



FISCAL FEDERALISM IN PAKISTAN

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**PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS
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Pakistan Institute of Development Economics
Quaid-i-Azam University Campus
P. O. Box 1091, Islamabad 44000, Pakistan

E-mail: publications@pide.org.pk
Website: <http://www.pide.org.pk>
Fax: +92-51-9248065

Designed, composed, and finished at the Publications Division, PIDE.

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FOREWORD

With the passage of the 18th Constitutional Amendment, Pakistan has taken a major step towards fiscal decentralisation which, together with the adoption of the 7th National Finance Commission (NFC) Award, has far reaching implications for fiscal federalism in Pakistan. This booklet has been prepared with the objective of providing a non-technical introduction to the subject of fiscal federalism emphasising opportunities and challenges that it entails for Pakistan. In so doing, it draws on an extensive body of literature on fiscal federalism and international experience to elicit insights that can help design appropriate policy instruments and institutional structures for better implementation of fiscal decentralisation in Pakistan. The booklet covers a wide range of topics including the federal legislative structure of Pakistan, institutional mechanisms for inter-jurisdictional resource sharing, provincial resource mobilisation, and macroeconomic management in a fiscally decentralisation framework.

The booklet is organised as follows. Chapter 1 provides a review of the structure of federation with an analysis of the functional jurisdictions over the constituent units of the state. Chapter 2 critically examines the institutional structure for the sharing of resource focusing in particular on the National Finance Commission Awards. The resource distribution criteria are examined in Chapter 3, whereas Chapter 4 deals with resource mobilisation with a focus on prospects for decentralised revenue generation. Chapter 5 explores the implications of fiscal decentralisation for macroeconomic management while Chapter 6 provides summary and conclusions.

It is hoped that the booklet will raise awareness about what fiscal federalism means for Pakistan's economic development and encourage dialogue and debate on ways to make the process of fiscal decentralisation a success in terms of better resource mobilisation as well as public sector efficiency and better service delivery.

Rashid Amjad
Vice-Chancellor

CONTENTS

	<i>Page</i>
Acknowledgements	iii
Foreword	v
Chapter 1: Federal Structure of Pakistan	1
1.1. History of Legislative Structure	1
1.2. Council of Common Interest	3
1.3. Analysis of the Federal Structure	4
1.4. Conclusion	14
Chapter 2: Intergovernmental Resource Transfers: Institutional Arrangements	15
2.1. Institutional Arrangements Used in Different Countries	15
2.2. Institutional Arrangements in Selected Countries	17
2.3. National Finance Commission of Pakistan	19
2.4. Proposed Institutional Arrangement for Distribution of Revenues	21
Chapter 3: Resource Distribution	24
3.1. Introduction	24
3.2. Resource Distribution Practices Adopted Internationally	26
3.3. Analysis of the Revenue Distribution Design	30
3.4. Conclusion	39
Chapter 4: Provincial Resource Mobilisation	40
4.1. Introduction	40
4.2. Theoretical Case for Decentralisation of Taxes	43
4.3. Assignment of Taxes: Levels of Government	46
4.4. Assignment of Taxes in Selected Countries	50
4.5. Assignment of Taxes in Pakistan	52
4.6. Conclusion	58

	<i>Page</i>
Chapter 5: Decentralisation and Macroeconomic Management	59
5.1. Introduction	59
5.2. Decentralisation: Functional Assignment and Possible Effects	59
5.3. Ensuring Fiscal Prudence	60
5.4. Fiscal Responsibility Law	63
5.5. Institutional Framework for Fiscal Discipline in Pakistan	64
5.6. Decentralisation: Impact on Quality of Macroeconomic Management	66
5.7. Macroeconomic Management: Medium-Term Budgetary Framework (MTBF)	66
5.8. Macroeconomic Management: Adjusting to Supply Shocks and Unexpected Expenditures	67
5.9. Planning for Development	68
5.10. Rethinking the Role of the Planning Commission	68
5.11. Conclusion	69
Chapter 6: Summary and Conclusions	70
Appendix	73
References	75

List of Tables

Table 1.1. Assignment of Functions to Different Tiers of Government Typical in Federal Countries versus Pakistan	6
Table 3.1. Criteria for Distribution of National Revenues	25
Table 3.2. Revenue Transferred to Provinces as Percentage of Gross Total Revenue of Federal Government	37
Table 4.1. Imbalance between Revenue and Expenditure in Countries at the Sub-national Level	41
Table 4.2. Tax Bases Assigned to Federal Government and Provinces	43

Chapter 1

FEDERAL STRUCTURE OF PAKISTAN

Pakistan is a federal country with two constitutional tiers of the government—the federal government and the provincial governments. Moreover there are some Federally Administered Tribal Areas (FATA) and the State of Azad Kashmir. The country has a bicameral legislature comprising the National Assembly (Lower House) and the Senate (Upper House). The members of the National Assembly are directly elected, every five years, by the population aged 18 years and above. The Senate has equal representation of members from each constituent unit (i.e. the Province). The Senate thus offers an institutional arrangement for the role of the provinces in the central decision making. The Council of Common Interests, with equal representation from the federal government and the provinces, decides over the legislation of such functions that require collective action of the federal government and the provinces. The functions over which the Council of Common Interest enjoys jurisdiction are contained in federal legislative list II. The Ministry of Inter Provincial Coordination, coordinates between the federation and the provinces.

1.1. History of Legislative Structure

Pakistan adopted a federalist structure at the time of independence in August 1947. As the Indian sub-continent under the British rule had a federalist structure therefore it was only natural for Pakistan to continue with this structure. For around a decade in the 1960s under a military regime, Pakistan adopted a unitary structure for West Pakistan. Before the promulgation of the present constitution in 1973, the country had made attempts at framing constitutions in 1956 and 1962. The constitution of 1956 was federal in character with provinces enjoying legislative jurisdiction over considerable functions. This constitution also assigned concurrent legislative authority to the federation and the provinces on 19 subjects. The federal legislation was to enjoy primacy in case of conflict between the federal and provincial legislation on functions declared 'concurrent' by the constitution. The constitution of 1962, introduced under the then military regime, was a highly centralised constitution, but recognised East Pakistan and West Pakistan as the two federating units and provided for the presidential form of government. The constitution of 1962 contained a single

legislative list of 49 federal subjects. The constitution of 1973 institutionalised the federal system and provided for equal representation from the provinces in the upper house of parliament.

There is no unique model of federalism and considerable variation exists in the distribution of functions and finances within the federations. The factors that have driven the desire for the union or regional identity include: demography, history, economics, lingual, international, cultural, security and the interrelation of these factors. Moreover another factor which has influenced the distribution of powers among the tiers of the government is the influence of the models developed and being used around the world. It was perhaps under the influence of the models used elsewhere that the framers of the constitution of 1973 kept only a restrictive list primarily including external affairs, defense, currency and trade as the functions exclusively assigned to the federal government. The concurrent list, however, contained as many as 37 subjects. The concurrent list from the very beginning was thought to be an encroachment over provincial jurisdiction and was considered against the spirit of provincial autonomy. Therefore doing away with concurrent list became synonymous with securing provincial autonomy. It is widely believed that the intention of the framers of the constitution of 1973 was to abolish the concurrent list after a period of ten years however no documentary evidence is available to validate this belief. The political parties, especially the regional ones, who had more to gain from provincial autonomy, had been demanding total repeal of the concurrent list. This demand stood accepted with the enactment of the 18th amendment to the constitution of 1973. With the repeal of the concurrent list the content and degree of federalism in Pakistan has undergone a sea change.

The repeal of the concurrent list is predominantly the result of a political compromise and less of a serious debate on what function should be assigned to which tier of the government; in fact the politics of autonomy had allowed little serious debate over the appropriate jurisdiction of a specific function. This, however, is not to say that there has been no debate whatsoever over the assignment of the individual functions included in the concurrent list. A sub-committee of the Parliament was constituted to debate and recommend the amendments. This sub-committee had representation from all the political parties represented in the parliament. More than 100 Articles of the constitution have been amended vide the 18th Amendment. Besides the repeal of the concurrent list the 18th Amendment included other matters such as trimming the powers of the President, and the role of the Parliament in the appointment of judges. It so happened that while

the 'X' political party had interest in repeal of the concurrent list the 'Y' political party was more interested in introducing parliamentary say over the appointment of the judges. The final outcome was the result of compromise struck by the political parties in the spirit of give and take. This kind of compromise is not atypical and is commonly referred to in the public policy literature as 'logrolling'. The changes that have occurred overtime in the federal jurisdiction over various functions are given in the Appendix. The federal functions have been segregated into those upon which the federal government enjoys sole jurisdiction (federal legislative list I) and those upon which the legislative authority is exercised by the federal government through the Council of Common Interest (Federal Legislative List II).

1.2. Council of Common Interest

The Council of Common Interest (CCI) is responsible for the formulation and regulation of policies in relation to matters contained in Part-II of the federal legislative list. The role of the Council of Common Interest has been considerably strengthened after the eighteenth amendment. Upon repeal of the concurrent list some functions that were concurrent before the enactment of the 18th Amendment and still require consultation between the federation and the provinces have been placed in the federal legislative list II and are thus under the jurisdiction of the Council of Common Interest. Some functions that were under the sole jurisdiction of the federal government have now been placed in federal legislative list II thereby further enhancing the role of the CCI. The Council now has equal representation from the federal government and the provinces put together. Prime Minister and three federal ministers are to represent the federal government while each of the four chief ministers represents their respective provinces. Before the 18th Amendment, only eleven meetings of the Council were held since 1973. However, after the passage of the 18th Amendment, it is mandatory for the Council to meet at least once in ninety days. As such, the Council has held regular meetings since July 18, 2010. The strengthened role of the Council of Common Interest is evident from the enlargement of the federal legislative list II as described below:

Under the 18th Amendment the following functions have been transferred from the federal legislative list I to federal legislative list II.

- Major Ports
- National planning and national economic coordination
- State Lotteries
- Census

- Extension of powers of the police force of one province in another province, with the consent of the concerned province.

The following functions included in the concurrent list before the 18th amendment have now been transferred to the federal legislative list II after the repeal of the concurrent list.

- Electricity
- Legal, Medical and other professions

Some new functions that were not included in any of the legislative list have now been included the federal legislative list II

- All regulatory authorities established under the federal law
- Supervision and management of public debt

The new entries in the federal legislative list II have enhanced the federal character of the constitution because matters related to the functions included in the list are to be deliberated in the CCI which has representation from the federal government as well as the provinces.

1.3. Analysis of the Federal Structure

A variety of federalist structures exists and there is no single model of federalism that can be termed as best. Given the success of different federalist models, especially with regard to extent of decentralisation, it is not possible to lay down rigid criteria against which one may gauge the extent of a country's federalism or find out whether or not a function has been correctly assigned to a particular tier of the government. However, there is a broad agreement that functions of macroeconomic management, especially stabilisation and redistribution, should be with the central government while subjects that have an allocative element should be performed at the regional or local levels¹ [Dafflon (2006)]. It is not possible to use sub-national budgets to employ stabilisation policies such as fiscal stimulus, because the multiplier effect of additional expenditures would spillover beyond local boundaries² thus making it difficult for the sub-national government to fully internalise the benefits of the policy. These issues, however, would not arise if such policies are administered at the federal level. Moreover, to guard against the possibility of huge provincial

¹In practice, a host of political, ethnic, and linguistic factors play a role in determining the assignment of functions across jurisdictions.

²For example, expenditure on a construction project by a sub-national government would stimulate demand for construction materials such as cement which may be produced in a different jurisdiction.

borrowings offsetting the national stabilisation efforts the central government must enjoy some control over the borrowings of the provincial governments.

Policies that involve redistribution from the rich to the poor cannot be easily used by the local and regional authorities. The use of redistributive policies by one region, in isolation from the rest of the country, may cause mass migration—immigration of the poor to enjoy redistribution and emigration of the rich to avoid it. The crucial assumption behind this argument is that people are sufficiently mobile across localities. However if the social and psychological bondages are strong enough then the mobility assumption may not hold true. If this is the case then moderate redistribution can also be practiced by the sub-nationals. However despite the lack of mobility, the need for equal access to redistributive programs may call for a central role in redistribution.

