

**Report And Recommendations of the
Provincial Finance Commission**



**Government of Sindh
Provincial Finance Secretariat
June 2004**

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Introduction

1. The first Provincial Finance Commission (PFC) in Sindh was constituted in February 2002 under the Chairmanship of the Minister for Finance through notification No. SO (C-IV) SGA&CD /7-381/2001. The first Award was announced as an Interim Award in June 2002, it was however subsequently extended till June 2004. This was implemented satisfactorily except that it did not address the finances of the TMAs and UAs separately. This particular issue was partially resolved, when the Finance department began making direct transfers to TMAs from March 2004 onwards. These transfers pertain to the OZT shares, which were being given to the TMAs on the basis of their historic collection. As such, these are not in tune with the TMAs requirements, in the wake of statutory functions assigned to them. The new PFC Award attempts to attend to the issue of TMAs fiscal need and fiscal effort as envisaged under the law along with other issues pertaining to fiscal decentralization.

2. Under the Interim-2002 Award, the shares of the Provincial and District Governments were estimated on the basis of benchmarks for recurrent expenditures for FY 2002-03. The Provincial Government was to retain 60% from the divisible pool, (consisting of all revenues other than non-tax receipts from user charges and the Federal Share of 2.5% GST funds being given to provinces in lieu of the abolishment of OZT) with 40% to be distributed among the District Governments on the basis of population (50%), backwardness (17.5%, to be determined on a composite index of 33 indicators), and tax collection (7.5%), with the remainder 25% earmarked for transitional transfer grants for bridging the gap between the expenditures of the District Governments and transfers on the basis of the three criteria.

3. The size of the divisible pool for development programs was determined after reserving funds for counterpart funding of foreign aided projects and for compensating District Governments that may not have adequate funds on the basis of the distribution formula. The divisible pool so determined was then distributed between the Provincial and District Governments on the basis of a 30:70 ratio. The criteria driving the distribution between the districts was population (50%) and backwardness (30%); 10% of the pool was to be shared equally and the balance 10% was set aside for financing the backlog of ongoing schemes. To protect the base of district finances, as it existed at the time of the abolishment of the OZT, it was decided that 65% of the 2.5% of the GST would be distributed among the District Governments on the basis of the historical collection of Octroi and Zila tax. It was also decided to maintain financial support to the Khushal Pakistan Program (KPP), funds from the residual 2.5% GST funds

Implementation FY 2002-03 & FY 2003-04

4. The 2002-03-revenue distribution was made on the basis of above formulae with certain variations. At **Table-I** are the details of district-wise funds transferred to the

District Governments. This distribution is on the basis of the gross budgeted salary. The other major features of the revenue distribution are;

- * As against the estimated Rs. 20,852.96 million for salaries, approximately an amount of Rs. 17,435.945 million net salary was released
- * As against the estimated Rs. 5,047.73 million for non-salary funds, an amount of Rs. 2,409.744 million was released for non-salary
- * An amount of Rs. 1,500 million approximately was funded by the Provincial Government on account of utility dues of the Local Governments and of this more than Rs. 900 million were on account of City District Government Karachi
- * An amount of Rs. 3,400 million was released to the District Governments against the development schemes. Against this Rs. 3000 million were utilized.

5. The 2003-04-revenue distribution was made on the basis of Interim Award extended to cover 2003-04, as well albeit some slight variations. At **Table-2** is the District –wise distribution of salary and non-salary funds. This distribution is again on the basis of the gross budgeted salary. For FY 2003-04 the total resources projected were Rs. 90 billion and the divisible pool was projected at Rs. 75.2 billion, with other features as under:

- * The projected Allocable amount was Rs. 30,081.76 million having a component of Rs. 24,744.211 million for salaries and Rs. 5,337.558 million for non-salary.
- * Of the total provincial ADP of Rs. 11,000 million Rs. 4,526.00 million were earmarked for District Governments over and above the Allocable amount.
- * As against the estimated Rs. 24,744.211 million for salaries, an amount of Rs. 19,621.964 million net salary was released.
- * As against the estimated Rs. 5,337.558 million for non-salary funds, an amount of Rs. 2296.353 million was released.
- * An amount of Rs. 4302.943 million was released to the District Governments against the development schemes. Against this Rs. 2728.092 million were utilized till May 04.

