PROVINCIAL FINANCE COMMISSION

ANNUAL REPORT, 2004-05 AND 2005-06

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INTRODUCTION

Section 120-E (5) and (6) of the Local Government Ordinance 2001 provides preparation and submission of an Annual Report to the Government on Fiscal Transfer and Local Government Resources by the Provincial Finance Commission. The Government and Local Governments will lay the said report before the Provincial Assembly and Local Councils respectively.

2. The first annual report for Financial Year 2002-03 and 2003-04 was prepared/published by the Provincial Finance Commission Secretariat and presented to Govt., which was laid down before the Provincial Assembly. The said report was also sent to District Coordination Officers for placing it before the respective Councils.

3. Provincial Finance Commission Second Annual Report for the financial year 2004-05 and 2005-06 has been prepared in pursuance to above referred provision of law and in accordance with the format prescribed in the Fiscal Transfer Rules 2004, wherein information on Provincial Finances and source of funding, Inter-governmental Fiscal Transfer in accordance with PFC Awards and Local Government own Resources and amount allocated out of Provincial Allocable Amount determined under PFC Awards have been provided. At the end challenges and issues being confronted with by the Provincial as well as District Governments in implementation of the Award have been highlighted.

CHAPTER-I

PROVINCIAL FINANCES

1.1 Pakistan is a federation of four provinces, unequal in area, population and levels of economic and social development. The ethnic distinction of provinces makes horizontal equity in development vital to political stability and national cohesion. The separation of East Pakistan from the federation in 1971 was rooted in a perception, right or wrong, of economic injustice. The adoption of the 1973 Constitution with unanimous support of all remaining provinces, by addressing many of the contentious economic issues, provided the country another opportunity to address regional economic disparities and strengthen the federation. Unfortunately, violations of the Constitutional mandate as well as partisan interpretation of various Articles of the Constitution over the last 33 years have aggravated economic disparities between the provinces and rekindled perceptions of economics injustice among provinces.

1.2 To understand issues in intergovernmental resource transfers, it is important to analyse the nature and implications of the existing federal fiscal structure as it is enshrined in the 1973 Constitution. The country now has three tiers of functional governments; federal, provincial, and local. The prime function of all three is to deliver various services apart from fulfilling their regulatory role. Services range from providing Defence to supplying water and sanitation services. The assignment of service delivery responsibilities to various levels of governments is specified in the Constitution in Article 70(4), (Fourth Schedule). The Federal Legislative List includes the functions to be performed by the federal government, while the Concurrent Legislative List includes all those functions, which can be undertaken by the federal and/or the provincial governments. The Constitution assigns all remaining functions to the provincial governments. Local governments in Pakistan do not have any distinct status in the 1973 Constitution but are established by provincial government ordinances (currently LGO of 2001), which also determine their powers and responsibilities.

1.3 In order to provide these services, governments need resources. In Pakistan, government resources come from three major sources; one, borrowings, two, royalties and profits from the exploitation of natural resources, and three taxes, user charges and non-tax revenues including proceeds of sale of assets. The Constitution is quite clear on the rights of various levels of Government over these resources.

- The distribution of taxing powers between various levels of government is spelled out in the Fourth Schedule of the 1973 Constitution. Following the last NFC award in 1996, the federal government collects all revenues from income tax including corporation tax, sales tax, custom duties and federal excise duties. The provincial governments collect user charges and tax revenues composed of agricultural income tax, provincial excise duty, stamp duty, motor vehicle registration tax, entertainment tax, and various types of cess'. There are few sources of revenue left with the local governments.
- The broad principles of allocation of royalties and profits from natural resources (applying only to gas and hydroelectric power) are spelled out in Article 161 of the

Constitution. According to the latter, federal excise duty on natural gas at wellhead and royalty on gas collected by the Federal Government shall be payable to the Province in which the well-head of gas is situated. In addition, the 1996 NFC Award allocates the net proceeds of development surcharge of gas to the provinces in which the wellhead is situated. Article 161 also allocates net profits from the bulk generation of hydroelectric power to the province where the station is situated.

- The exercise of borrowing powers by the Federal and Provincial Governments conferred under the Constitution, and which constitutes a major resource, is to be determined by the National Finance Commission.

1.4 By and large, the distribution of regulatory and service delivery functions and taxation in Pakistan conforms to international best practices and criteria of efficiency, constitutional assignment of taxing powers and expenditure responsibilities in Pakistan is that on the one hand all broad-based and buoyant sources of tax revenue are assigned exclusively to the Federal Government and the provinces (and local governments) are left with residual taxation authority. On the other, the provinces and local governments are entrusted with substantial expenditure responsibilities. As a result, public finances in Pakistan are characterized by persistently large vertical fiscal imbalances between the federal and provincial governments. The federal government collects about 93 percent of total revenue collected in Pakistan, while it accounts for only 72 percent of aggregate national expenditure. The provinces, by contrast, collect only 7 percent of total national revenue but account for nearly a quarter of total expenditures. While royalty and profits from the sale of natural resources were meant to remedy at least to some extent the deficit of the poorest provinces (which happened to be rich in natural resources), in practice this has not happened due to non-compliance with the Constitution and due to manipulations of the calculations of those transfers. Consequently all provinces have remained in deficit of resources in relation to their expenditure responsibilities.