Anderson (2008) provides a list of typical assignments based on examination of the structure of federalism in different countries. This list of typical assignments is given in Table 1 which describes how the assignment of function in Pakistan compares with the typical picture developed by Anderson.

It is clear that the functional assignment in Pakistan is by and large in accord with typical assignment prevalent in federal countries.³ Most of the countries seem to have a collaborative form of federalism with number of functions being treated as concurrent, joint or shared. The structure of federalism that emerged in Pakistan after the 18th amendment is one of exclusiveness—a function is typically either federal or provincial but rarely joint or concurrent. Only one function, namely ‘ownership of natural resources’ has been explicitly declared as ‘Joint’. However the functions now included in the federal legislative II can also be considered joint to a certain extent because the legislation on these functions can be undertaken only after the CCI has deliberated over the issue and the Council of Common Interests has equal representation from the federal government and the provinces. While concurrent functions are the norm in a number of countries, Pakistan has almost done away with concurrency vide the 18th amendment. Before the passage of the 18th amendment as many as 37 subjects were under concurrent legislative authority of the federal government and the provinces. It then seems pertinent to ask why Pakistan has done away with the ‘concurrency’?

³The assignment of only a few functions is at variance with the typical international practice and these include environment, pensions, court systems, criminal law and corporate and personal taxes.

Table 1.1

*Assignment of Functions to Different Tiers of Government
Typical in Federal Countries versus Pakistan*

	Functional Assignment	
	Typical Assignment in Federal Countries	Assignment in Pakistan
Currency	Always federal	Federal
Defense	Always federal, sometimes Constituent- unit (CU)	Federal
Treaty Ratification	Almost always federal, sometimes CU	Federal
External Trade	Usually federal, occasionally concurrent, joint or shared	Federal
Interstate/ interprovincial trade	Usually federal, occasionally concurrent, joint or shared.	Federal
Major physical infrastructure	Usually federal, sometimes concurrent, joint or shared	Federal
Primary/Secondary Education	Usually CU, occasionally concurrent, rarely federal	Provincial
Post Secondary Education	No clear pattern	Provincial
Income Security	Mix of federal, concurrent, joint or shared	Provincial
Pensions	Either concurrent, joint shared or federal	Provincial
Health care	Usually CU, sometimes concurrent, joint or shared	Provincial
Mineral resources	No clear pattern	Joint
Agriculture	No clear pattern	Provincial
Environment	Usually Concurrent, Joint or shared	Provincial
Municipal	Usually CU, occasionally joint or shared	Provincial
Court system	Usually joint or concurrent, occasionally federal, rarely CU	Federal
Criminal Law	No clear pattern	Provincial
Police	No clear pattern	Provincial
Customs/excise taxes	Almost always federal, sometimes concurrent	Federal
Corporate and Federal Taxes	Usually joint, shared or concurrent, sometimes federal	Federal

1.3.1. Concurrency

The advantages of assigning a particular function to only one level of the government are but obvious. It reinforces the autonomy of that level of government and makes explicit as to which level of government is responsible for what. Notwithstanding the advantages of exclusiveness it is not always possible to define watertight compartments of legislative jurisdictions and therefore some degree of overlap and some intergovernmental interactions are unavoidable. This brings us to the need of concurrency. It is the realisation about the inevitable jurisdictional overlap that the constitutions of United States, Germany, Australia, India, Brazil, Mexico and Nigeria allow concurrency in an extensive area of functional assignment. Concurrency has several advantages. It is argued that federal legislatures can provide overarching framework legislation for setting standards leaving it for the states/provincial legislatures to legislate over the details. The provincial legislatures can then legislate keeping in view the local sensitivities. Thus concurrency is not bad per se rather it affords some benefits. Concurrency earned a bad name in Pakistan due to the manner in which it was implemented.

As mentioned earlier, under the Constitution of 1973, the federal government as well provincial governments could legislate over a function declared 'concurrent' in the constitution. In case of a conflict between the legislation of the federal government and the province concerned, the federal legislation was to prevail. Given the primacy clause the concurrent functions came to be regarded as federal subjects, at least as far as the legislation was concerned, and the provincial governments rarely made an attempt to legislate over concurrent functions, though constitutionally they were empowered to do so. It is the manner of implementation that gave concurrency a bad repute and led to the belief that provincial autonomy and concurrency cannot coexist. This belief raised the demand for repeal of the concurrent list.

However all is not lost with the repeal of the concurrent list that contained as many as 37 subjects. The authorities, fully aware of the overlap of functions and the need for consultation between the two tiers of government, have enlarged the federal legislative list II after the repeal of the concurrent list. Some functions included in the concurrent list as well as those under the sole jurisdiction of the federal government have been transferred to the federal legislative list II apparently to accommodate the views of the federal government as well as the provinces before legislating on these subjects. It is noteworthy that though the federation enjoys legislative authority over the federal legislative list II but the matter is to be tabled for legislation only after it has been approved by the CCI where the

federal government and the provinces are equally represented. It is important to point out here that despite equal representation in the CCI the federal government may in fact have an effective majority. This is because the three federal members, other than the Prime Minister, are to be federal ministers who in all probability would be either from the party in power or from its coalition partners. The party in power at the federal level would also be in power in at least one province which would tend to support the federal position thus lending an effective majority to the federal government in the CCI. However, despite the weaker voting position of the provinces, the dynamics of running all affairs of the government smoothly should not allow the federal government to override provincial preferences, merely on the strength of majority in the CCI—mere consultation over an issue should prove helpful in improving the outcome. To sum up the strengthened role of the CCI augurs well for federalism in Pakistan.

1.3.2. International Treaties

The past experience of some countries suggests that the federal governments, enjoying jurisdiction over external affairs and signing of international treaties, have at times conducted external affairs in a manner adversarial to the interests of the sub-nationals. To avoid recurrence of such instances, the constitutions of these countries now require that meaningful consultation must occur or that consent of the constituent units must be obtained in matters that may affect the sub-nationals. In Canada the federal government can sign a treaty related to a provincial subject only if the consent of the concerned province has been obtained. In Germany such treaties require the approval of Bundesrat, which is composed of delegates of Land (provincial) governments. The constitutions of Belgium and Switzerland also require that consultation must occur with provinces before signing of such international treaties that may affect the provinces. In Pakistan the signing of international treaties is under the exclusive domain of the federal government while, for example, the subject of 'environment' is under the jurisdiction of the provinces. It is possible that the federal government may sign an agreement regarding environmental standards that a particular province may not be willing to go along with. Given such possibilities it would have been better had the 'ratification of international treaties' been under the jurisdiction of some forum where both the federal government and the provinces are represented. Such a forum is Council of Common Interest and appropriate constitutional place for 'signing of international treaties' is federal legislative list II upon which the authority rests with Council of Common Interests.

1.3.3. Environment

Environment is another area which before the 18th amendment was included in the concurrent list but stands devolved to the provinces after the repeal of the concurrent list. In federalist regimes, sole provincial jurisdiction over environment is atypical. In most of the federal countries the legislative jurisdiction over environment is usually concurrent and occasionally joint or shared. Arguments for and against provincial jurisdiction over environment are discussed below.

The main theoretical argument in favour of devolution of the subject of 'environment' is the same which is put forth to argue for devolution in general—individual (regional/local) preference should be respected. The question here is: are preferences over environmental standards different across jurisdictions? While this may be true for the public goods in general, but may not be true for environmental standards because what is at stake is life, for which the concern should not be different across jurisdictions. The relevant literature suggests that preferences over environment are determined by income levels rather than location—affordability, and not the taste, determines the choice. The guiding economic principal is that if the benefits of the provision of public good are contained within a specific jurisdiction, then decentralisation is desirable. On the other hand if the benefits spillover to neighboring jurisdictions, then the provision should be the responsibility of the higher tier because regions fearing spillover are likely to under provide such goods. As the benefits of environmental protection tend to spillover across geographical boundaries, therefore there is a case for assigning the function to a higher order of the government. The political economy perspective suggests that dominant regional commercial interests may lobby for lax environmental standards and that the central government is better positioned to resist such interests.

One might learn from the Canadian example, especially from a political economy perspective, in deciding which tier of government should enjoy legislative jurisdiction over environmental issues. The 1980s mark a watershed between the passive and the active interest of the Canadian federal government over the subject of environment. It is argued that the Canadian federal government was restrained by the constitution as well as by the provincial opposition to act aggressively over environmental issues. It was feared that strict environmental standards may provoke separatist movement in Quebec. Serious objections from the politicians of the Canadian provinces dependent on oil and gas and other natural resources were also expected. After the 1980s the Canadian federal government took an active role on the

subject of 'environment' due to pressures from international agencies and local environmentalist. The federal government in Canada has used inter-governmental agreements rather than legislation to make the provinces agree to certain environmental standards. Though this kind of collaborative federalism is seemingly a success some critics believe that competitive federalism holds a greater promise.

The argument for a federal role over 'environment' appears to be much stronger. Provincial governments are more apt to become hostage to the local interest groups and therefore may refrain from legislation that would harm such groups. The federal government is also not thought to be free of such pressures from local interest groups. However the influence of international agencies on the federal government is likely to tilt the balance in favour of strict environmental standards. A compromise between the federal and provincial role is collaborative federalism which boils down to placing 'environment' in the federal legislative list II. Through the Council of Common Interest the federal government and the provinces would enjoy some sort of joint jurisdiction over environmental legislation. Those in favour of 'environment' as a provincial subject, may argue that environmental standards would still be determined by international treaties the ratification of which continues to be a federal subject. However, international standards may not address all national needs and therefore an agency that determines national standards remains in demand. Hence federal jurisdiction in some form is warranted.

1.3.4. Interprovincial Trade

Inter provincial trade is a federal subject in Pakistan and there are no restrictions on the movement of goods across the provinces. However the Constitution allows a province to restrict the movement of a commodity outside the province concerned if there are fears of shortage of that commodity in the province. This clause of the Constitution is often used by the government of Punjab to restrict the movement of Wheat outside Punjab. The movement is typically banned at the time when the government is procuring wheat from the farmers at the support price declared by the federal government. This restriction reduces the size of the market for the farmers in Punjab and compels them to sell to the government at the support price fixed by the federal government. Such restriction is imposed when the farmers could secure a price better than the support price fixed by the government. Moreover, agriculture being a provincial subject, the determination of support price for wheat by the federal government is itself questionable. The question regarding jurisdiction over the determination of the

support price for wheat is important because the fiscal burden for procuring wheat from the farmers is borne by the provincial governments rather than the federal government which fixes the price. As all the provinces are not self-sufficient in the production of wheat therefore the procurement policy as well as interprovincial trade of wheat affects areas beyond the geographical boundaries of a province. This context makes it appropriate that all the provinces and federal government should have a joint jurisdiction over interprovincial wheat trade and fixation of support price for wheat. The forum for such joint jurisdiction, as indicated earlier, is the Council of Common Interest which includes representatives from the federal as well as all the provincial governments. As the Council enjoys jurisdiction over all functions included in the federal legislative list II, therefore the appropriate place for interprovincial trade is federal legislative list II and not list I.

1.3.5. Social Policy

There are strong arguments for some federal role in social policy, especially income security, health and education. The one issue that potentially threatens the federalist structure in any country is the regional disparity in terms of income and access to public services. Even in the most decentralised regimes like Canada and Switzerland the federal government plays a key role in the provision of uniform education and health services to all citizens up to a certain defined minimum level. In some countries these functions are concurrent while in others the federal government influences the regional policies vis-à-vis these functions through conditional or matching grants. In Pakistan, legislative as well as administrative authority over health and education have been completely devolved (setting standards being an exception) to the provinces. In the absence of conditional or matching grants, the complete devolution of health and education has the potential of further increasing disparity. In a country where the demands for new provinces seems to be rooted in income disparity and unequal access to public services, the complete devolution of health and education may not be entirely appropriate.