Award 2004-05

Provincial Consolidated Fund and Provincial Divisible Pool

6. The Government of Sindh re-constituted the Provincial Finance Commission on 2nd June 2003 under the Chairmanship of Syed Sardar Ahmed, Senior Minister for Finance and Cooperation (Annexure 'A'). This Commission held four meetings and discussed at length the new issues, current international practices and allied matters. However, delay in the announcement of the new award was basically due to non-finalization of the National Finance Commission Award.

7. According to Section 120-D of the SLGO-2001, the Provincial Finance Commission is required to distribute between the Government and Local Government the proceeds of the Provincial Consolidated Fund into Provincial Retained Amount and Provincial Allocable Amount respectively. The Provincial Consolidated Fund comprises of the i) Revenues from federal transfers and provincial own source revenues'. ii) Loans and grants from donor agencies. In the wake of the non-finalization of the NFC Award, the budget estimates for the FY 2004-05 were considered as conveyed by the Federal Government. The ADB assisted Devolved Social Services Programme (DSSP) funds are to be distributed on the basis of a formula to be approved by either the Provincial Steering Committee or the PFC for spending on social sectors namely education, health water and sanitation. These funds are required to be transferred to the District Governments and TMAs over and above the regular transfers. Accordingly these were not included in the over all Provincial Consolidated Fund. The over all Provincial Resource Position is projected as under (Rs. In million):

	<u>2004-05</u>
Federal Divisible Pool	47,628.58
Straight Transfers	25,049.86
Provincial Receipts	16,509.55
2.5% GST	11,496.30
Total	<u>100,684.29</u>

8. The OZT share indicated above is not based on the figures conveyed by the Federal Government but on the actual claim of the Province on the basis of its actual collection of OZT in the base year. After separating the OZT amount and the Provincial non-tax receipts the size of the Provincial Divisible Pool was estimated at Rs. 83,758.44 billion. The detail is given in **Table-4** and as under (Rs. In million):

	<u>2004-05</u>
Federal Divisible Pool	47,628.58
Straight Transfers	25,049.86
Provincial Tax Receipts	11,080.00
Total	<u>83,758.44</u>

Provincial Allocable and Retained Amount

9. The PFC reviewed the provincial expenditures and on the recommendation of Finance Department agreed that the provincial expenditures common to both sides should be accounted prior to apportionment of vertical shares. It was agreed that the expenditures of subsidy, debt servicing, pensions and priority programme pertain to Provincial Government as well as District Governments as such these need to be provided fiscal cover before distribution of the provincial divisible pool into Retained and Allocable amount. The details of these expenditures are given in **Table-5** and as under: -

Priority of Expenditures	Amount
Pension	6,541.00
Debt Servicing	11,871.48
Subsidy	4,012.78
Priority Program	1,300.00
Total	23,725.26

10. After deduction of the 'Priority Expenditures' the net Divisible Pool for the FY 2004-05 was worked out to be **Rs. 60033.18 million**. The PFC deliberated on the vertical distribution of the amount and before determining the respective share of the Province as well as District Governments combined, the expenditure benchmarks on both sides were determined.

11. On the provincial side, the following expenditure was considered other than the priority expenditures/ **Table-6** (Rs. In million):

	2003-04	2004-05
Establishment	15,640.40	18,596.44
Commodities	9,930.03	16,569.07
Total	25,570.43	35,165.51

12. The combined District Governments' expenditure was considered by giving 15% increase to basic salary whereas utilities were projected at 6% increase. In addition, the amounts pertaining to the newly created posts in the education and health sectors of the District Governments were also added to arrive at the current revenue expenditure requirement of District Governments combined **Table-6** (Rs. In million):

	2003-04	2004-05
Salary	24,744.20	27,293.79
New SNEs		564.96
Utilities/Commodities	5,337.55	5657.8
Total	30,081.75	33,516.55

13. The PFC considered current revenue expenditure requirements of both sides in order to arrive at appropriate ratio of distribution and for determining the, 'Allocable Amount'. It may be seen that there was a combined short fall of about Rs. 8648.88 million in the available net divisible pool and the expenditure requirements of the two sides. Mr. Syed Ashraf Wasti, member, PFC pointed out that as per rules the District Governments can not have deficit budgets therefore the Province must bear the major share of the over all deficit. The PFC accordingly recommended the division of the net divisible pool in the ratio of 45:55 for the Provincial Government and the District Governments combined. The projected figures for the Provincial Retained and Allocable amount is given in **Table-7**.