1.5 The vertical imbalances in the budgets of the three tiers of government could be rectified by reassigning taxation authority downward to the provincial and local governments, which could also be supported on grounds of better fiscal accountability and greater autonomy of provinces, but the 1973 Constitution does not follow that route because it will increase regional economic disparities and erode federal cohesion. The latter because fiscal capacities of provinces (and also districts) are diverse, devolving taxation authority will result in growing differences in public revenues and service delivery between the provinces (and districts). Alternatively, fiscal imbalances can be remedied by reassigning upwards service delivery responsibilities to the Federal Government and provinces, (in fact this is what happened in the period prior to 2001), but the impact is well known: poor governance, poor service delivery etc. The 1973 Constitution follows instead the third alternative response to vertical fiscal imbalances: transfer resources from the federal to provincial governments (and from provincial to local governments in LGO 2001). Equitable transfer mechanisms can address regional resource redistribution objectives and ensure efficient service delivery at the appropriate level of government. This is the route adopted in the 1973 Constitution and LGO 2001. The National Finance Commission (NFC) and PFCs are entrusted to come up with such equitable transfer mechanisms.

1.6 The last NFC award was made in 1996 for a period of five years. According to the award, the Federal share in the net proceeds of divisible poor was fixed at 62.5% with the remainder 37.5% to be distributed between the four provinces on the basis of population. As a result Punjab received 57.88% Sindh 23.28%, NWFP 13.54% and Balochistan received 5.30% of the provincial share. In consideration of their relative backwardness, NWFP and Balochistan received special grants/subventions, which in 1997/98 were Rs.3310 million and Rs.4080 million respectively, set to increase at 11% annually. The 1996 NFC Award also recommended straight transfers to the provinces in lieu of net profits on account of generation of hydel power and net proceeds of development surcharge, royally and excise duty of natural gas and oil. However, controversy prevailed throughout the period over the proper determination of royalty, gas development surcharge and hydel profits paid to NWFP and Balochistan.

1.7 At the end of the Constitutional period of five years life of the last NWFP award, a new Commission was constituted to reach consensus on the distribution of resources, but without success. The failure of the National Finance Commission to reach consensus on the division of resources between the Federal and four provincial governments was the most serious deadlock facing the nation that potentially could destabilize Pakistan's federal structure. The deadlock was particularly significant because neither the interim nor the present elected governments were able to resolve it. Disagreements remained over almost all issues before the NFC mainly because constitutional obligations, logic and economic arguments were rejected on grounds of so-called political compulsions. Since an unwritten tradition of the Commission requires that any change in existing shares of governments be made by consensus, a new agreement eluded the Commission because there was always one government that would not agree with the others on each of the issues before the NFC. For instance:

- The Federal Government refused to discuss the borrowing powers of the five governments and kept projecting unrealistic decline in its own budget deficit over the next five years to underestimate the resources available to it. The federal Government also denied provincial governments to repay or refinance existing expensive Cash Development Loans (CDLs) during the period of low interest rates causing the taxpayers losses of billions of rupees.
- The federal Government as alone in refusing to increase the share of provinces to 50 percent from the previous 55.5 percent. Since the last award, provinces had been starved of resources; resulting in deterioration of provincial infrastructure, decline in social service delivery and rapid growth in poverty. The excessive share of the federation was difficult to justify following debt rescheduling by Pakistan's external creditors, which has drastically reduced debt-servicing needs of the federal budget. Instead of passing on rescheduling benefits to the provinces, the federation set out to spend billions on high profile mega projects including developing holiday resorts for the rich in Gwadar, while depriving provinces of much needed funds to invest in

infrastructure, improve social services and address poverty which increased to unprecedented levels during the last NFC period.