In a number of countries the federal government runs social security programs that include minimum monthly income, food and health facilities. Before the repeal of the concurrent list neither the federal government nor the provincial governments were offering any worth mentioning social security payments to the citizens (the federally administered Benazir Income Support Program (BISP) being an exception over the past couple of years). With the repeal of the

concurrent list, subjects like welfare of labour and unemployment insurance stand devolved to the provinces. This may have implications for uniformity of standards and minimum wage policies across different provinces.

1.3.6. Taxation

There could be no two opinions on the view that each level of the government should have enough revenues to perform the functions assigned to it. Typically in developing and less developed countries the power to raise revenues through taxation is highly centralised. The centralised taxation system calls for a well-designed transfer program to provide funds to the lower tiers of the government. However in developed countries the lower tiers typically generate a large a part of their finances through own taxation measures (the revenue raising abilities of the federated entities are discussed in more details in chapter 4). Here it suffices to say that leaving greater revenue generation potential to the sub-nationals has more merits than demerits as provincial governments would be compelled to show better performance to generate own tax revenues. Corporate and personal taxes are either concurrent or shared subjects in most of the federal countries. In Pakistan the two taxes fall under the federal jurisdiction. Arguments against the devolution of tax collection to the sub-nationals include lack of scale economies as well as the capacity to collect the taxes. Except for Sindh, the other provinces have requested the federal government to collect the recently devolved sales tax on services on their behalf. This is cited as an evidence of the lack of tax collection capacity with the provinces. While there is some truth in this argument there is no harm in leaving the collection of even the personal and corporate tax to the federal government for an express charge payable by the provinces. The legislative authority on taxes only determines on whom the tax is to be levied and at what rate. To collect taxes the legislative authority need not essentially be with the federal government—the federal government can collect taxes levied by the provincial governments and remit the net proceeds to the provinces. This practice has been adopted in some federal countries.

1.3.7. Functions Included in Federal Legislative List II

After the 18th amendment a large part of economic activity that the federal government can influence through planning falls in the legislative and administrative jurisdiction of the provinces. Therefore it is essential that the provinces should have a role in national planning. The assignment of this function to the CCI will help generate the

consultative process between the federal government and the provinces on national planning issues. The permission to the provinces to engage in electricity generation seems to have started paying dividends, as attractive royalty on electricity generation have encouraged the provinces to start developing projects of electricity generation. The 18th amendment has allowed the provinces to borrow abroad. This has raised concerns about the management of national debt. Concerns have also been expressed about the adverse impact of the provincial borrowing on the national fiscal deficit. These concerns appear to be unwarranted, because adequate safeguards seems to have been built-in to avert these fears. First, the province that owes money to the federal government will not be able to borrow abroad before retiring the federal debt and second, the plan of provincial borrowing has to be approved by the National Economic Council. The two safeguards together will ensure that a provincial borrowing plan that has the potential to adversely influence macroeconomic indicators will not be approved.

1.3.8. Creation of New Provinces

Off and on the demands for the creation of new provinces crop up in Pakistan. If provinces are viewed as administrative units only then new provinces should become inevitable with increase in population of a province beyond a level considered optimal for administrative purpose. In practice historical, ethnic, lingual, cultural and political forces play a key role in determining the size of a province or in determining whether or not a new province should be carved out of an existing one, if the population of a region crosses the optimal level.

The procedure for the creation of new province, in Pakistan is that the provincial assembly of the province concerned, from which the new province is proposed to be carved-out, should pass a resolution in favour of the creation of the new province. This process is self-defeating—nobody wants to cut the size of its own empire and so the resolution required is very unlikely to come through. The practice in India is that if Lok Sabha (Lower House) votes by 2/3rd majority in favour of the creation of a new State then the State is deemed to be created. The concerned State from which the new State is proposed to be carved-out has no role in allowing or disallowing the creation of the new State. No wonder that 12 new States have been created in India since 1947 while in Australia where the process is similar to that of Pakistan no new State has been created since over a century.

1.4. Conclusion

The legislative and administrative structure of Pakistan after the 18th amendment is sufficiently decentralised. The distribution of functions barring a few areas is similar to the typical practice observed in federal countries. However the appropriate jurisdiction for functional areas like interprovincial trade, environment and signing of international treaties should be reconsidered. Functional jurisdiction at times overlaps in such a manner that concurrent jurisdiction of the federal and provincial government becomes essential. Though the 18th amendment has abolished the concurrent list but has rightly introduced a new form of concurrency by strengthening the role of the Council of Common Interest. More functions, for example environment, interprovincial trade, pricing of wheat and signing of international treaties should be placed under the domain of the Council of Common Interest. The legislative procedure for creation of new provinces also needs a review.

Chapter 2

INTERGOVERNMENTAL RESOURCE TRANSFERS: INSTITUTIONAL ARRANGEMENTS

The Constitution of Pakistan requires that the National Finance Commission (NFC) be constituted every five years to recommend the annual distribution of national revenue between the federation and the provinces as well as among the provinces. The 4th NFC Award was announced in 1974 and the next one was due in 1979 but came as late as 1990 i.e. after 12 years instead of 5 years envisaged in the constitution. Similarly the 7th NFC award was announced in December 2009, almost 14 years after the announcement of the 6th award. In fact the National Finance Commissions were constituted in the intervening period when the awards were not announced but these failed to reach a consensus on the distribution criteria, hence the failure to announce the awards. The rather long intervals between the awards and the failure of the Commissions to announce the award suggest that something is wrong with the institutional set-up i.e., the NFC for the distribution of specified national revenue.⁴ In this chapter, after a review of the institutional set-up prevalent in some countries for the distribution of national revenues, the structure of the NFC is examined highlighting the reasons for the periodic failure in timely announcement of the award, and an alternative institutional set-up is proposed for the distribution of federal revenues in Pakistan.

2.1. Institutional Arrangements Used in Different Countries

Institutional arrangements used in different countries for devising the distribution criteria and making transfers from the federation to the constituent units can be broadly classified into the following four categories:

- Central Agency (central government's ministry)
- Intergovernmental Forum
- Independent Agency

⁴It is interesting to note that in neighboring India, which follows the same practice of announcing Awards of the National Finance Commission every five years, 13 Awards have been announced since Independence as against only 8 in Pakistan (including the first Raisman Award).

2.1.1. Central Agency

The federal government is directly responsible for undertaking decisions regarding transfers to the sub-nationals. This is the practice in a number of countries and the rationale is that it is the federal government which is responsible for managing the national objectives to be delivered through the fiscal arrangement. However the problem with this approach is that this tilts the system towards a federal character whereas the essence of the federal systems is decentralisation [Shah (2007)]. This difficulty can be partly overcome by imposing constitutional restrictions on the ability of the federal government to override the preferences of the sub-nationals [Shah (2007)]. Typically the office of the president or prime minister or the ministry of home affairs or the ministry of finance assumes the sole or partial responsibility for the fiscal transfers to the constituent units. Countries that are relying upon central agency include Kyrgyz Republic, Tanzania, China, Italy, Kazakhstan, Netherlands, Poland, Switzerland, Ukraine, Ghana, Zambia and Japan.

An alternative to the federal government's direct role in the distribution of national revenue could be a separate body which is entrusted the task of designing the fiscal relations among the various tiers of the government. This could be an independent body or an intergovernmental forum or even an intergovernmental-cum-civil society forum. These bodies could be temporary or permanent and may enjoy statutory authority or advisory status. A variant of the intergovernmental forum is the intergovernmental-cum-civil society forum. It is this type of forum that operates in Pakistan. The forum is appointed by the President every five years.

2.1.2. Intergovernmental Forums

The intergovernmental forums are typically mandated to recommend the criteria for distribution of national revenues among the various tiers of the government. These forums facilitate consultation among various tiers of the government and provide room for limited bargaining among the constituent units—limited because the limits are defined by the constitution. Countries that rely solely on intergovernmental forums include Germany, Indonesia and Nigeria. Countries like South Africa and India make use of an independent agency in addition to intergovernmental forum. Pakistan also relies on the intergovernmental forum with the difference that the Commission members also include a non-government expert from each province. The intergovernmental forums are best suited where constituent units do not have any conflicting interests so that consensus is easier to achieve.

2.1.3. Independent Agency

An independent agency is created by the central government to make recommendations to the government or the legislature on resource transfers to the constituent units. Typically, this kind of agency has an advisory position. Australia was the first to establish an agency for recommending resource transfers in 1933, since then this institution has become popular in a number of countries including India and South Africa. The independent agency was established in Australia after some states had expressed dissatisfaction with the process of bilateral negotiations with the federal government on requests for special grants. A secession threat by Western Australia proved especially instrumental in the decision to set up an independent agency. Thus the origin of the independent agency has lessons for countries where any constituent unit is dissatisfied with the resource distribution.

An independent agency is typically established to let the experts recommend the distribution criteria based on professional knowledge and rigorous analysis of the prevailing environment. The rationale for an independent agency is that it can divorce the distribution criteria from politics. However Shah (2007) points out that independent agencies have rarely been able to achieve this noble objective and that they have a greater incentives to offer complex solution to otherwise simple problems because the market regards complexity with respect—the complexity of the distribution formulae and associated calculations increases the market for professionals. Moreover outside experts and developmental agencies also put a premium on greater sophistication and complexity. All this increases the cost of devising the resource distribution criteria. Lastly, an independent agency weakens citizens' oversight of the distribution formula—complexity makes it difficult for the non-experts to comment on the formula.

2.2. Institutional Arrangements in Selected Countries

Canada, a country enjoying a very high level of fiscal decentralisation, has left the design of the federal fiscal transfers to the federal government and the national legislature however strong emphasis is placed on the intergovernmental consultation. Various committees feed information and recommendations to a high level committee chaired by the federal finance minister that has provincial treasuries (finance ministers) as members. It is worth mentioning here that a large part of the revenue of the Canadian provinces is 'own-source revenue' and only a small part is to be transferred to the provinces through the consultative process. In Germany, the forum of federal and state leaders takes a decision on the fraternal equalisation

program. The inputs for the decision are provided by the Financial Planning Council, which establishes guidelines on financing of the budget in short and medium term. The federal minister of finance and representatives of the municipalities constitute the Council. Indonesia has a regional Autonomy Advisory Board (DPOD) that serves as the intergovernmental forum. The Board has representatives from the federal as well as the provincial governments. The Directorate General for centre-region fiscal relations provides input to the Board. Planning grants are recommended by a separate Board called National Planning Board (NPD). The NPD and the ministry of finance give their recommendations to the DPOD which takes a final decision on the fiscal arrangements between the centre and the provinces. In Nigeria, a Commission called Revenue Mobilisation, Allocation and Fiscal Commission decides on the resource allocation between the centre, state and local jurisdiction. The Commission has adequate representation from the centre and the constituent units. As mentioned earlier Australia was the first country to establish an independent agency for recommending the fiscal relationship between the central government and the states. The Australian Commission consists of a chairperson appointed by the federal government in consultation with the states. The Commission is among the pioneers in taking cognizance of the fact that fiscal capacity and fiscal needs may vary across states and that the two should be accounted for while taking a decision on revenue allocation. The Australian agency looks minutely at fiscal capacities and the fiscal needs of the individual states to take a decision on revenue allocation.

The Indian Finance Commission is an independent body charged with distribution of taxes and Grants-in Aid among the states. The Commission comprises a chairperson and four members. The Commission is established for a period of five years. The Chairperson and the members are full-time or part-time employees of the Commission and draw salary from the Commission. This helps in making the chairperson and the members serve the interest of their principal i.e. the federal government rather than the interests of their native states. Under the constitution the chairperson of the Commission must have experience in public affairs. The qualifications for the members include; a retired judge of a High Court or a person having knowledge of finance and/or economics. The Commission members are usually a mix of politicians, retired civil servants and experts in fiscal federalism. The Commission typically decides on distribution of taxes among the federal government and the constituent units and also on the grants-in-aid from the federal government to the States and the local bodies (Municipalities and Panchayats). Though the Commission's

recommendations are not binding upon the federal government however under the Constitution these must be presented to both the houses of the parliament along with the response of the government. This creates pressure on the government to take the recommendations very seriously and not to reject any recommendation without sufficient justification.