14. The PFC discussed at length the existing criteria of horizontal distribution namely population (50%), backwardness (17.5%), tax collection (7.5%) and transition transfer (25%). The Commission generally agreed that the criteria are in line with internationally recognized practices of revenue distribution as these address factors of fiscal need and fiscal effort however it was noted that the criteria of Transition transfers now needs to be gradually tapered off and the factor of fiscal performance needs to be gradually introduced. The criteria of Transition transfer was primarily added in the 2002 Interim Award, as a large number of districts were not getting enough funds on the basis of first three criteria namely population, backwardness and tax collection. In order to ensure that the districts got their minimum expenditure benchmarks, the transition transfer component was added. The PFC noted that as the reduction of this component continues to impact the expenditure benchmarks of many Districts as such it was agreed that it would be tapered off gradually. Its weightage was accordingly reduced to 20%. The remaining 5% was retained for further distribution on the basis of performance. It was decided that the PFC would subsequently finalize the performance benchmark in its next meeting.

15. The criteria of backwardness have been calculated on the basis of the SPDC study, which had calculated the multiple deprivation indexes for each district on the basis of published data. The weightage of each District Government under population, backwardness, tax collection and transition transfer is given in **Table-8**. The share of each District Governments from the Allocable amount and on the basis of the approved formula is given in **Table-9**.

16. There continues to be a huge mismatch between the functional responsibilities of district governments and the financial resources available to them, too much having been devolved in substantive terms in relation to their fiscal powers. On the one hand, they are overly 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. The potential revenues that can be raised effectively from local tax bases are more limited than the expenditure requirements of the tasks assigned to the district governments. This is a particularly debilitating weakness considering the legislative restrictions on them to mobilize resources through borrowings.

17. The PFC in its earlier meetings had accordingly considered options, which could strengthen the Districts fiscal base such as transferring the powers to levy and collect a potentially buoyant tax like the Agriculture Income Tax (AIT) to the District Governments. Other than the positive impact that it could have on the incentive structures for District Governments to exploit the full potential of such a tax, it would also dilute their overwhelming reliance on transfers from the provincial divisible pool to finance operations. The distribution criteria governing the PFC Award could be appropriately modified to account for the revenues that would be retained by such District Governments and to compensate non-agricultural districts, or those with limited potential for raising substantial revenues from other sources. This however was deferred, as the subject had not been scrutinized technically for facilitating a decision on this account.

18. The issue of distribution of Federal share of 2.5% GST was discussed by the PFC on the basis of the proposal forwarded by the Local Government Department. The LG Department primarily recommended that after accounting for historical shares of all the stakeholders in the OZT revenue as it stood in the base year, the additional revenue from this head should be used to provide funds for the Union Administrations (UAs); base funds for new TMAs; funds for pension of SLG employees and the residual funds to be distributed amongst the TMAs on the basis of a formula.

19. This proposal was analyzed on the basis of projected funds of 2.5% GST for next financial year amounting to Rs. 10 billion. After accounting for the historic share of all District Governments and TMAs; from the remaining amount, a fixed grant of Rs. 0.6 million per annum is to be provided for 1095 UAs, Rs. 1.2 million per annum for six new TMAs and Rs. 140 million per annum for clearing the pension liabilities of the SLG employees. The residual amount shall be distributed solely amongst the TMAs on the basis of criteria comprising of population, collection, and backwardness. The Local Government department had consulted TMAs on this issue and it placed two formulae before the Commission. The Local Government proposed formula comprising of population (60%); historic collection of OZT (10%); and backwardness (30%). The Taluka Nazims, proposal was almost the same except they sought a slightly higher weightage for backwardness from 30% to 40% with proportionate decrease in the % age of population.

20. In order to compute a backwardness index of all the 102 TMAs in Sindh, the PFC Secretariat had sought assistance of Syed Ashraf Wasti, Senior Economist AERC and member PFC. Mr. Wasti and Mr. Minhajuddin Siddiqui, Research Economist at AERC prepared a Multi-indicator Deprivation Index (MDI) at the TMA level for the first time in Pakistan. The MDI of individual TMA has been developed using the

standard methodology as defined in the UNDP reports (as in the Pakistan National Human Development Report 2003 by UNDP). The data has been taken from the Housing and Population Census report of 1998. The indicators used for developing MDI has been taken from education and housing information reported in the census and reflects the level of deprivation of these services and facilities in various TMAs. The variable used includes proportion of illiterate population in each Tehsil /Taluka, proportion of houses having katcha structures, having katcha/ pacca structures and proportion of houses with out water and with out electricity connection. The MDI for an individual TMA is calculated on the basis of individual score of TMA divided by the Total. The figures of variables for each TMA and accordingly calculated weightage of each TMA on the basis of given variables is given in **Table-10**.