- The federal Government was alone in denying that the share of provinces needed to be increased substantially and urgently to allow them to transfer adequate funds to local governments whose needs could not be met with proceed of 2.5% GST revenues from the federation alone. The previous formula left little money for the provinces to pass on to local governments, which in turn, adversely impacted service delivery and poverty. For instance, currently the Provincial Finance Commission in NWFP has allocated 60 percent of the provincial divisible resources for the district governments, but this amount is not enough to meet just the salary bill of local governments. As a result, the development needs of 24 district governments (three tiers in each district) are being met out of a paltry Rs.0.9 billion, insufficient to finance anything.
- Sindh was alone in arguing that revenue collection must be one of the indicators in the formula dividing resources between the provinces. Sindh's demand implied that provinces have some claim on federal revenues collected within its provincial boundaries. This is not in accordance with the 1973 Constitution. The Constitution is very clear about the division of taxation powers and has given the federation exclusive right to particular tax bases. No province can lay claim to federal resources. If revenue collection were used as a basis for dividing resources, provinces which are better off and therefore collect more revenue would get a larger share of the public resources and thus increase the disparities that already exist. And if the revenue collection basis were used within the province as well in the PFC, Karachi and Hyderabad would receive all the provincial resources with little left for rural Sindh- a politically explosive proposal. And in any case the revenue collection potential of provinces today reflects to a considerable extent the allocation of resources over the last fifty-five years which the smallest two provinces may not consider to have been equitable. Thus revenue collection as one or the only factor in the NFC formula will

aggravate disparities and provoke divisive debates about the country's past development priorities.

- Sindh was also alone in demanding that revenues from 2.5 percent of GST for local governments be divided according to the collections of Octroi and Zilla Tax on the eve of abolition of the tax. The other provinces view was that the number of local governments was based on population; hence the latter was a good basis for the division of these resources.

1.8 The lack of consensus at the NFC was further complicated by the continuing dispute between the provinces and federal departments over the determination of royalties and surcharges on gas and over calculation of hydel profits. In the case of hydel profits, an explanation exists in the Constitution following Article 161, defining hydel profits more clearly. This was followed by a number of decisions of Council of Common interest (CCI), ratifying the AGN Kazi Committee Report on establishing the method of calculation. Yet the refusal of WAPDA to enter into discussion of NWFP's claim and unilateral freezing of profits at Rs.6 billion had kept the dispute unresolved since 1991. On the eve of the last elections in 2002, agreement on many of the outstanding issues in the NFC could have been reached but NWFP refused to agree on the NFC unless the Federal Government agreed to an arbitration of the dispute over hydel profits. In 2005 NWFP finally forced the issue and arbitration in the dispute was begun which has recently announced its decision in favour of NWFP. Similarly, the payments for natural gas remain in dispute. The Federal Government uses two different prices of gas at wellhead when calculating royalty and development surcharge on gas for Balochistan, in each case to the disadvantage of Balochistan. This flagrant violation of justice has fuelled alienation, contributing to militancy in the province and the spread of a growing insurgency.

1.9 Despite having potential persuasive powers, the Federal government failed to display leadership and a commitment to the constitutional mandate, to resolve disputes over earnings from natural resources and bring about an agreement at the NFC that would serve national cohesion and strengthen the federal structure. Instead, when the deadlock at NWFP persisted, the federal Government asked all the provincial Chief Ministers and NFC members

(Finance Ministers and non-statutory members) to sign off their constitutional responsibilities as members of NFC in favour of the President on letters drafted for them, giving him unquestioned authority to decide what he deemed fit. Unfortunately all provinces signed off their responsibilities except the NWFP. NWFP held out on grounds that it would violate the Constitution, it would further erode the remaining provincial autonomy and it would set a precedent that would weaken the federation. In response the President announced an award anyway, calling it an amendment in the 1996 award, a route available in the Constitution without requiring the consensus of all provinces. The changes announced in the 1996 Award do not reflect any principles or equity considerations. The share of the Federation has been reduced by 1.5 percent of the divisible pool, or Rs.8 billion in the first year (Rs.53 per capita), to be divided between four provinces--- a mockery of the needs of the provinces to address poverty (almost all service responsibilities which address poverty are in the provincial domain), and the additional cost of running the huge local government machinery. To rub salt in the wound, the Federal Government has subsequently announced that henceforth provinces must finance their own public investment program without federal support, thus taking away more than what they had initially given.

1.10 In addition to the issues related to resource allocation among provinces, a more important factor which impacts equity in provincial economic development is the federal Public Sector Development Program or federal public investment. The grievances of the smaller provinces are further aggravated by the complete lack of balance in federal development spending through the annual PSDP and in grants given to provinces by various heads of government and state over the last many years.