In South Africa the Commission is appointed by the President in consultation with the Cabinet and Executive Council of the nine provinces. The Commission has nine members including a chairperson and a deputy chairperson, three provincial nominees, two nominees of local governments and two other members. The Commission advises the government on sharing of central revenue with the provinces and local governments, provincial taxation, municipal fiscal powers, sub-national borrowings and central government guarantees. Overall the Commission enjoys strong constitutional authority to advise the government on intergovernmental fiscal relations. The Commission enjoys permanency and two of the members are designated to work on full time basis. The commission has staff strength of 31.

2.3. National Finance Commission of Pakistan

The National Finance Commission regulates the distribution of specified national financial revenues between the federal government and the provinces and among the provinces. The Commission is constituted under article 160 of the Constitution and consists of federal minister of finance (Chairman), provincial ministers of finance and such others persons as may be nominated by the government (typically the government nominates one person enjoying sufficient knowledge of the subject from each province). The Commission can constitute several working groups to gather and analyse the information that it may require. The federal ministry of finance provides secretarial services to the Commission. The Commission makes its recommendation to the President, who declares the Award based upon recommendations of the Commission.

As mentioned in the beginning of this chapter the National Finance Commissions constituted in 1979, 1985, 2001 and 2006 did not announce the awards due to their failure to reach a consensus over the distribution criterion. The problem apparently lies with the unanimity rule that the Commission follows. However this is not to say that majority vote as the decision rule would solve the problem. This kind of rule may end the deadlock over distribution of revenue resources but may raise serious problems on the political front. Smaller provinces may feel being subjected to the hegemony of the federal government or

the larger provinces. Such feelings could have adverse consequences for the cause of national harmony. Therefore the unanimity rule under the present institutional arrangement is not a choice but a necessity.

While the 6th NFC award was being negotiated in 1996 objections were raised to the distribution of revenue resources solely on the basis of population. The province of Sindh was the first to demand the inclusion of more elements in the distribution criterion. With Karachi, the capital city of Sindh and a hub of business activity in Pakistan, Sindh demanded that the national tax revenue be distributed among the provinces on the basis incidence of tax collection. The smaller and relatively backward provinces of Khyber Pakhtunkhwa and Balochistan raised the demand that additional resources should be given to the two provinces to ameliorate their lot. Baluchistan also suggested that the resource distribution criterion should include elements like area, population and the level of social indicators. The province of Punjab, then home to more than 60 percent of country's population, insisted that the distribution formula should remain unchanged and the final award did keep the formula unchanged. It is noteworthy here that the political party then in power at the national level drew its major strength from the Punjab and had coalition governments in the Sindh and Khyber Pakhtunkhwa. The objections regarding the distribution criterion that were raised while the 6th NFC award was being negotiated were raised with such intensity later on that these created a deadlock in the NFCs of 2001 and 2006. The cynics would perhaps say that even the 6th award reflected the strength of the then ruling coalition rather than the provincial preferences. It is also noteworthy that the four commissions that failed to announce the awards were constituted during military regimes (1979, 1985, 2001 and 2006). The inference could be that democratic regimes provide a relatively better environment for striking a compromise solution at a forum where conflicting interests are represented. However this also brings forth the fact that the present structure of NFC on its own is not conducive to reaching a solution that can stand on merits.

The 7th NFC was initially again temporarily deadlocked over the issue of the distribution criterion. Ultimately elements like backwardness/poverty, area and revenue generation (i.e., tax effort) the inclusion of which was being demanded since 1996 were included in the distribution criterion. How the seemingly endless deadlock over the distribution criterion was broken? Five factors played key role in this regard. One, in absolute terms each province got substantially more than what it would receive under the previous formula. Two, the weight of population share was not drastically reduced. (The weight was reduced from 100 percent to 82 percent only, in India the population

share has a weight of only 10-20 percent and a number of countries do not take the population share into account). Three, the federal government bore the major brunt of the change in formula (federal share in the divisible pool was reduced from 53 percent to 43 percent). Fourth, given the previous failures, the federal government as well as provinces were under pressure to end the deadlock. Fifth, the governments of the smaller provinces interested in revising the distribution formula were part of the ruling coalition at the federal level.

The point is that notwithstanding the spirit of compromise shown by the federal government and the provinces while negotiating the 6th and the 7th NFC awards, there is nothing inherent in the structure of the NFC to prevent a deadlock. Therefore the possibility of encountering deadlock in the future remains. This calls for revisiting the institutional arrangement for the distribution of revenue resources among the provinces. Moreover there is little evidence to suggest that the Commission takes a thorough account of the research available on the subject except that some members of the Commission or of the working groups might be aware of it on their own. The absence of research on topics like appropriate weights for the elements of the criterion used by the 7th NFC award supports this view. Therefore there is a need to develop an institutional mechanism whereby the Commission makes greater use of research on the issues under consideration.

2.4. Proposed Institutional Arrangement for Distribution of Revenues

The intergovernmental forums as well as the independent agency have their own merits and demerits. The intergovernmental forums can protect the regional interests more forcefully but typically these have a deadlock prone structure, especially if these follow the unanimity rule which is often a necessity rather than a choice. The independent agency has the incentive to make a simple task complex but then it can also bring in the required rigour in the distribution criteria. A better option then could be to combine the two institutional structures as elaborated below.

A two tier institutional set up may be designed to suggest the distribution of national revenue among the different levels of the government. The proposed two tiers are: (i) an independent body of experts and (ii) an intergovernmental forum. The proposed independent body would be a committee of experts the members of which would be chosen without regard to provincial affiliation. Persons who have

sufficient academic background and practical experience in the field of fiscal management would qualify to become a member. The members would be a full time/part time employees of the agency and would draw salary from the agency. The agency would first determine what type of federal revenues should form the 'divisible pool' i.e. the pool of federal revenues that can be distributed, and then recommend, who gets how much from the 'divisible pool'. The agency would also recommend the assignment of revenue sources to the federal government and the provinces. A key element of the manner in which the independent body would approach the issue of determining the 'divisible pool', recommending its distribution and the assignment of revenue sources would be to rely on research on the issues under consideration. If the need be the agency would commission research on the subject for example research on fiscal needs and capacities of each province and weights to be assigned to the different elements of the distribution criterion etc. Based on the findings of the good quality national and international research and views of the experts comprising the independent agency, the agency would formulate and forward its recommendations to the National Finance Commission. The recommendations would be accompanied by a fairly detailed justification especially if the advice deviates from the established practice. The recommendations would also be made public to encourage debate on the subject. The independent body would not be required to give unanimous recommendations. The notes of the dissenting members should form part of the independent agency's report. The proposed agency may begin its task two years before the award is to be announced and should have 16-18 months to complete the task assigned.

The National Finance Commission would be a purely intergovernmental body comprising the federal and provincial ministers of finance only. The experts need not be on the NFC because the independent agency would primarily be a committee of experts. The NFC would review the recommendations of the independent agency and may or may not accept all or some of these. The NFC would pay due regard to the political factors and other sensibilities that the independent agency would not have accounted for. Moreover the Commission will also pay regard to the public debate on the recommendations of the independent agency. If the NFC decides not to accept some or all of the recommendations of the independent agency it would be required to fully justify the decision. The NFC would then send its recommendation to the government for final approval and announcement of the award.

This two step approach is likely to put an end to the deadlocks which have marred the history of revenue distribution among constituent units in Pakistan. The experts drawn from the profession and the academia without regard to provincial affiliations and put in the position of a 'judge' are less likely to take an unjustified stance. Moreover being paid employees of the independent agency they are more likely to fit themselves into the assigned role rather than favour a particular constituent unit. Reliance on research would enable the independent body to offer sound and practical recommendations that would not be easily ignored by the Commission, whereas the public knowledge of and debate over the recommendations of the body would make it even harder.

Chapter 3

RESOURCE DISTRIBUTION

3.1. Introduction

Potential revenue sources around the world are typically assigned in such a manner that the central government generates more revenue than its expenditure needs while the opposite is typically true for the lower tiers of the government. This calls for the establishment of revenue sharing arrangements between the central government and the provinces/states.

In Pakistan the provinces generate only about 8 percent of the total national revenue through taxes and duties. This revenue meets only a small part of the provincial needs therefore the provinces have to rely on transfers from the federal government. Under the Constitution the National Finance Commission (NFC), constituted every five years, has to recommend to the government the criterion for the distribution of a given resource pool. The revenue resource pool, commonly known as the divisible pool, is also specified in the Constitution. The president can add more revenue sources to the divisible pool while notifying the Terms of Reference of the Commission. Overtime, the divisible pool has not undergone much of a change except that sales tax on services which was a part of the divisible pool till 2006 is no longer a part thereof as it now falls under the exclusive domain of the provinces. Moreover the divisible pool includes the net proceeds from certain specified taxes. The net proceeds are worked out as gross collection minus collection charges, which till 2006 were taken as 5 percent of the revenue collected. The federal government has agreed to reduce the collection charges to 1 percent. This has allowed the 7th NFC to increase the provincial share in divisible pool to 57 percent. The current divisible pool includes:

- Personal Income tax
- Tax on corporate income
- Wealth tax
- Capital Value Tax
- Taxes on sales and purchase of goods
- Custom duties
- Federal Excise Duty (excluding on Gas)

The constitution of 1973 requires that the NFC be constituted every five years. Since the country gained independence in 1947 there have been eight revenue sharing awards—the Riesman Award of 1951 and the NFC awards of 1961, 1964, 1970, 1974, 1990, 1996, presidential order of 2006 and the 7th NFC Award announced in December 2009 which is being implemented since July 2010.

Had the NFCs been regularly constituted at an interval of every five years, as envisaged in the Constitution of 1973, there would have been seven awards since the Award of 1974, rather than the three awards announced since then. An award was due in 1979 but came as late as 1990—delayed by 11 years. Similarly, though the commissions were constituted timely in 2001 and 2006 but they failed to announce the awards as required. The 7th NFC Award came after 19 years instead of 5 years specified in the constitution. The non-consensus on the distribution formula, despite the time consuming negotiations, led to failure of the two NFCs to announce the awards. This non-consensus prompted the then NFC to authorise the president to announce an interim award. Hence distribution of revenue was announced in 2006 vide the Presidential Order 2006. The fact that the previous two NFCs had failed to reach a consensus had put considerable pressure on the 7th NFC to proceed with a spirit of compromise which led to the announcement of the Award in December 2009. The 7th NFC Award was a landmark event in the sense that it introduced a multiple indicator criterion for distribution of national revenues amongst the provinces replacing the population share criterion that was being used even before the country had gained independence in 1947. The criterion prescribed by the 7th NFC is given in Table 1. To ease comparison, the criterion used by the immediately preceding Award has also been included in the table.

Table 3.1

Criteria for Distribution of National Revenues

	Presidential Order	7th NFC Award 2006
Provincial Share in Divisible Pool	46.25%	56% increasing 57.5%
Grants and Subventions	3.75%	–
Indicators and Weights		
Population	100%	82.0%
Poverty		0.3%
Revenue Generation		5.0%
Inverse Population Density		2.7%

Given the weights indicated above the provincial share in the Divisible Pool works out as follows:

Punjab	53.01%	51.74%
Sindh	24.94%	24.55%
Khyber Pakhtunkhwa	14.88%	14.62%
Balochistan	7.17%	9.01%

As is evident from Table 1, the 7th NFC has replaced the population share as the sole element of the resource distribution criterion with a four element criterion including population share, revenue generation (tax effort), poverty, and inverse population density (IPD). Before the announcement of the 7th NFC Award in December 2009 'population share' was the sole criterion for the distribution of resources amongst the provinces. It has been a long standing demand of the provinces, except Punjab, that more indicators be included in the revenue distribution criterion. The 7th NFC Award accepted this demand of the provinces for replacement of the population share as the sole criterion with the multiple indicator criterion. However it is noteworthy that share of population still enjoys a weight of 82 percent in the distribution formula. Thus a significant part of the divisible pool is still being shared amongst provinces on the basis of the population share.

