector could have built the metro extension at no cost if they had just chosen to collect less than one-third of the increased land values arising from the new transit line.[21]

The urban centers of KP are, of course, currently a long way off building a metro, but for other forms of public transportation, such as bus stations, similar positive changes in land wealth can be observed.

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[20] See Don Riley, 2001

[21] See Dave Wetzel, 2006, page 40-46.

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

(1) Severe restriction and generally no independent local borrowing

- Ethiopia, China (until 2015) and the current system in Khyber Pakhtunkhwa

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

- Canada and India

(3) A municipal bond system

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

(4) Commercial and private bank

- France, Belgium (Dexia)

(5) Public "saving banks"

- Austria, Germany

Because of the limited capital market in Pakistan, options three and four are not possible and the example of South Africa proves that the municipal bond system is not always a silver bullet.[22]

The **fifth recommendation** for revenue enhancement is that the tehsils are allowed to attract credits.

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

A "natural candidate" for pool financing is the Bank of Khybe, which is a bank mainly owned by the province of Khyber Pakhtunkhwa. Such a pooled financing system could start in the medium term of two years. The provincial government would only have to add one new clause to Khyber Pakhtunkhwa Local Government Act 2013 and would still have an indirect control mechanism to avoid an untamed local credit volume through their share in the Bank of Khybe.

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

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

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

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

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

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

Currently, a sum of ₹ 1714.15 crores is available with TNUDF for providing financial assistance for the implementation of urban infrastructure projects.[23]

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

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

4 Conclusion and brief outlook

A lack of public funds for local infrastructure is always a sign of an unsound local public finance system in a country and for this reason, increasing local tax autonomy by installing a new, all-embracing property tax for the 73 tehsils and the 4 towns of Peshawar should be the subject of political discussion in the province of Khyber Pakhtunkhwa. A new property tax can generate a stable revenue flow and is relatively easy to administer.

[23] Tamil Nadu Urban Development Fund , 2014, page 5

However, the local units should also start collecting more tax revenues and making greater use of their legal right to introduce a local new tax, namely the local tax on services with a poll tax concept at the tehsil level. The capacity to raise own revenues is decisive in terms of political accountability and the quality of service delivery as well as creditworthiness.

Besides taxes, fees and credits, the transfer system from the provincial to the local level plays an important role in the local public finance system in Khyber Pakhtunkhwa. Some of the vertical grants from provincial to local level are driven mainly by political decisions and not economic reasons and for this a revision, like presented in the executive summary, is also necessary.

Another lesson to be learned from the international perspective is that it makes sense to limit and to control the local debt and to avoid any unlimited municipal bonds or Private Public Partnership and borrowing in foreign currency, even if the credit costs are significantly lower.

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

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

5 Appendix

Annex 1: tax schedule for private property under UIP tax in the province of Khyber Pakhtunkhwa

[1][SCHEDULE-I

[See section 3(2)]

PART 'A'