1.11 Looking ahead, there are some broad measures and principles, which can create a more equitable economic environment that would enhance federal cohesion:

i. Decisions at the NFC need not be consensus, but require the support of at least any four out of five governments, calling upon the fifth to concede in the interest of national unity.

ii. Equity in distribution of resources must take all resources into account, borrowings, and earnings from natural resources, taxation and non-tax revenues, as well as the impact of the federal PSDP.

iii. Recognising that differences exist today between the provinces in terms of the average level of social and human development, the first principle should aim to reduce those disparities and eliminate them over a reasonable period of time. The reasons for the disparities could be natural resources, location or the unequal allocation of resources over the last 55 years; whatever the reasons, we have to look forward now and eliminate those differences to strengthen the federation.

iv. The NFC can consider differences between the average levels of social and human development across whole provinces, and not the relative backwardness of some areas within a particular province___ the latter needs to be addressed by the respective Provincial Finance Commissions.

v. Resource allocation should not attempt to correct the disparities created over decades in a very short period, since that will retard growth in the advance provinces. Hence the NFC should ensure that the distribution of resources, while reducing disparities, does not retard the social and human development of any province.

vi. The Federation and provinces should remain within the ambit of the 1973 Constitution. What belongs to the Federation is theirs and what belongs to the provinces must be given to the provinces.

vii. Looking ahead to the next NFC award, the share of the provinces must be increased substantially to allow them to undertake more development expenditure.

viii. In parallel, provincial equity considerations should play a greater role in the Federal Annual Development Program, which is outside the ambit of the NFC.

ix. The provincial share should be distributed between the provinces on the basis of a formula that reflects their needs as well as reduces the disparities between them. The multi-indicator formula should include population (since many of the provincial needs are directly proportional to it), area (since the density of population affects the per capita cost of delivering some public services) and an indicator of relative social and human development (to reduce disparities). The weight of the development indicator in the formula will depend on the speed with which the NFC chooses to correct regional disparities.

x. The demand of the provinces for their profits and royalties from natural resources be transferred according to the Constitutional. If there are differences over the calculation of provincial shares, these can and should be addressed according to the norms of accounting, decisions of Council of Common Interest, and the Constitution.

xi. According to water apportionment accord, no restriction is placed on all schemes not exceeding 5000 acres above elevation of 1200 ft SPD. No restrictions are placed on developing Irrigation uses in the Kurrum/Gomal/Kohat basins, so long as these do not adversely affect the existing uses on these rivers. All efforts would be made to avoid wastages. Any surpluses may be used by other Provinces would not established any rights to such uses. It has accordingly deprived itself of revenues on investment, self-sufficiency employment, and surplus in Agriculture. Till such time province unable to utilizes it full potential it may like to charge/user charge on others for using its water.

1.12 NWFP get more than 90% 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 and Net Hydel Profit. Revenue received during the Report periods in terms of %age are indicated in

Table 1.1:-

Table-1.1 (Rs. in percent)

S.No.	ITEMS	2004-05	2005-06
1	Federal Tax Assignment	64.6	66.8
2	Straight Transfer	13.9	14
3	Grant / Subvention	12.4	10.8
4	Provincial Own Receipt	9.1	8.4
	TOTAL:-	**100.00**	**100.00**

CHAPTER-II

LOCAL FINANCES

a) DISTRICT GOVERNMENT

2.1 All the District Governments mostly rely on the Provincial Government transfer from the Provincial Allocable Amount under PFC Award. In addition District Governments have some Local resources, which were earlier accrued to Local Fund. The Local Fund of erst-while District Council was made part of District Fund with effect from 1-7-2004 in pursuance to Section 107 of the Local Government Ordinance 2001. All Local Fund receipt is now part of District Fund. In the year 2003-04, the Provincial Government handed over the collection of UIP Tax to two Districts on pilot basis but the progress of collection of both the District was found unsatisfactory. The PFC therefore, decided that the collection of UIP Tax should continue to be made by the Provincial Government. In the year 2005-06, the Provincial Government decentralized the collection of receipt on account of Health and Education Sector in Account-IV, through District Governments in line with the provision of LGO, 2001 with extra incentive of matching grant in case the District Govt., collect additional receipt over and above the targets.

2.2 Section 116 of the Local Government Ordinance 2001 provides that a council may, levy taxes, cesses, fees rates, rents, tolls, charges, surcharges and levies specified in the second Schedule;

Provided that Govt., shall vet the tax proposal prior to the approval by the concerned Council.

2.3 The Provincial Government, with the approval of Provincial Finance Commission, has encouraged the District Governments that generates additional resources, either by enhancing the existing rates or enforcing new taxes/duties/fees, shall be given 100% matching grant but none of the District Governments availed this opportunity during 2004-05 either due to non-availability of proper guidelines or there involved some procedural difficulties/clarification. The Governments of Abbottabad and Manshera have however, initiated a case for matching grant but the same was not materialized for want of certain clarifications on the part of District Governments. In the year 2005-06 the District Governments were again encouraged for availing matching grant on account of extra expenditure incurred on M&R of Roads. Two districts viz. Haripur and Bannu have availed the opportunity and they were provided matching grant.

b) <u>TEHSIL/TOWN ADMINISTRATION</u>

2.4 On commencement of Local Government Ordinance, 2001 every Tehsil and Town shall be rating areas within the meaning of the NWFP Urban Immovable Property Tax Act 1958 and Tehsil Council or Town Council as the case may be determine the rate of Property Tax in an areas within the Tehsil/Town. At present the UIP Tax is being collected by the Provincial Govt., through Excise and Taxation Department and after deducting collection charges the balance amount is transferred to Districts for further disbursement to TMA's. The collection of UIP Tax will be handed over to TMA's in line with provision contained in LGO, 2001 as soon as the TMA's are placed on sound footing in terms of capacity building.