Recommendations:

1. The Provincial Divisible Pool would consist of Federal Tax Assignment, Straight Transfers and Provincial Tax Receipts. The priority expenditures comprising of pension, subsidy and debt servicing and priority program will be subtracted from the Gross Divisible Pool to arrive at 'Net Divisible Pool'.
2. The present practice of sharing in the net proceeds for current revenue, development, non-salary has been done away with from the next Financial Year (2004-05). There will be 'One line transfers', to the District Governments from the FY 2004-05.
3. The Provincial Government will retain 45% from the Net Provincial Divisible Pool as Retained amount, whereas, 55% will be the Allocable Amount for the District Governments combined. The transfer of the Allocable Amount will be a general purpose grant and following principles will apply on the use of this grant:
 - i) This grant will be available for appropriation according to priorities set by the local councils.
 - ii) Eligible expenditure will be salary, non-salary and development.
 - iii) The grant will be transferred through Account IV.
 - iv) All development, non-development and other expenditures are to be borne from this fixed amount..
4. The horizontal shares of the District Governments from the Allocable Amount shall be determined and distributed on the basis of the following formula:

i)	Population	50%
ii)	Backwardness	17.5%
iii)	Tax Collection	7.5%
iv)	Deficit Transfers	20%
v)	Performance	5%

5. The indicators for the backwardness will be the same as in the last Award. The PFC will determine the benchmarks for performance within a month's time.
6. In addition, to the above mentioned allocable amount, an amount of Rs. 1.89 billion will be given to the District Governments under DSSP (Devolved Social Services Program). The DSSP funds will be utilized on the basis of the Memorandum of Understanding to be so signed with each District Government and TMA. The funds will be distributed amongst the DGs and TMAs on the basis of the formula suggested by the Provincial Steering Committee of DSSP:

i. Population	50%
ii. Backwardness	30%
iii Equal Share	20%
7. Additional amount of Rs. 900 million will be given to the District Governments under the World Bank supported Sindh Reform program as tied grants for education sector reforms.
8. TMAs (all) in the Province of Sindh will be receiving an amount of Rs. 613 million on account of the transfer of functions and to the extent of the transfer of establishment of PHED

Recommendations for Distribution of 2.5% GST Share

9. From the Federal Share of 2.5% GST, the historic share of each District Government and TMAs as it stood in the base year of abolishment of OZT will be financed first. The summarized distribution under this head is given in **Table-10-A**. The historic share of the District Government from the defunct OZT is given in **Table 11**. Out of the remaining amount, following expenditures will be incurred:
 - i) Union Administration (all) in the Province of Sindh will be given an annual fixed grant amounting to Rs. 0.6 million each.
 - ii) The newly created six TMAs will be give an amount of Rs. 1.2 million each as an annual fixed grant.
 - iii) An amount of Rs. 140 million will be provided to the Local Government department for meeting the pension expenditure of the SLG service retirees.
 - iv) After deduction of the above expenses, the residual amount will be distributed amongst TMAs on the basis of the following formula:

i. Population	50%
ii. HDI	40%
iii Tax collection	10%

21. The historic share of the TMAs and their respective share from the residual amount, which has been calculated on the basis of the weightage of each TMA, are given in **Table- 11-A**.

Acknowledgements

22. The Commission appreciated contribution of various entities especially Mr. Syed Ashraf Wasti, Senior Research Economist AERC/ member PFC; Mr. Minhajuddin Siddiqui, Research Economist AERC and the PFC Secretariat for their support in facilitating finalization of the Award. The Commission appreciated the special contribution of Syed Ashraf Wasti's in collection of development data, preparation of backwardness indicators for each TMA, developing different simulations etc. The Commission acknowledged that the fiscal transfer system needed further development especially in the context of collection of data including the district and TMA budgets, actual expenditures, revenue streams, revenue potentials and certain development indicators for moving forward towards further refinement of the distribution formulae. At the same time it was agreed that there continue to be certain constrains especially the given establishment force in many districts which consumed over 90% of actual transfers and due to which efforts at raising the non salary expenditures remained less than desirable and which at the same time limited the scope of flexibility in terms of formulae application.