Sr. No.	Category	Rate of tax for areas of Provincial headquarter as notified by the Government (per annum)			Rate of tax at Divisional headquarters (per annum)		Rate of tax in suburban areas of Divisional Headquarters (per annum)		Rate of tax at District Headquarters (per annum)		Rate of tax at District other than District Headquarters (per annum)	
		A	B	C	Townships	Other than Townships	Townships	Other than Townships	Townships	Other than Townships	Townships	Other than Townships
1	Up to 5 Marlas (other than self occupied)	Rs.1000/-	Rs.900/-	Rs.750/-	Rs.900/-	Rs.750/-	Rs.500/-	Rs.325/-	Rs.400/-	Rs.300/-	Rs.200/-	Rs.150/-
2	Exceeding 5 Marlas but not exceeding 10 Marlas	Rs.1700/-	Rs.1600/-	Rs.1500/-	Rs.1600/-	Rs.1500/-	Rs.900/-	Rs.750/-	Rs.800/-	Rs.750/-	Rs.600/-	Rs.500/-
3	Exceeding 10 Marlas but not exceeding 15 Marlas	Rs.2200/-	Rs.2100/-	Rs.2000/-	Rs.2100/-	Rs.2000/-	Rs.1100/-	Rs.1000/-	Rs.1100/-	Rs.1000/-	Rs.600/-	Rs.500/-
4	Exceeding 15 Marlas but not exceeding 18 Marlas	Rs.3300/-	Rs.3200/-	Rs.3000/-	Rs.3200/-	Rs.3000/-	Rs.1700/-	Rs.1500/-	Rs.1700/-	Rs.1500/-	Rs.900/-	Rs.750/-
5	Exceeding 18 Marlas but not exceeding 20 Marlas	Rs.10000/-	Rs.9000/-	Rs.8000/-	Rs.9000/-	Rs.8000/-	Rs.5000/-	Rs.3000/-	Rs.4000/-	Rs.2000/-	Rs.1500/-	Rs.1000/-
6	Exceeding 20 Marlas but not exceeding 30 Marlas	Rs.15000/-	Rs.14000/-	Rs.12000/-	Rs.14000/-	Rs.10000/-	Rs.8000/-	Rs.6000/-	Rs.5000/-	Rs.3000/-	Rs.3000/-	Rs.2000/-
7	Exceeding 30 Marlas but not exceeding 40 Marlas	Rs.20000/-	Rs.18000/-	Rs.16000/-	Rs.18000/-	Rs.16000/-	Rs.14000/-	Rs.12000/-	Rs.10000/-	Rs.8000/-	Rs.6000/-	Rs.4000/-
6	Exceeding 40 Marlas	Rs.30000/-	Rs.25000/-	Rs.20000/-	Rs.25000/-	Rs.20000/-	Rs.15000/-	Rs.12000/-	Rs.10000/-	Rs.8000/-	Rs.6000/-	Rs.4000/-

Annex 2: tax schedule for commercial property under UIP tax in the province of Khyber Pakhtunkhwa

[1][SCHEDULE-II]

[See section 3(2)]

1. The commercial areas shall be divided into five localities namely A1, A, B, C and D, depending on the area and the business being carried therein.

2. The "A1 and A" localities shall, for the time being, be defined in Provincial Capital.

3. The locality factors as worked out for computing the tax are-

(a) For A1 locality. (located within 100 yards of either sides of the Main road of Peshawar).	[2]Thirteen
(b) For A locality.	Ten
(c) for B locality.	Seven
(d) for D locality.	Four
(e) for D locality.	Three

4. The above factors are for the Provincial Headquarter, that is for Peshawar. There shall be a rebate of 30% on the total tax calculated on the basis of the above factor value in respect of former Divisional Headquarters and 50% rebate on the total tax so calculated in respect of all other rating areas.

5. The tax shall be calculated as under:

   a. area in square yards;

   b. covered area in square feet; provided that open sheds in the commercial units shall be counted as one half of its total measurements, while calculating the covered area; and

   c. (a) + (b) multiplied by the locality factor.

6. For educational Institutions:

   a. The tax shall be calculated on the basis of covered area only. The area of the plot as required per item 5(a) above shall not be taken for computing the tax. This is to encourage the institutions in providing sports and other recreational facilities to their students; and

   b. The tax calculated on the basis of (a) above shall get a special thirty percent rebate, being provided to all the educational institutions.

7. [1][Petrol pumps and CNG Stations with convenience store shall be charged at flat

rate of Rs.15,000/- and those without store at Rs. 7,500/- per annum.]

7(A) [2][Service Station of vehicles, irrespective of operating in addition to other services such as filling station or otherwise shall be charged at flat rate of [3][Rs.15,000] per annum.]

8. Industrial buildings within the limits of rating areas shall be assessed for the purpose of this tax at a flat rate of Rs. 2.50 per square foot of the building. The provision of item 5(b) above shall be applicable to all the industrial areas as well.