2.5 Since the discontinuation of Octroi and Zila Tax (OZT) on the directive of the Federal Government in 1999, 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 Tehsil/Town Administrations depend on the inherited property tax, Octroi revenue and development grant from Provincial Allocable Amount. The OZT together accounted for more than 70% revenues of local councils as these were abolished with the agreement that the federal government would compensate the local councils for their losses through the additional 2.5% GST.

2.6 The issue is that both Octroi and Zilla Tax were highly buoyant levies, which grew at an average 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 flow of funds declined, the overall 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. Out of the 61 TMAs, only 60% 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 spiralling cost of electricity. The remaining 40% were in deficit and were unable to meet even the cost of their salary so much so that many TMAs had been unable to undertake any functions mandated to them. Although they have been empowered to levy taxes fee etc., under Section 116 but no such proposal has been initiated towards generating local taxes.

c) <u>UNION ADMINISTRATION</u>

2.7 The main source of income of Union Administration is the grant provided in lieu of Zilla Tax. This grant is transferred to Union Administration at flat rates by the District

Governments after retaining 10% share of Zilla Council. Besides Union Administration has some local receipts like birth/death registration, for marriage registration fee etc.

CHAPTER-III

INTERIM PROVINCIAL FINANCE COMMISSION AWARD 2004-05

3.1 Under the Interim Provincial Finance Commission Award 2004-05, the shares of the Provincial and District Governments were determined as under:-

Table-3.1 PROVINCIAL POOL (Rs. in billion)

S.No.	ITEMS	B.E 2004-05	Actual 2004-05
1	Revenue Assignment from Federal Divisible Pool*	27.761	29.728
2	GST on Services	0.406	0.389
3	Royalty on Crude Oil	0.188	0.487
4	Royalty on Natural Gas and Gas Dev. Surcharge	0.169	
5	Net Hydel Profit	8.000	6.000
6	Subvention	4.500	4.500
7	Provincial Own Receipt	4.022	4.235
	TOTAL:-	**45.046**	**45.339**

*Does not include 2.5% G.S.T Federal Share (1.287).

Table-3.2 OBLIGATORY EXPENDITURE (Rs.in billion)

S.No.	Items	B.E 2004-05	Actual 2004-05
1	Debt Servicing	9.700	13.335
2	Pension	3.780	3.053
3	Subsidy	1.000	0.900
4	Contribution to GP Fund & Pension Fund	1.000	0.700
5	Charged Expenditure	0.154	0.181
	TOTAL:-	**15.634**	**18.169**

Table-3.3 DIVISIBLE POOL (Rs.in billion)

S.No.	Items	B.E 2004-05	Actual 2004-05
1	Provincial Pool	45.046	45.339
2	Provincial Obligatory Expenditure	15.634	18.169
3	Divisible Pool (1-2)	29.412	27.170
4	Provincial Retained Amount	11.765	10.068
5	Provincial Allocable Amount	17.647	16.302

Table-3.4 AMOUNT TRANSFERRED TO THE DISTRICT GOVERNMENTS (Rs.in billion)

S.No.	Items	Actual 2004-05
1	Salary	15.431
2	Non-Salary	1.499
3	Development	0.973
	TOTAL:-	**17.904**

CHAPTER-IV

IMPLEMENTATION OF PFC AWARD FY 2004-05

a) PROVINCIAL FISCAL RECEIPTS FY 2004-05

4.1 As against the budgeted Rs.28.168 billion of Federal Tax Assignment (including divisible pool transfers and GST on services) an amount of Rs. 30.117 billion was received by the end of June 2005, showing an increase of 23.7% over the transfers for the Financial Year 2003-04.

4.2 The full year income from the straight transfers including royalty on oil and gas, excise duty on gas and development surcharge on gas was Rs.0.487 billion Rs.6 billion were received as Net Hydel Profit against the budgeted amount of Rs.8 billion. In addition, Rs. 4.5 billion were received on account of subvention. Thus the over all federal transfers for FY 2004-05 totalled to Rs.41.104 billion (28% higher than the receipts of Rs.30.957 billion during Financial Year 2003-04.