The 7th NFC has also enhanced the share of the provinces at the expense of the federal government. Before the 7th NFC Award the federal government used to levy 5 percent collection charges on the amount of such taxes collected that were transferred to the provinces. The federal government has under the 7th NFC has agreed to charge only one percent as collection charges. The fiscal space thus created has been used to increase the share of the provinces in the divisible pool.

3.2. Resource Distribution Practices Adopted Internationally

Before analysing the revenue distribution criterion practiced in Pakistan, it would be useful to review the design of revenue distributions followed in other countries. The lessons drawn from such review would prove useful in analysing the design of revenue distribution system prevalent in Pakistan.

Taxing powers are centralised to varying degrees in different federal countries. Resultantly the federal governments have more at their disposal than what they need while the opposite holds true for the lower tiers of the government. This necessitates transfer of financial resources from the federal government to lower levels of the

government (henceforth referred to as sub-nationals). The magnitude of transfers, among other factors, depends upon revenue generation by the sub-nationals from their own sources. This in turn depends upon the administrative capacity of the sub-nationals and the taxable sources (tax bases) available to them. Transfers from the federal government to the sub-nationals are formula based as well as discretionary. The transfers could be block unconditional, conditional or matching. Transfer programs typically aim at fiscal equalization—provision of same kind of services with comparable level of taxation, among the federating units.

In Canada the equalisation transfers are unconditional and are given to only those provinces whose revenue raising capacity is below the national average. It is worth noting here that revenue generation in Canada is highly decentralised with share of provincial own-source revenue standing close to 80 percent of the total national revenue. It is only under this kind of revenue decentralisation that some of the provinces can manage without a penny of equalisation transfers. The Indian system essentially involves distribution of funds on the basis of estimated expenditure needs and to an extent accounting for potential of the sub-national to generate revenues from their own sources i.e. fiscal capacity. The finance commission of India primarily uses the gap filling approach for equalisation of fiscal capacity across states. Under this approach, current expenditure requirements of the states are estimated on the basis of projected budgetary expenditure requirements of the centre and states, and revenues of the states from own sources. The states are allocated shares in central taxes based on a formula and the difference between state's budgetary expenditures and state revenues is filled through grants in aid. The gap filling methodology not only acts as a disincentive for the sub-nationals to raise revenue from own sources but is a source of inequity as well. In Australia, the comprehensive nature of equalisation allows assessment of all circumstances that affect the relative cost differences a state is faced with in delivering standard services. These include additional costs faced by government in meeting requirements of large cities as well as in providing services in rural areas and remote locations. A state's differential per capita revenue or expenditures considered beyond the control of a state, for example, due to geography, are estimated and the states are compensated for that. It is worth mentioning here that the Australian approach to equalisation calls for voluminous data across states at a high level of disaggregation. The equalisation program has been criticised in Australia on the grounds of efficiency, complexity and reliance on internal standards rather than best practices. It is argued that reliance on average internal standards in a sense rewards states for

maintaining lower standards. Despite these shortcomings, however, the system continues to be in vogue. It is precisely because of carrying out a very thorough equalisation program that federal government (known as Commonwealth government) has been able to keep the states satisfied despite continuing with the large vertical fiscal balance (difference between revenue generated by the federal government and states). Rather the federal government has been able to contain secessions of states from the federation precisely because of carrying out a thorough equalisation program.

In the United States, unlike other federal countries, there is no set form of general revenue sharing. However 600 grant programs exist for state and local governments. The different forms in which grants are provided include project, categorical and block grants. While some grants have matching component others have structured formulas. Barring federal transfers for some specific purposes the overall grant system is small relatively to other countries. Though a degree of equalisation is built into grant programs however in general the intergovernmental transfers in the US do not aim at equalisation despite wide differences in taxable capacity across states. The intergovernmental transfer system in Germany is highly egalitarian. The unique feature of the German system is that richer states transfer money to the poorer states. In practice the states whose taxable capacity is below the national average receive transfers from the states with taxable capacity above the national average. The transfer program is designed in a manner that fiscal capacity of the below average state is brought to 90 percent of the national average. These interstate transfers are unconditional.

The transfers from the federal government to the provinces typically attempt to equalise fiscal capacity and in some cases fiscal needs as well. The amount of transfers in a number of countries is determined on the basis of some formula. Indicators like population share, poverty, demographics, fiscal effort and population density are typically used to determine fiscal needs and capacities. 'Population share' is not considered a good indicator of fiscal needs and is used only in a handful of countries. Even the countries that use population share as the criterion for revenue distribution typically accord a rather low weight to it in the distribution formula e.g. India. Nigeria, with transfers based solely on the basis of population is an exception. Pakistan, with 82 percent weight for population share, stands close to Nigeria.

Transfers are also used to achieve certain national objectives, for example, education and health care for all. One of the typical characteristic features of the transfer programs is the use of conditional

and matching transfers for provision of extensive health care, education and social security. The use of conditional/matching transfers for these services reflects the importance attached nationally to the provision of these services. The aim is to provide the specified services to all, up to a minimum level defined by the society. Such choices are made through a variety of collective choice mechanisms such as voting for electoral promises of the political parties/candidates.

In Canada, besides the equalisation transfers, the other major forms of transfers are the equal per capita transfers which are nominally divided into two components—the Canada Health Transfer (CHT) and the Canada Social Transfer (CST) which includes welfare and post secondary education. Only some minimal conditions are attached to the payments. To be eligible the provinces cannot impose residency condition on welfare payments and health insurance programs have to follow general criteria including access, affordability and comprehensiveness.

In Australia, huge transfers from the federal government to the states are made under the special purpose programs (SPPs). These SPPs are intended to support the implementation of some national priority and these are in addition to the transfers from the united pool of funds determined in the manner described earlier. The largest SPPs are in the area of education, health, social security, transportation and housing. SPPs constitute a significant proportion of the total assistance from the federal government to the states. This proportion has varied from 25 percent of the total federal assistance in early 1970s to 50 percent in 1990s. The majority of the SPPs are subject to conditions that are designed to ensure the achievement of national objectives. These conditions include general policy conditions, that the amounts so transferred be spent on designated purpose only. Sometimes the transfers require matching expenditures from the state's own sources for the same purpose (matching grants). Such grants are determined through bilateral negotiations between the federation and the concerned state as well as negotiations at some forum where all states are represented. In the United States grants for health and income security constitute the major purpose for which transfers are made to the state and local governments. These grant program are discretionary at the national level and are determined through the annual budget process. The interstate highway system is financed jointly by the federal and state governments with federal government typically funding 90 percent of the construction cost. Other major grant categories include education and transportation. In South Africa, in recent years the share of conditional specific purpose grants, which are discretionary in nature, have exhibited sizable growth in the total transfers to the

provinces. The discretionary nature of the conditional grants has made the transfers system less transparent.

3.3. Analysis of the Revenue Distribution Design

3.3.1. Bridging the Fiscal Gap

Fiscal gap refers to the revenue deficiency arising from mismatch between revenue means and expenditure needs. The gap may arise due to the centralisation of taxing powers and/or the lack of revenue generating potential of a region. Persistent fiscal gap leads to large fiscal disparities among regions which could be politically divisive and may even create cession/separation threats. This threat is real: since 1975 more than 40 new countries have been created. Though reasons for separatist demands may be various, fiscal equalisation would help curb the feeling of deprivation and thus help forestall cession/separation. Australia and Canada have successfully thwarted such threats through adequate fiscal equalisation programs and autonomy measures. The demand for new provinces which time and again surfaces in Pakistan too has roots in regional fiscal disparities. However, the precise timing at which the demand resurfaces might also have political undertones.

The typical methods of determining the size of transfers from the federation to the sub-nationals include:

- A combination of fiscal capacity and fiscal need equalisation
- Fiscal capacity equalisation
- Need criterion
- Population share criterion

The literature suggests that the use of population as a sole criterion is least effective at securing equalisation of fiscal needs across regions. The population share criterion assumes that per capita expenditure needs are equal across regions. However the per capita expenditure needs may vary across regions, due to differences in population density, size, geography, history, resource endowments and the level of development. Moreover, the remote location of an area as well as metropolitan character of a city may call for incurring above average expenditures. To transfer revenue resources to the sub-national for over 60 years (1947–2009), Pakistan has used population share criterion—a criterion considered least effective at fiscal equalisation.

The method of equalising fiscal needs and fiscal capacities practiced in some developed countries aims at meeting the net fiscal needs of the sub-national after accounting for their fiscal capacity and

fiscal needs. This method recognises the possibility of variation across regions in fiscal capacity as well as fiscal needs and seeks to address the net variation. The method of fiscal capacity equalisation seeks to transfer more funds to such sub-nationals whose fiscal capacity is below the national average, thereby equalising fiscal capacities. This approach again assumes that per capita fiscal needs of the regions are more or less equal. Both these methods require extensive data to estimate the fiscal capacities and fiscal needs. These methods are therefore difficult to implement in developing countries.

The need indicators criterion estimates the expenditures on certain major fiscal needs and uses these estimates to arrive at the total fiscal need of the sub-nationals. To estimate expenditures on different categories weights are assigned to various categories and where required need indices are developed for each expenditure category. The weights and indices are developed using statistical tools and historical data on expenditures and population. Typical fiscal need indicators include population, per capita income, unemployment rate, population density, geographical area, infant mortality, life expectancy, school enrolment rate and infrastructure.

The multiple indicator criterion used by the 7th NFC is similar in spirit to the need indicator criterion however some important need indicators like school enrolment rate and infant mortality are not included in the criterion. Moreover the assignment of weights seems to have been influenced by historical factors (e.g., 82 percent weight for population share, marginally down from 100 percent) and political considerations (e.g. inverse population density). This is in contrast to the systematic exercises undertaken elsewhere to develop need indices (the weight assignment exercise is elaborated later in this chapter).

Notwithstanding the sophistication of the revenue distribution criteria, actual choices made in almost all countries also account for the objectives of the government, historical factors and political compromises between the federal government and its constituents. Pakistan is no exception to this rule.

3.3.2. The Case for Marching Grants

Conditional or matching grants especially for social services like health care, education and social security are an essential feature of the transfers from the federal government to the sub-nationals in many countries. In some developed countries, funds for expenditure on social needs are provided by the federal government despite revenue mobilisation being fairly decentralised. Examples include the United States and Canada and a number of other countries. The rationale is that

the sub-nationals in an effort to woo businesses and rich individuals to the region would impose lower tax burden and therefore under provide redistributive social services. Moreover, the desire and merits of provincial/regional autonomy notwithstanding, there is a strong case for setting minimum national standards, across jurisdictions, for provision of public services like health and education. The homogeneous national standards contribute to free flow of goods, services, labour and capital across jurisdictions, which allow the regions to reap numerous benefits. Though more than half a century ago it was advocated that inequality is good for economic growth [Kuznets (1955), Lewis (1955)], an influential body of recent literature provides evidence to the contrary [Easterly (2007), Galor and Zeira (1993)]. Raising living standards of less developed regions is now considered important for aggregate economic prosperity as well as for political stability. Establishing relatively homogeneous standards call for incurring greater expenditures in regions below the national average. Greater transfers from the federal government by way of block unconditional grants may not essentially be spent on providing social services like health, education and income security. Hence the case for conditional or matching grants.

Conditional grants impose conditions on the sub-nationals with respect to inputs (expenditures) or outputs (results achieved by the transfers). Output based grants are favoured on the ground that these do not adversely affect the incentives of the sub-nationals for cost efficiency but still meet the national objective of some minimum level of service. Conditions are thus imposed not on the specific use of grants but on attainment of standards in quality, access and level of service. Matching grants allow the sub-nationals to access transfers if they spend a certain specified percentage on a specific service from their own sources. Such grants are termed open-ended when there is no limit to transfers from the federal government on this count. Close-ended programs, on the other hand, put a maximum cap on matching transfers. These are favoured over open-ended programs as these take into account the budget constraint of the federal government.