9. [4][Buildings acquired for the use as offices by government, semi-government, non-governmental organizations, Development Financial Institutions, private commercial organizations, guest houses, hostels, banks shall be assessed for the purpose of tax on the basis of twenty percent of the actual annual rent.]

10. [5][Buildings and Lands used for erection of Mobile Phone Towers shall be assessed and taxed at the rates:

(i) Provincial Headquarter ..... Rs.40,000 per annum;

(ii) Divisional Headquarter and respective sub-urban areas ..... Rs.30,000 per annum and;

(iii) District Headquarter and respective sub-urban areas] ..... Rs.20,000 per annum and;

Annex 3: Local Government Taxation Rules 2016

GOVERNMENT OF THE KHYBER PAKHTUNKHWA,
LOCAL GOVERNMENT, ELECTIONS AND
RURAL DEVELOPMENT DEPARTMENT.

NOTIFICATION

Peshawar, dated the 13.07.2016.

No. SO(C&D)/TaxationRules/LG/2016.-In exercise of the powers conferred by section 112 of the Khyber Pakhtunkhwa Local Government Act, 2013 (Khyber Pakhtunkhwa Act No. XXVIII of 2013) the Government of the Khyber is pleased to make the following rules, namely:

THE KHYBER PAKHTUNKHWA LOCAL GOVERNMENT TAXATION RULES, 2016.

1. **Short title, application and commencement.**---(1) These rules may be called the Khyber Pakhtunkhwa Local Government Taxation Rules, 2016.

(2) These rules shall apply to the District Council and Tehsil Council:

Provided that for the purpose of fixation of rate and fee, at the level of Village and Neighbourhood Council, shall be specified by Government in separate rules as required under PART-V of THIRD SCHEDULE of the Khyber Pakhtunkhwa Local Government Act, 2013 (Khyber Pakhtunkhwa Act, XXVIII of 2013.

(3) These rules shall come into force at once.

2. **Definition.**---(1) In these rules, unless the subject or context otherwise requires, the following expressions shall have the meanings respectively assigned to them, that is to say-

(a) "Act" means the Khyber Pakhtunkhwa Local Government Act, 2013 (Act No. XXVIII of 2013);

(b) "Finance Committees" mean the Finance Committees, elected under clause (e) of section 18 and clause (g) of section 25 of the Act;

(c) "inhabitant" means any person, who ordinarily resides, carries on business, owns or occupies immovable property in the local area;

(d) "local council" means, for the purpose these rules, the District Council and Tehsil Council;

(e) "Nazim" means the Nazim of the concerned local council;

(f) "tax" means any cess, fee, rate, toll or other charge leviable under the Act; and

(g) "taxation proposal" means the taxation proposal as specified in rule 3 of these rules.

(2) Words and expressions used but not defined in these rules shall have the same meanings, as are respectively assigned to them in the Act.

3. **Taxation proposal.**---(1) The District Officer (Finance and Planning), in case of City District Government or District Government and the Tehsil Officer (Regulation), in case of Tehsil or Town Municipal Administration, as the case may be, shall formulate or caused to be formulated a taxation proposal based on review of the financial position of the concerned local government as part of annual or revised budget process or as Government may direct.

(2) There shall be a separate taxation proposal for each tax.

(3) The taxation proposal shall include the following:

(a) the class of persons, activity or business or category of property proposed to be taxed;

(b) the rate at which the tax is proposed to be levied; and

(c) the date for the enforcement of the tax.

(4) These rules shall mutatis mutandis be applicable for increasing, reducing or abolition of the rate of any existing tax.

(5) No taxation proposal shall be formulated in respect of a tax before the expiry of one fiscal year since its imposition, reduction, suspension or abolition.