4.3 The provincial own revenue collections as per June Final Accounts were Rs.4.235 billion showing an increase of 17.05% over to the provincial receipts of Rs.3.618 billion collected during Financial Year 2003-04.

b) FISCAL TRANSFERS DURING FY 2004-05

4.4 For Financial Year 2004-05 revenue distribution was made on the basis of existing formula. Table 3.1 shows the details of actual receipts of the Provincial Govt., during Financial Year 2004-05. After deducting the obligatory Expenditure (Table 3.2), table 3.3 indicates the vertical distribution of the provincial divisible pool receipts between the Provincial Govt., and the District Governments. The district wise distribution of funds is at **Annex-I**. Important features of the revenue distribution are as follows:-

1. The horizontal distribution of Development funds amongst District and TMA's was made @ 70:30 ratio. 10% funds were provided to Districts on the directives of Chief Minister. Interse distribution of Development funds amongst the District are made on the following formula:-

1.	Population	50%
2.	Backwardness	25%
3.	Lag. in infrastructure	25%

2. Similarly 90% Non-Salary finds were transferred on aforementioned criteria while 10% funds were distributed as fiscal equalization grant to off set the losses of those districts those suffered under the aforementioned formula.

3. 25% Additional funds were earmarked to Districts keeping in view the financial constraint faced by the District Governments, owing to payment of electricity charges.

4. 2.5% G.S.T received from Federal Government as grant in lieu of O.Z.T was distributed amongst Local Governments in the following manner. Details are reflected at **Annex-II & III** of the Report:-

i) An increase of 5% in Octroi grant over last year's share was given to old TMA's. A special grant of Rs.One million each was provided to new TMAs who were not collecting Octroi at the time of its abolition. An additional grant of Rs.21.740 million was distributed amongst weak TMAs for payment of electricity bills and other essential expenditure.

ii) Historical share of each District in grant in lieu of Zilla Tax as distributed by District Govt., amongst the Union Councils at flat rate after deducting 10% share of Zilla Council.

iii) Rs.30.524 million were provided to Cantonment Boards having sharing arrangement with adjoining T.M.A's.

5. As against the estimated Rs.15.384 billion on account of salary budget of the District Governments, an amount of Rs.15.431 billion was utilized.

6. On account of non-salary funds, Rs.1.499 billion were transferred.

7. An amount of Rs.0.973 billion was released to the district governments against budgeted amount of Rs.0.963 billion for the development schemes. The District Government utilized Rs. 0.461 billion, which is 47% of the released amount.

4.9 In order to assess the broad distribution it may be seen that the actual divisible revenue available to the Governments during Financial Year 2004-05 was as under.

		Rs. In billion
*	Federal Tax assignment (Excluding 2.5% G.S.T)	30.117
*	Net Hydel Profit	6.000
*	Straight Transfers	0.487
*	Subvention	4.500
*	Provincial own receipt	4.235
*	**Total**	**45.339**
*	**(-) Obligatory Expenditure**	**18.169**
*	**Net Divisible Pool**	**27.170**
*	**District Share @ 60%**	**16.302**

4.10 As against their share of Rs.16.302 billion, an amount of Rs.17.903 billion was transferred to District Governments (Table 3.4). This is around 11.9% more than due share. The salary expenditure was incurred through Account-I of the provincial government. The non-salary funds and Development Funds were transferred to Account-IV on quarterly basis.

4.11 As against a receipt of Rs.1.287 billion on account of Federal share of 2.5% GST during 2004-05, Govt. of NWFP released an amount of Rs.0.926 billion (72%) to the Local Governments on the basis of their historical collection of OZT, while remaining amount was released for Development Expenditure. The Govt. of NWFP's share of the 2.5% GST, which was included in the Sales Tax, was distributed on the basis of PFC formula.

4.12 The bifurcation of the District Governments grants into salary, non-salary and development is primarily on the basis 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 flown through the Account-IV.

4.13 The reasons for not transferring the salary component to Account-IV were:

i) non-availability of Managerial staff at District level.

ii) Un-sound Cash balance position of most of districts.

iii) Lack of proper reconciliation between District Govts. Banks and Accounts Department. Accounts of following districts were found in-deficit on 30-6-2005:-

1) Bannu	2) Haripur
3) Karak	4) Lakki Marwat
5) Swat	6) Tank

4.14 During 2003-04, on the recommendations of Wapda Cell, established for the purpose of reconciled of electricity bills. Govt. of NWFP released Rs.1.4 billion to WAPDA to clear the outstanding dues of various Local Govt. Offices. A meagre amount was adjusted against Development Grant and UIP Tax of Local Governments, while balance amount was paid through Account-I.

4.15 The allocation of Development funds at local level was mainly utilized on minor schemes. The District Governments have been made bound to spend 40% of the District Development Share on big schemes/projects.