(SYED SARDAR AHMAD)
*Senior Minister for Finance &
Cooperation
Government of Sindh
Chairman Provincial Finance
Commission*

(JEHANGIR SIDDIQUI)
Private Member

(Prof. EJAZ AHMED QURESHI)
Private Member

(SYED ASHRAF WASTI)
Private Member

(GHULAM SARWAR KHERO)
*Additional Chief Secretary
(Development)
Government of Sindh
Ex-Officio Member*

(MOHAMMAD SALEEM KHAN)
*Additional Chief Secretary
(Local Government)
Government of Sindh
Ex-Officio Member*

(MALIK ASRAR HUSSAIN)
*Secretary Finance & Cooperation
Department
Government of Sindh
Ex-Officio Member/Secretary*

(SYED NASIR HUSSAIN SHAH)
*Zila Nazim, Sukkur
Member*

(ALI MUHAMMAD MUGHAL)
*Nazim, UC-10
Gulshan-e-Iqbal Town, Karachi
Member*

(NAVEEDUL ISLAM)
*Town Nazim, Malir Town Karachi
Member*

ANNEXURES

AND

TABLES

ANNEX-A

GOVERNMENT OF SINDH
SERVICES GENERAL ADMINISTRATION &
COORDINATION DEPARTMENT.
Karachi dated 2nd June 2003.

NOTIFICATION.

No. SO (C-IV) SGA&CD/ 7-381/2001: - In suppression of Notification of even number dated 1st June, 2002 and pursuant to the SLGO (8th amendments) Chapter XII-A (under Section-120-B), the Government of Sindh is pleased to reconstitute a Provincial Finance Commission comprising the following: -

- | | | |
|-------|---|---------------------------------|
| i) | The Minister for Finance & Cooperation, | Chairman. |
| ii) | Additional Chief Secretary (Dev.)
Planning & Development Department. | Ex-officio Member. |
| iii) | Additional Chief Secretary Finance. | Ex-officio Member/ Secretary. |
| iv) | Secretary Local Govt. Department, Sindh | Ex-officio Member |
| v) | Professor Aijaz Ahmed Qureshi | Private Member. |
| vi) | Mr. Jahangir Siddiqui. | Private Member. |
| vii) | Syed Ashraf Wasti | Private Member. |
| viii) | Syed Nasir Hussein Shah | Zila Nazim Sukkur. |
| ix) | Mr. Azam Ali, | Town Nazim Malir. |
| x) | Mr. Ali Mohammed Mughal | Nazim UC-10, G.I. Town Karachi. |

TERMS OF REFERENCE

- Determine obligatory and priority expenditure of the provincial government and formulation of divisible pool for distribution of resources.
- Preparing benchmarks of revenues and expenditures and revenue and expenditure projections for the Provincial and District Government such that they are consistent with their respective mandates and envisaged by the Local Government Ordinance 2001 and their powers to levy and collect taxes and reduce finances through borrowings.
- Criteria and formula for the vertical distribution of resources between the Provincial and Local Government i.e. determination of Provincial Retained and Allocable amounts.
- Fiscal distribution criteria/formula (e) and mechanisms for the horizontal distribution between District Governments of the Allocable amount.
- Correcting inter-regional disparities by means of equalization grants from the Provincial Government to economically weaker District Governments subject to availability of resources.
- Suggest parameters for achieving fiscal discipline to maintain appropriate fiscal balance at the provincial and local levels.
- Any other matter relating to finance referred to the Commission by the Governor.

The Commission will furnish its recommendations to the Governor for consideration and approval.

K.B. RIND
CHIEF SECRETARY Sindh
Karachi dated the 2-06-2003

No. SO (C-IV) SGA&CD/ 7-381/2001

A copy is forwarded for information and necessary action to: -

- The City District Nazims (All).
- The Additional Chief Secretary (Dev.), Planning & Development Department.
- The Senior Member (including Members), Board of Revenue, Sindh.
- The Principal Secretary to Governor, Sindh, Karachi.
- The Administrative Secretaries to Government of Sindh (all)
- The Chairman, Anti-Corruption and enquiries Establishment, Sindh.
- The Chairman, Governor's Inspection Team, Karachi.
- Headquarters 5 Corps, Karachi.
- Chairman/ Members of the Committee.
- The Districts Coordination Officers (All) in Sindh.
- The Deputy Secretary (Staff) to Chief Secretary/PS to Secretary (GA/C) SGA&CD.

(ABDUL WAHAB MEMON)
SECTION OFFICER (C-IV)