(6) Before placing the taxation proposal to the local council, the same shall be submitted for approval to-

(a) Nazim, City District Council or District Council, as the case may be, by the District Officer (Finance and Planning) through Deputy Commissioner of the district concerned; and

(b) Nazim, Tehsil Council by the Tehsil Officer (Regulation) through Tehsil Municipal Officer.

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Govt. of Khyber Pakhtunkhwa
Law Department

(7) The Nazim of the concerned local council, before placing the taxation proposal to the local council, may approve the said proposal with or without modifications for the publication.

4. Publication of taxation proposal.---(1) The Nazim or an officer authorized by him in this behalf, shall issue a public notice in respect of each taxation proposal which shall specify-

(a) the salient features of the taxation proposal;

(b) the class of persons, activity or business or description of property or both, affected thereby;

(c) the amount or rate of tax to be imposed and the previous amount or rate if any;

(d) the system of assessment of the tax or valuation therefore to be adopted;

(f) additional income likely to be raised by the imposition of the tax or the increase in the tax and the purpose on which this additional income is proposed to be spent;

(g) the loss of income likely to be caused by the abolition or suspension of the tax or reduction in the rate of the tax and the manner in which this shortfall in income is proposed to be made up;

(h) justification of the taxation proposal; and

(i) any other particulars considered necessary for the information of the public.

(2) Alongwith the public notice under sub-rule (1), the Nazim or the officer authorized by him in this behalf, shall publish taxation proposal specifying therein-

(a) the date, which shall not be less than fifteen days from the publication of the taxation proposal by which objections and suggestions to the taxation proposal may be made to the Nazim by the inhabitants;

(b) the date or dates fixed for the hearing of objections or suggestions, received under clause (a), by the Nazim; and

(c) the date by which the taxation proposal shall be enforced.

5. Hearing of objections and suggestions on taxation proposals.---(1) The Finance Committees shall be the competent forum for hearing of objections and suggestions to the taxation proposals.

(2) All objections and suggestions, received under rule 4 of these rules, shall be entered into a register maintained for the purpose.

(3) On the date or dates, fixed for the hearing of objections and suggestions, the Finance Committees shall hear the same in public and shall afford all possible facilities to the persons making them to present their case.

(4) On the close of hearing of objections and suggestions, the Finance Committees shall finalize the taxation proposals, draw up and furnish detailed report to the concerned local council for consideration and sanction. This report shall specify-

(a) the salient features of the taxation proposal;

(b) the number and nature of objections and suggestions received within the specified period;

(c) the manner in which the objections and suggestions were heard;

(d) the findings in respect of each objection and suggestion heard;

(e) the recommendation with regard to the taxation proposal; and

(f) the financial implications involved in such recommendations.

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Law Department

6. Convening of meeting of the local councils.---(1) The taxation proposals, concerning the annual budget of the local council, shall be presented in the budget session or the special session of the local council convened for this purpose.

(2) The taxation proposals concerning revised budget of the local council shall be presented in the special session of the local council convened for this purpose.

same. The local council may, by passing a resolution, adopt the report as so submitted by the Finance Committee.

8. **Post-sanction publication.**---(1) After approval of the taxation proposal by the local council, the Nazim shall-

(a) forward a copy of the tax Notification to the Government for publication in the official Gazette; or

(b) publish the tax Notification in the form of a public notice.

(2) The taxation proposals, approved by the local council, shall come into force on and from such date as may be specified in the Notification.

9. **Repeal and Saving.**---(1) The Khyber Pakhtunkhwa Local Government (Imposition of Taxes) Rules, 1980, are hereby repealed.

(2) Notwithstanding the repeal of the said rules, any instructions issued and orders made under the repealed rules, not inconsistent to the provision of the Act or these rules shall continue to remain in force until altered, amended or withdrawn by the Competent Authority.

SECRETARY TO
GOVERNMENT OF THE KHYBER PAKHTUNKHWA,
LOCAL GOVERNMENT, ELECTIONS AND
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