CHAPTER-V

PFC AWARD 2005-06

5.1 Since 2002-03 the Commission had been recommending yearly interim Awards for Local Governments. For the first time the Commission has recommended a 3 years Award for 2005-06, 2006-07 and 2007-08. For Financial Year 2005-06 the share of Local Governments as determined as under:-

Table-5.1 PROVINCIAL POOL (Rs.in billion)

S.No	ITEMS	B.E 2005-06	Actual 2005-06
1	Revenue Assignment from Federal Divisible Pool*	30.733	33.788
2	GST on Services	0.420	0.536
3	Royalty on Crude Oil	0.469	0.492
4	Royalty on Natural Gas and Gas Dev. Surcharge	0.091	0.692
5	Net Hydel Profit	8.000	6.000
6	Subvention	5.000	3.898
7	Provincial Own Receipts	4.474	4.341
	TOTAL:-	**49.187**	**49.747**

*Does not include 2.5% G.S.T Federal Share (1.683) billion.

Table-5.2 OBLIGATORY EXPENDITURE (Rs.in billion)

S.No.	Items	B.E 2005-06	Actual 2005-06
1	Debt Servicing	10.299	11.480
2	Pension	3.744	3.408

3	Subsidy	0.900	0.900
4	Contribution to GP Fund & Pension Fund	0.700	0.954
5	Charged Expenditure	0.187	0.256
	TOTAL:-	**15.830**	**16.998**

Table-5.3 DIVISIBLE POOL (Rs.in billion)

S.No.	Items	B.E 2005-06	Actual 2005-06
1	Provincial Pool	49.187	49.747
2	Provincial Obligatory Expenditure	15.839	16.998
3	Divisible Pool (1-2)	33.357	32.749
4	Provincial Retained Amount	13.342	13.099
5	Provincial Allocable Amount	20.014	19.648

Table-5.4 AMOUNT TRANSFERRED TO THE DISTRICT GOVERNMENTS (Rs.in billion)

S.No.	Items	R.E 2005-06
1	Salary *	19.396
2	Non-Salary	1.650
3	Development	0.963
	TOTAL:-	**22.009**

* Salary figures have been based on R.E. whereas the rest of the figures are actual.

CHAPTER-VI

IMPLEMENTATION OF AWARD 2005-06

a) PROVINCIAL FISCAL RECEIPT FINANCIAL YEAR 2005-06

6.1 Table 5.1 shows the Provincial Pool, which mainly consists of Federal Divisible Pool Transfers. At the close of financial year 2005-06 the Fiscal Receipts are accounted as Rs.49.747, which is 9.5% higher than financial year 2004-05. There is increase in Federal Tax assignment as well as in straight transfers as compared to financial year 2004-05 while decrease was observed in Federal grants. The %age increase is explained in table 6.1: -

Table-6.1 %AGE INCREASE IN FISCAL RECEIPT.

S.No.	Item	Actual 2004-05	Actual 2005-06	%age
I	Federal Tax Assignment	30.117	34.324	13.9
ii	Straight Transfers	6.487	7.184	10.7
iii	Grants	5.787	5.581	(-)3.5
iv	Provincial own Receipts	4.235	4.341	2.5
	TOTAL:-	**46.626**	**51.344**	**(+)10.1**

b) **FISCAL TRANSFERS DURING FINANCIAL YEAR 2005-06**

6.2 For Financial Year 2005-06, Revenue distribution was made on the basis of existing criteria as contained in Table 5.1 to 5.4. Salient features of revenue transferred to Local Govts., are as follows: -

1) The horizontal distribution of Development Grant amongst Districts and TMAs was made on 70:30 ratio. 10% of development funds were distributed on Chief Minister's directive amongst the Districts.
2) 90% Non-Salary funds were distributed on the basis of formula while 10% funds were distributed as fiscal equalization grant to offset the losses of those districts whom suffered due to the formula.
3) Interse distribution of Development and non-salary funds has been made on following formula: -

1.	Population	60%
2.	Backwardness	20%
3.	Lag in infrastructure	20%

4) The salary component amounting to Rs.19.396 billion as disbursed through Provincial Account-I as usual. The non-salary and Development grants were disbursed through District Account-IV.

6.3 Table 5.4 indicates that against the Local Government share of Rs.19.648 billion, an amount of Rs.22.009 billion were transferred to them which is 44.9% of Provincial Pool. Details are reflected at **Annex-IV** of the Report.

6.4 The grant in lieu of O.Z.T that was received from Federal Government as 2.5% G.S.T share was distributed amongst TMA's and Union Councils in the following manner. Details are reflected at **Annex-V&VI** of the Report:-

i) The historical share of old TMA's was increased by 7.5% over the previous year 2004-05.

ii) Rs. 1 million each was provided to New TMAs, which are 21 in numbers.

iii) Rs.35.359 million were distributed amongst Cantonment Boards having sharing arrangements with adjoining TMAs.

iv) Rs.48.359 million were distributed amongst weak TMAs.

v) Rs.491.000 million were distributed amongst Union Councils at flat rate through District Governments.