In Pakistan there are no conditional or matching grants to the sub-nationals—all transfers are block unconditional grants. This allows the provinces to spend as they like thereby allowing maximum provincial autonomy but at the cost of homogeneous minimum national standards for essential services. The use of elements like poverty and inverse population density as indicator in the distribution formula are based on the fact that some provinces lag behind others in the level of development. The transfers of additional funds on these grounds, while

welcome, do not provide assurance that the additional funds will be used to alleviate poverty or for example be spent on increasing the number of schools in the sparsely populated Baluchistan. The higher transfers would have proved more effective had these been conditioned upon measurable alleviation of poverty and some pre specified improvement in development outcomes such as school enrolment or patient-doctor ratio.

3.3.3. Weights Assigned to Elements of the Multiple Indicator Criterion

The 7th NFC Award assigns different weights to the four elements of the revenue distribution criterion. It is not clear how the weights assigned to the four elements of the multiple indicator criterion have been determined. To what extent historical facts, research and statistical tools have influenced the determination of weights and to what extent the weight determination has been influenced by political compromises and rule of thumb. The weights, if arrived at as a result of political compromises, might prove less stable as some quarters might demand a review as soon as the power configuration undergoes a change. Anecdotal evidence suggests that the weight of 2.7 percent for inverse population density was determined in the following manner. A Baluchistan Development Package was agreed upon under the previous regime (military regime) as a result of negotiation with the influential persons of Baluchistan. Under the package an amount of Rs 83 billion was to be given annually to Baluchistan. The weights, especially, the one for inverse population density was arrived at by working backwards from Rs 83 billion. This is not to say that the weight of 2.7 percent for inverse population density (IPD) is exaggerated. The point is that adequate research on weight determination might have yielded a weight greater than 2.7 percent.

To illustrate how weights should be computed one could compute the per pupil cost of education for a school located in some remote area of Baluchistan and compare this with corresponding cost for some school located in central Punjab. The difference in the two costs could be used to compute weight for inverse population density. This example is only illustrative and of course cost differential would have to be examined in greater detail to construct the weight. Similar type of exercises could be undertaken to compute weights of other elements of the criteria.

3.3.4. Weight of Population Share

Despite the introduction of multiple indicator criterion for the distribution of national revenues the share of population still enjoys a

large weight of 82 percent indicating that a very large part of the revenues is still being distributed on the basis of population. Thus all the grounds on which the previous distribution formula was criticised still seem to be valid. Most of the countries making formula based transfers to the sub-nationals do not include the share of population at all as an indicator in the distribution formula and the countries that do include population share accord it a relatively small weight e.g. 10–20 percent in India. One major problem with the use of population share as an element in the revenue distribution formula is that provinces may question the veracity of the population census. Such problems have been noted in Nigeria where the funds are transferred to the sub-nationals solely on the basis population share. It is perhaps to avoid controversy of the sorts that India is still using the population share of 1971 to assign weight to the population share in the revenue distribution formula.

3.3.5. Poverty as an Element of Multiple Indicator Criteria

Some analysts have argued against including such indicators in the distribution criterion that generate perverse incentives. The use of poverty as an indicator acts a disincentive for the provinces to alleviate poverty because the poorer a province, the greater the transfers under the NFC Award. Moreover even before the inclusion of ‘poverty’ as an element of the revenue distribution criteria, the poverty estimates have been marred by controversies and independent analysts have questioned the intentions behind the estimates as well as the methodologies used to arrive at the estimates. It was perhaps for this reason that the poverty figure used by the 7th NFC Award is the average of the estimates generated by three different agencies. The inclusion of ‘poverty’ as an element of the revenue distribution criterion will make the province a stakeholder in the poverty estimation exercise. The consequences of this are difficult to predict; it may add to the raging controversy about the veracity of estimates but on a positive note the possibility is that given the potential gains and losses of the different stakeholders, the estimation exercise may become more transparent and less questionable.

3.3.6. Tax Effort

The effort made by a province to generate tax revenue is accounted for in a number of countries while determining the size of transfers. The objective is to encourage the provinces to generate more revenues from own sources by rewarding the existing revenue generation. The 7th NFC has included revenue generation (more

commonly known as tax effort) as an element of the resource distribution criteria. This is a welcome development. Own revenue generation has a number of advantages. It reduces dependency on the federal government, introduces transparency into dealings and improves governance at the regional level. The governance would improve because to mobilise revenues better organisation is required and more importantly because successful taxation is a bargain between government and the citizens with the latter ensuring effective delivery of services in return for taxation.

Our appreciation for inclusion of the tax effort as an element of the distribution criteria is not without a caveat. It is noteworthy that revenue generated by the provinces includes mostly federal tax revenues from tax sources (i.e. tax bases) assigned to the centre. The collection includes taxes paid by the public sector corporations located in the provinces. Moreover there are a number of firms that generate income from doing business in more than one province but pay tax in the province where their head office is located. This gives an undue advantage to the province which might be home to head offices of a greater number of firms.

Collection of revenues against tax sources assigned to the federal government would not yield (and has not yielded) the benefits of own revenue generation discussed above. First the machinery for tax collection is federal rather than provincial and secondly the citizens do not expect the provincial governments to provide better services in return for federal taxes. Thus improvement in governance at the provincial level would not result merely because more federal revenue is generated from a province.

A more realistic approach would be to include only the revenue generated against provincial tax bases for determining the tax effort of the province. Such an exercise would encourage provinces to increase revenue generation from provincial tax bases. Some important tax bases assigned to the provinces include property tax, tax on agricultural income and GST on services.

3.3.7. Impact on Revenue Generation

Greater transfers to the sub-nationals envisaged under the 7th NFC Award are likely to dampen the revenue generation (i.e. fiscal effort) of the provinces from their own sources. The following excerpts taken from Nabi and Shaikh (2010) are sufficient to support our statement.

A few months before the announcement of the 7th NFC Award, the government of Punjab had set up a task force to examine the structural weaknesses of the property tax and recommend

measures to improve the tax effort. This was motivated by... ambitious plans to increase expenditures on social protection and upgrade urban infrastructure.... After exhaustive discussions—the task force decided that for reasons of political feasibility, it was prudent to focus on two issues: updating the [property] valuation tables and rationalising the [property] tax rate....

The revenue impact of the proposed reform would be substantial... compared to the existing demand of Rs 2.8 billion, the new valuation would result in demand of Rs 12.7 billion. Combined with reduced differential, the demand would rise to Rs 16.3 billion or a five-fold increase—while the potential for substantially higher revenues following reform was attractive, ... Punjab had to balance this against political cost of passing on the increased demand to constituents, even the rich ones.

...The political calculus outlined above was being done on the eve of the 7th NFC Award. However as soon as it became apparent that the new NFC Award would result in substantially larger transfer from the divisible pool the motivation for levying the higher tax demand was lost and the political campaign was shelved. Thus, at least in short term, the new award has had a dampening effect on the revenue effort in Punjab, a critical sub-national entity.

3.3.8. Specification of Divisible Pool: A Disincentive for Resource Mobilisation

The process of distribution of revenues between the two tiers of the federation begins with the specification of distributable revenue sources commonly referred to as the 'divisible pool'. These revenue sources are largely mentioned in the constitution but the President can add to these sources. Not all revenue sources are included in the divisible pool, for example personal and corporate taxes are a part of the divisible pool while Petroleum Development Levy (PDL) is not. The practice of including some revenue sources in the divisible pool and excluding others acts as a disincentive for the federal government to increase revenues from such sources which are part of the divisible pool. To illustrate, suppose that the federal government wants to raise its own revenues by Rs 100. To raise the required amount through corporate taxes the federal government would have to increase the corporate tax rate by such percentage that an additional amount of Rs 236 is mobilised. The federal government needs to mobilise more than its required revenue because 57.5 percent of the additional revenue

i.e. Rs 136 would go to the provinces, thus leaving the federal government with the required Rs 100. An alternative for the federal government is to increase the PDL by such percentage so as to raise an additional Rs 100 only. The PDL requires lesser increase because it is not a part of the divisible pool i.e., the revenues from PDL are not to be shared with the provinces.

What could be done to avoid the disincentives referred above? A look at Table 3.2 provides the answer. It is evident from Table 3.2 that a substantive change in the proportion of revenues transferred to the provinces has occurred only in the first year of any new award. Thereafter the percentage has remained more or less constant in the remaining years. Presently, under the 7th NFC Award 44 percent of the gross federal revenue is being transferred to the provinces. Thus instead of framing an elaborate divisible pool the authorities can simply state that 44 percent of the total gross revenue of the federal government would be available for distribution among the provinces. This simplification of the divisible pool would improve the incentive for the federal government to increase collection from revenue sources included in the divisible pool.

Table 3.2

*Revenue Transferred to Provinces as Percentage of Gross Total
Revenue of Federal Government*

NFC	Financial Year	Percentage
1991	1991-92	26.0
	1992-93	26.1
	1993-94	27.9
	1994-95	30.1
	1995-96	31.8
1996	1996-97	33.8
	1997-98	26.3
	1998-99	24.2
	1999-00	27.4
	2000-01	30.4
	2001-02	27.7
	2002-03	27.5
	2003-04	27.8
	2004-05	28.0
	2005-06	29.5
2006	2006-07	
	2007-08	
	2008-09	31.4
2009	2009-10	31.9
	2010-11	44.6
	2011-12*	44.0

3.3.9 Evaluation of Distribution Design Against Best Practice

The broad principles of resource distribution derived from the review of relevant literature are given in Box 1.

Box 1

Design of Distribution of National Revenue: Broad Principles

Autonomy: The transfers should allow the sub-national governments to determine their own expenditure priorities.

Predictability: The amount transfers should be known well in advance so that the provinces may budget their expenditures with a modicum of certainty.

Simplicity: The transfer criteria should be objective and be fairly easy to understand.

Equity: The transfers should take care of the fiscal needs of each sub-national government.

Revenue Adequacy: Transfers should take care of the imbalance in resource availability between the federal government and the provinces as well as amongst the provinces.

Incentives: Transfers should encourage constituent units to raise revenues and control expenditures.

Accountability: The grantor must be accountable for the design and operation of the program. The recipients must be accountable to the grantor and the citizens for financial integrity and better utilisation.

Source: Adapted from "Pulling Back from the Abyss: Third Annual Report", Institute of Public Policy, Beaconhouse National University. (The last point 'Accountability' is an addition to the criterion included in the Beaconhouse report.)

The existing revenue distribution design of Pakistan fulfils the criterion of autonomy, simplicity and predictability but falls short on the yard sticks of incentives for the provinces to raise revenue from own sources and accountability of the provinces with respect to appropriate utilization of available financial resources. How well the distribution design performs on 'equity' and 'revenue adequacy' indicators can only be ascertained with the passage of time. A large number of functions that were under the jurisdiction of the federal government stand devolved to the provinces under the 18th amendment while greater funds have been transferred to the provinces under the 7th NFC Award. With more functions and greater financial resources at the disposal of the provinces since July 2011, it will be clear only after the passage of sometime that whether or not resources are enough to meet the financial needs of the provinces and if these are equitably distributed across provinces. The revenue distribution design falls short on 'incentives' to raise own-source revenue and 'accountability' as to

the appropriate use of the funds. Lesser transfers from the federal government coupled with perhaps partial allocation of some attractive tax sources, like income tax to the provinces will encourage the provinces to increase revenue generation from their own tax sources. This would also make the provinces accountable to their own electorate as successful taxation is essentially a bargain between the citizens and the government—tax revenues in return for public provision of services.

3.4. Conclusion

The shift from population share as the sole element of the revenue distribution criterion to the multiple indicator criterion is a move in the right direction. However Pakistan still has to go a long way before she is able to develop an optimal distribution criterion. First and foremost the revenue distribution criterion has no provision of conditional/matching grants which are essential for securing homogeneous minimum national standards in respect of essential needs. The conditional/matching grants can play an important role in reducing disparity among regions. This would curb the feeling of deprivation that prevails in some regions. The unaddressed feelings of deprivation, that might run high in some regions, pose serious threat for holding the constituent units together in the federation. The revenue distribution criterion is similar in spirit to the need indicator criterion however some important elements like school enrolment, infant mortality and demographic structure of the population have not been included in the criterion. The assignment of weight to an element of a criterion should ideally be based on detailed and careful assessment of the factors that influence the expenditures. Need indices should be developed based on such assessment. The indices thus developed would then contribute to the determination of weights. In practice, the weights seem to have been assigned in the spirit of striking a political compromise instead of undertaking the kind of exercise referred above. Inclusion of the revenue generation in the revenue distribution criterion is a welcome development. However, the revenue generated by the provincial governments from their own tax sources should form the basis of revenue distribution. The sudden jump in magnitude of unconditional block transfers to the provinces is likely to weaken the revenue generation efforts of the provinces. Own-source revenue generation by the provinces in Pakistan is one of the lowest among the federal countries and the distribution design does not provide much of an incentive to the provinces to increase their revenue generation.