6.5 With the Establishment of Energy Monitoring Cell (EMC) in Finance Department, excess billing and their prompt payment by the Local Governments and advance payment on account of WAPDA dues has been curtailed. During Financial Year 2005-06 an amount of Rs.137.728 million were paid to WAPDA on account of outstanding dues of various Local Governments as compared to the preceding year payment of Rs.257.042 million. Energy Monitoring Cell (EMC) is playing a vital role in this behalf and they have succeeded to gain a Credit from WAPDA. With the passage of time the payment on account of electricity by the Local Governments will be regularized and no advance payment would be required on behalf of Local Governments.

CHAPTER-VII

ISSUES AND CHALLENGES

7.1 Implementation of the Provincial Finance Commission Award 2004-05 and 2005-06 may be viewed in the context of multiple constraints ranging from problems of weak staffing at Local Governments to a wide range of issues relating to fiscal constraints, 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 have 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 other legal restrictions on them to mobilize resources through borrowings.

7.2 In this perspective, the Finance Department had placed before the PFC, the issue of transferring the powers to levy and collect a potentially buoyant tax like the Property Tax to the district governments. Besides the positive impact on the revenue structures of district governments to exploit full potential of such taxes, it would also reduce their reliance on transfers from the provincial divisible pool. The distribution criteria making basis for the PFC Award could be appropriately modified to account for the revenues that would be retained by such district governments and in order to compensate other districts, with limited potential for raising substantial revenues from other sources.

7.3 The concept of equalization grant as introduced, as some districts were not getting enough funds on the basis of other criteria of population, backwardness and lag in infrastructure.

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

7.5 The devolution proposes various reforms to enhance citizen participation in decision-making process. The public participation through Citizen Community Boards (CCBs) is still in its infancy and its effectiveness has yet to be seen. There is very limited progress in utilization of budgets allocated for CCBs' schemes in most of the districts. Largely the funds are unutilized due to non-constitution of C.C.Bs and lack in identification of appropriate schemes coupled with lack of clarity in understanding rules for allocations/prioritization of schemes. Although CCBs have been formed at number of places but their role and effectiveness is yet to be determined in improving service delivery. According to data collected from various Districts some Districts have been able to utilize a small amount allocated for C.C.Bs during 2004-05, whereas information pertaining to the year 2005-06 is yet to be received.

7.6 In the PFC Award 2003-04, the intra local government fiscal transfer arrangements were not identified. The transfer of funds was left on the discretion of district governments that enhanced uncertainty in transfer of funds to TMAs and UAs. This aspect was partly addressed when Finance Department begun direct transfers of OZT grant and Development grant shares to TMAs from 2004-05 onwards. However, direct transfers to Union Administration is still to be done and presently they have been paid through District Governments.

Annex-I

FUNDS RELEASED TO DISTRICT GOVERNMENTS DURING 2004-05

S.No	District	Salary	Non-Salary	Development	Total
1	2	3	4	5	6
1.	Abbottabad	1,037.430	68.898	28.857	1135.185
2.	Bannu	654.204	83.039	39.207	776.450
3.	Battagram	228.339	28.127	14.912	271.378
4.	Buner	360.533	33.375	22.053	415.961
5.	Charsadda	858.318	51.928	28.131	938.377
6.	Chitral	442.903	36.539	14.202	493.644

7.	D.I.Khan	673.314	148.558	57.908	879.780
8.	Hangu	176.498	25.655	14.602	216.755
9.	Haripur	670.357	79.541	37.194	787.092
10.	Karak	602.288	96.578	19.425	718.291
11.	Kohat	575.126	62.884	22.590	660.600
12.	Kohistan	232.764	45.333	43.223	321.320
13.	Lakki Marwat	531.645	82.985	20.068	634.698
14.	Lower Dir	746.994	43.089	36.274	826.357
15.	Malakand Agency	510.053	41.583	17.077	568.713
16.	Mansehra	826.318	56.049	37.635	920.002
17.	Mardan	1,233.708	66.867	39.117	1339.692
18.	Nowshera	764.242	45.540	24.494	834.276
19.	Peshawar	1,480.621	94.376	74.084	1649.081
20.	Shangla	296.725	35.325	19.665	351.715
21.	Swabi	805.986	52.800	28.421	887.207
22.	Swat	1,087.567	60.982	35.809	1184.358
23.	Tank	234.562	30.242	19.022	283.826
24.	Upper Dir	400.973	40.697	22.077	463.747
	Sub-Total	**15,431.468**	**1,410.990**	**716.047**	**17558.505**
Share of TMA,s		-	-	257.123	257.123
Addl. Grant on need basis		0.000	0.000	0.223	0.223
Addl.Grant for electricity charges		0.000	88.131	0.000	88.131
Sub-Total		**0.000**	**88.131**	**0.223**	**345.477**
GRAND TOTAL		**15431.468**	**1499.121**	**973.393**	**17903.982**