Chapter 4

PROVINCIAL RESOURCE MOBILISATION

4.1. Introduction

The intergovernmental fiscal relationship in Pakistan is imbalanced. The provinces account for around 35 percent of all government expenditures but generate merely 8 percent of the consolidated national total tax revenue which is only 0.5 percent of the GDP. The need to improve provincial resource mobilisation is but obvious. (A comparison of the intergovernmental fiscal imbalance is given in Table 4.1. Though the comparison is 6 years old but nevertheless conveys the essential message that the decentralised revenue generation is among the lowest in Pakistan). The low revenue mobilisation on the part of the provinces should be viewed in the perspective of the national tax effort. The aggregate tax-to-GDP ratio in 2009-10 was 10.5 percent and has been on the decline for over a decade from 12.5 percent in 1996. This is significantly lower than the average for developing countries (15 percent) and developed countries (35 percent). Even the South Asian countries present a better picture with tax-to-GDP ratio in Sri Lanka at 16 percent and in India at 14.5 percent [Nabi and Shaikh (2011)].

This chapter discusses the options to increase provincial revenue mobilisation in Pakistan. To begin with, the present state of revenue decentralisation portrays a dismal picture. The provinces have access to as many as 15 tax bases but the effective yields are very low. The tax administration is weak, records are dated and tax bases are undervalued, incomplete and considerably squeezed by various exemptions. Despite significant revenue potential the provinces have not made a serious effort to reform the tax administration and increase tax yields [Bhal, *et al.* (2008)].

Broad based taxes like personal income tax, tax on corporate profits, sales tax on goods and custom duties are with the federal government while the menu of provincial tax bases include the hard to tax bases like sales tax on services and the tax on agricultural income—the former is administratively difficult and the latter is politically sensitive. One possible reason for the rather low national tax to GDP ratio could be that the taxes are assigned to such level of government where the incentive to mobilise tax revenue is insufficient. First, the fact that a large part of what is collected will not remain with the

Table 4.1

*Imbalance between Revenue and Expenditure in
Countries at the Sub-national Level*

	Revenue	Expenditure
Australia	31	46
Brazil	31	46
Canada	56	63
India	34	55
South Korea	5	50
Germany	35	63
Pakistan	8	28

Adapted from Watts (2005), cited in Beaconhouse National University (2010).

federal government may dampen efforts of the federal government to collect more (57 percent of the collection is transferred to the provinces under 7th NFC award). Second, the federal government with access to money creation (borrowing from the central bank) and foreign aid may not be as hard pressed to mobilise revenue as the provinces would be if they do not enjoy access to funds from other sources—provinces cannot create money and they have only recently been allowed to borrow abroad but with restrictive conditions.

In the context of decentralised revenue generation, the primary policy question to be addressed is whether the federal government should collect a larger part of the revenues and then distribute it among the federating units for their fiscal needs or the federal government should let the provinces generate revenue themselves and allow them to rely on the centre only for equalisation funds (i.e. the funds required to meet the fiscal needs of those provinces which do not have the capacity to generate revenue themselves). As argued later in this chapter, the latter approach should be the preferred option as it entails several benefits including greater incentive for mobilising tax revenues by the provinces, better accountability, and lesser dependency on the federal government. It needs to be emphasised that due to the differences in endowments and initial conditions such as state of availability of human capital and the geography, access to revenue generating opportunities is not likely to be the same across provinces. However the solution to the differential access to opportunities is not the transfers from the federal government for all the fiscal needs. A better option is to let the provinces mobilise revenues to their full potential and then fill the gap through strong fiscal equalisation programs. To make the provinces stand on their own feet, the magnitude of transfers would have to be reduced and broad based tax bases would have to be put at

the disposal of the provinces or shared between the federal government and the provinces.

Some developed countries are successfully sharing broad based taxes like the personal income tax and the tax on corporate profits with the sub-nationals i.e. both levels of government levy tax on the same tax base. In Pakistan the federal government is sharing all the tax revenue that it generates with the provinces, not through allowing them to tax the bases reserved for the federal government but through transfers under the NFC award. Allowing the provinces to tax, along with the centre, the broad based tax bases like personal income and corporate profits would solve the free rider problem. The provinces would make an effort to generate more from the tax bases because the revenue would belong to them. The provinces which fail to make revenue generation effort will not get the revenues.

To contain the overall tax burden while at the same time allowing the provinces to generate more revenues, the federal government may reduce its tax rate on the personal income tax and the tax on corporate profits to make room for the provinces to levy tax on these bases. For example if the federal government reduces the tax rate on corporate profits to 25 percent from the present rate of 34 percent, the provinces can levy tax at the rate of 9 percent on corporate profits. The revenue loss to be incurred by the federal government may be made up by reducing the transfers to provinces under the NFC award, with the province endowed with greater revenue generation capacity facing the larger cut. It is expected that the revenue generation by the province from these two tax bases would be greater than the revenue loss incurred by the federal government. This would contribute to improvement in the national tax to GDP ratio. The federal government may collect the two taxes as agent of the provinces against a specific charge.

Income from agriculture and property are the two major tax bases with the provinces but both remain largely untapped. The levy of tax on agricultural income has been much debated in Pakistan. The fact that not much progress has been made on this count is generally attributed to the lack of political will by the federal and provincial governments which are dominated by the landed elite. The property tax regime also needs a complete overhaul. In particular, a more scientific approach needs to be adopted to determine the property values for the purpose of taxation. Valuation tables need to be periodically updated on the basis of surveys and the assessed values indexed with inflation during the period intervening between the surveys. This chapter argues for devolving property tax to the lowest administrative tier of the government i.e. the 'union council', as also envisaged in local

government ordinance (2001). This is because local bodies would be better able to collect the tax because of their geographical proximity with the tax base and also because resource-starved local governments may have better incentives to levy and collect tax on property.

The tax bases to which the federal government and the provinces presently have access are given in Table 4.2 below:

Table 4.2

<i>Tax Bases Assigned to Federal Government and Provinces</i>	
Federal Taxes	Provincial/District Taxes
Direct Taxes	Direct Taxes
Personal Income Tax	Land Revenue
Corporate (Profit) tax	Urban Immovable Property Tax
Indirect Taxes	Tax on Transfer of Property
Sales Tax (GST on Goods)	Agricultural Income Tax
Custom Duties	Capital Gains Tax
Excise Duties	Tax on Professions, Trade and Callings
	Indirect Taxes
	Motor Vehicle Tax
	Stamp Duties
	Entertainment Tax
	Provincial Duties
	Miscellaneous Duties
	Sales Tax (GST on services)
	Royalties on natural resources*

*Royalties on natural gas and hydal power generation do not strictly constitute taxes but are important revenue source for Balochistan, Khyber Pakhtunkhwa and Sindh.

The rest of the chapter is organised as follows. Section 2 reviews the theoretical case for decentralisation of taxes whereas Section 3 examines the rationale for the assignment of different taxation sources to different levels of government. Section 4 describes the practice of tax assignment in selected countries to provide a basis to critically examine the practice of provincial resource mobilisation in Pakistan. Section 5 discusses the issue of provincial resource mobilisation in Pakistan while Section 6 summarises the discussion.

4.2. Theoretical Case for Decentralisation of Taxes

The theory of decentralised tax assignment attempts to answer questions like what is the optimal vertical structure of taxation, what type of taxes should be imposed by which tier of the government, which level of government may choose the tax base⁵ and which one the

⁵ Tax base implies the source upon which the tax is to be levied. For example for income tax the base is 'income'.

tax rate, and what level of government may administer the different tax tools [Ambrosano and Bordinon (2006)]. The relevant literature suggests two extreme positions and a unified framework recently propagated by [Ambrosano and Bordinon (2006)] which attempts to assess the usefulness of the insights furnished by different theories. The two extreme approaches follow the normative approach advocated by Musgrave (1959) and Oates (1972) and the public choice approach propagated by Brennan and Buchanan (1980). Musgrave classifies the economic functions of the government into three categories; resource allocation, macroeconomic stabilisation and income redistribution. As macroeconomic stabilisation and income redistribution have spillover effects therefore these functions, it is argued, should be performed by the central government whereas resource allocation can be performed by all levels of the government. Under the normative approach the personal income tax and corporate taxes should be assigned to the central government as these are good instruments for stabilisation as well as income redistribution. Regarding allocation, the sub-nationals should focus on benefit taxes i.e. the individual who benefits from a service should pay. A basic principle of the conventional approach regarding local tax assignments is that the sub-nationals should levy taxes on relatively immobile tax bases to avoid damaging tax competition among the sub-nationals. Because if the sub-national X was to choose a mobile tax base,⁶ such as tax on corporate profits, and the rate structure thereon then the subnational Y may offer a lower tax rate to attract the tax base to its own geographic jurisdiction. This kind of fiscal war can drive down the tax rates very low across jurisdictions leading to what the literature refers to as 'beggar-thy-neighbour' policies or 'race to the bottom'. The conventional approach also suggests that the sub-nationals should use only such types of taxes which have a relatively stable yield to avoid forecasting and planning problems. Finally the sub-nationals should levy taxes on bases distributed relatively evenly across jurisdictions to prevent horizontal fiscal imbalances.

The normative approach has been criticised on various grounds. First, it assumes that the governments and politician are benevolent and maximise social welfare. In practice the governments and the politicians may seek rents. Under centralised revenue generation the politicians at the helm of affairs in the centre may spend more in their own electoral constituency rather than distribute resources fairly. The demand for new provinces in Pakistan has roots in this kind of

⁶ Tax bases which may relocate from one geographic jurisdiction to another. For example land is an immobile tax base while firms are mobile.

grievance. Second, the theory only poorly explains the observed assignment of taxes in the real world. For example some countries like Canada have either successfully devolved to the provinces or are sharing the mobile tax bases like the tax on corporate profits without generating fiscal competition among the provinces. The practice shows that institutions like the ‘harmonised tax agreements’,⁷ can be developed to avoid the fiscal competition. Moreover much against the prediction of the normative theory the sub-nationals do successfully engage in income distribution and do not always make use of benefit taxation. Finally, it is argued that the theory completely ignores the political bargaining and the role of the interest groups that goes into government’s decisions and actions.

In the Brennan and Buchanan approach, the government (including politicians, bureaucrats and dictators) is considered non-benevolent: it attempts to maximise tax revenues from the private sector to maximise its spending power. To avoid the excesses of the Leviathan⁸ (i.e., large government) Brennan and Buchanan argue for encouraging tax competition within the sub-nationals to restrain the budget size of the governments. If one were to apply the Brennan and Buchanan framework then, contrary to postulates of the normative theory, the sub-nationals would be encouraged to impose tax on mobile tax bases. As in the Tiebout model, competition imposes limits on the power of the government to expropriate citizens because people ‘vote with their feet’ i.e. migrate from less attractive geographic areas to more greener pastures—attractive in terms of high service delivery and low tax burden. The Brennan and Buchanan model is criticised on the ground that in practice governments are not as monopolists as is assumed in the model. Moreover tax competition can lead to serious distortions in the economy in the shape of beggar-thy-neighbour policies. Finally evidence in favour of the Leviathan hypothesis is at best mixed [Ambrosano and Bordinon (2006)].

Winer (2000) rejects these two approaches to argue that the observed tax assignment in a federation is the result of a struggle between the different tiers of the government to raise their respective share of the taxing power. Ambrosano and Bordinon (2006) argue that while Oates and Musgrave are concerned with solving the benevolent

⁷Such agreements are generally executed by the central government with sub-nationals to bring uniformity in the tax structure.

⁸The literal meaning is sea monster. The word ‘Leviathan’ is used in public policy literature to refer to a government that has vast powers. Typically, in public policy literature this reflects a government that spends too much however occasionally ‘Leviathan’ is also used to imply the vast authority of the government that might be used for personal advantage.

social planner's problem, Brennan and Buchanan are focused on limiting the 'predatory appetite' of the Leviathan. Both the models, argue Ambrosano and Bordinon, are static and do not explain the observed assignment of taxes in the economy.

Ambrosano and Bordinon (2006) develop a unified approach with a simple case where there are no differences across jurisdictions; regions are identical in terms of population, resources, preferences and income of the resident individuals. It is further assumed that factors of production are completely immobile across regions. Ambrosano and Bordinon argue that in this highly abstract world there will be no role of local taxation or even local governments as all decisions can be taken by the central government without any risk of inducing discrimination across regions. They further argue that even in this abstract world creating several jurisdictions rather than relying on a single one would pay if those in charge of governance are not uniformly benevolent or competent across regions. In this case creating several regions would allow the citizens to compare the quality of their governments.

Relaxing the immobility assumption, the study points towards the conventional wisdom that the mobility of agents induces inefficiency in spatial allocation of agents and therefore yield sub optimal equilibria, a result which may be reversed if the rulers are non-benevolent or if political failures of other kinds occur. For example tax competition among jurisdiction may be beneficial if the rulers are Leviathans i.e. spend too much. Competition might also be beneficial if politicians are benevolent but are unable to commit, for example, due to uncertainty of their tenure or due to reliance on unstable ruling coalitions. The study argues that if preferences are heterogeneous across jurisdictions then tax rates would have to be different. For example if region X wants more public goods than region Y, then those residing in region X will have to pay more tax as well. The benefit-taxation (e.g. user charge) is the main instrument to solve the allocation problem and address the issue of heterogeneity of preferences across regions. Further, it is argued that if the sub-nationals also offer essential services like health and education which have a redistributive content as well then there is little justification for refusing to assign personal income tax to the sub-nationals as this is the main tool used to finance these services.

4.3. Assignment of Taxes: Levels of Government

The traditional theory of taxation put forth by Musgrave and others suggests that the sub-nationals should impose benefit taxes.

These benefit taxes would come as charges or quasi charges payable by the beneficiary of the public services. The main economic role of the sub-nationals, as discussed earlier, is allocation of resources which can be achieved through benefit taxation in an efficient manner [McLure (1999b), p. 14]. There are at least two hurdles in the way of implementation of benefit taxation. First, user charges and user fee cannot yield enough revenues to meet all the expenditure needs of the sub-nationals. Second, the sub-nationals perform redistributive functions as well which cannot be accomplished with benefit taxation and lastly, but more importantly, the public goods produced by the sub-nationals generate generalised benefits which cannot be closely related to specific beneficiaries.

Overall the desirable features of subnational taxation drawn from the literature are that it should: promote efficient resource allocation; discourage tax-exporting;⁹ avoid predatory competition; achieve vertical and horizontal fiscal balance; and be easily administered and enforced. [see Ambrosano and Bordinon (2006), Shah (2007)]. The principle of economic efficiency suggests that taxes on mobile tax bases¹⁰ should preferably be with the national government. If mobile tax bases are decentralised the sub-nationals might engage in socially wasteful competition to attract the tax bases, leading to what is referred to as race-to-the-bottom or beggar-thy-neighbour policies. Tax bases that are redistributive in nature should also be with the federal government because otherwise the sub-nationals may attempt to attract high income people and shun the ones with low income. To minimise administrative and compliance costs taxes should be levied at such tier of the government which can monitor the tax assessment better at the least cost. To ensure accountability it is essential that revenues should be matched with expenditure needs. It is clear that at times there is a trade-off involved in observing these principles e.g. the desire to lower administrative costs may require that most of taxes be with the central government thereby compromising on accountability aspect of revenue generation. Shah (2007) argues that scale economies are involved in centralised collection and given that there are efficiency and equity considerations as well the case for revenue decentralisation cannot be pursued as forcefully as one would pursue the case for decentralised public service

⁹Tax levied on production of goods in one region is largely paid by the residents of other regions because the good is consumed in regions other than where it is produced e.g. Oil.

¹⁰Tax bases which can relocate to avoid excessive taxation e.g. labour or some type of firms.

delivery. The feasibility of the assignment of some tax bases to the sub-nationals is examined below.

4.3.1. Property Tax

The property tax is one tax about which there are no two opinions that it should be assigned to the sub-nationals and this is the case in most countries including Pakistan. In a number of countries, this tax is assigned to the local bodies. In Pakistan the tax has been theoretically devolved to the local governments under the local government ordinance (2001) but in practice the tax still remains with the provincial governments. We suggest that the property tax should be practically devolved in the spirit of the local government ordinance (2001). The tax base is immobile and the earnings from the base are relatively stable yielding consistent tax revenue. The problem of tax exporting may occur if capital, land or houses are owned by the non-residents.

4.3.2. Personal Income Tax

Personal income taxes are typically levied by the central government and besides meeting expenditure needs these taxes serve the purpose of macroeconomic stabilisation and redistribution. However, in a number of countries, these are and should be available, at least partially, to sub-nationals for meeting such expenditure needs that produce generalised benefits. The sub-nationals in a number of countries apply a surcharge on the national income tax base and the revenues thus raised are assigned to the sub-nationals according to the 'residence principle'. The allocation of personal income taxes to sub-nationals, as mentioned earlier, can be related to the generalised benefits of public services. Moreover the personal income tax is highly visible and is therefore suitable from the perspective of accountability of the rulers by the citizens.

The allocation of personal income taxes to the sub-nationals may raise at least two problems. First, the income tax base is not uniformly distributed across jurisdictions. This could be a disadvantage for the poorer regions. Second, if local tax rates are substantially different across jurisdictions and labour is sufficiently mobile, then this may create distortions with negative implications for labour supply. These problems, however, have acceptable solutions. The disadvantage to the poorer regions can be and is being tackled in developed countries through fiscal equalisation programs. Transferring only for fiscal equalisation among regions, rather than for almost all the fiscal needs, will reduce the net amount of transfers and would therefore reduce

dependency of the sub-nationals on the federal government. The problem of non-uniform rates can be handled by introducing more or less uniform rates through 'tax harmonisation agreements' between the federal government and the provinces. Even if the provinces are to be legally bound to impose uniform rates with the personal income tax base allocated to them, still this would be an improvement over the existing regime, whereby the personal income tax collected becomes a part of the divisible pool and is transferred partially to the provinces under the NFC award. The reason is that larger NFC transfers create dependency. Moreover it is difficult to design a transfer mechanism which is completely free of arbitrariness, therefore lesser the transfers the better. Finally the labour mobility, envisaged in the Tiebout's 'voting with feet' model, is based on restrictive assumptions¹¹ the fulfilment of which has been questioned.

4.3.3. Tax on Corporate Profits

The literature suggests that tax on corporate profits is not a suitable source of revenue at the sub-national level for a number of reasons. First, it is difficult to determine the exact geographic source of the corporate profits. Though proxies like sales revenue generated in an area are used to estimate the geographic location of earnings these are only proximate indicators. Second, there is a possibility of tax-exporting if the goods produced in one area are consumed all over the country. Third, corporate earnings are not too stable. This may cause fluctuation in revenues of the sub-nationals which they may not be able to offset easily. The central government enjoying the ability to create money or borrow abroad with relatively greater ease is in a better position to offset the impact of depressed corporate earnings on the national exchequer. Again some solutions to these problems are possible.

True that the changes in tax on corporate profits can be effected to stabilise and that stabilisation is essentially a central function but to the extent that corporate taxes are transferred through the NFC award there is a case for devolving these to the provinces. The potential adverse effect of fluctuations in corporate earnings on provincial revenues should be viewed in the following perspective. Under the distribution mechanism, it is the tax revenue generated against specified tax bases, including corporate earnings, which the federal government has to share with the provinces. If the federal revenues fall

¹¹These assumptions include perfect labour mobility, availability of similar employment opportunities across jurisdictions, and full knowledge of government budgets in all jurisdictions.

due to decrease in corporate earnings the transfers to the provinces will also register a decline. On the other hand if the corporate tax is with the provinces, the provincial revenues would decline directly. Thus as far as the fluctuations in corporate earnings are concerned this would affect the funds at the disposal of provinces more or less equally, whether the tax base is with federal government or the provincial governments.

Regarding the proximate nature of the corporate earnings we need to understand that the collection by the centre and then transfer to the provinces through the resource sharing mechanism is only the second best option. It is not possible to design a resource sharing formula which is completely free of arbitrariness. If the estimation of the geographic earnings of a firm which has nationwide presence is arbitrary then the devolution of taxes on corporate profits only involves replacing one form of arbitrariness with another. This kind of swap will encourage the provinces to take measures for increase in business activity in the province. Again the uniform corporate tax rate is a better option than the transfer of corporate taxes by way of the resource sharing formula.

4.3.4. Value Added Tax

Value added tax (VAT) is not considered a good source of revenue at the subnational level in a federal system (Keen, 2000). The theory suggests various reasons in support of this view. These include: adverse effect on interregional trade, tax exporting, transfer pricing if origin principle is applied and the problem of tax fraud if destination principle is observed. More recent literature, however, challenges this view and suggests different modifications in the VAT to make its levy feasible at the sub-national level. The modifications include VIVAT (viable integrated VAT, proposed by Keen and Smith) and CVAT [compensating VAT, proposed by Ricardo Varsano and developed by McLure (2000)]. Given that Pakistan is still struggling with the levy of the VAT [under the nomenclature of RGST (Reformed GST)] it is too early to consider its devolution.

4.4. Assignment of Taxes in Selected Countries

The Canadian provinces meet most of their expenditure needs from the revenue that they generate themselves.¹² Therefore the examination of the revenue decentralisation regime in Canada is especially relevant. The good thing about the Canadian tax regime is

¹² For the exposition of the Canadian tax regime the material draws on Boadway (2010).

that while the revenue generation is highly decentralised still the scale economies involved in centralised collection have not dissipated. This has been achieved by allowing the federal taxation agency—Canadian Revenue Agency—to collect taxes on behalf of the provinces. The important feature of the Canadian System is that both the federal government and the provinces principally derive the revenue from the same tax bases namely personal income tax, sales tax and payroll tax. The provincial income tax rate is similar to the federal one however sales taxes vary from province to province. The Canadian provinces also levy tax on corporate profits. Taxes are made identical or at least similar across jurisdictions by way of tax harmonisation agreements which include the tax collection agreements (the collection by the federal government on behalf of the provincial government). These agreements are negotiated bilaterally between the federal government and the individual provinces. The provinces have the option but cannot be forced into signing the agreement. The federal government collects the income tax as well as the tax on corporate profits on behalf of the provinces. The income tax is allocated to the provinces based on the tax payer's province of residence as at end of the calendar year. The corporate tax is allocated on the basis of average revenues and payrolls of a corporation in the province concerned. The apprehension expressed in the literature that assigning tax bases like the personal income tax and the corporate income tax may lead to tax competition is not borne out in the case of Canada, except the tendency to drive down the tax progressivity. The possible reasons for lack of tax competition could be the implicit and explicit cooperation between the provinces through tax harmonisation agreements and the strong fiscal equalisation program practiced by the federal government. All the Canadian provinces have not, as yet, elected to impose VAT moreover all the provinces have not joined the harmonisation of VAT either. This reflects the difficulties involved in operating and harmonising VAT in a decentralised regime. Under harmonised sales tax (HST) regime that exists between some provinces and the federal government, the central government collects the tax on behalf of provinces and this revenues is allocated to the participating provinces in relation to their aggregate consumption. Thus again the taxing power remains with the provinces while the collection is still centralised. This mechanism ensures that scale economies involved in centralised collection are not dissipated due to decentralisation of revenue generation.

In a number of countries including Australia, India, Malaysia, and South Africa the taxing powers are fairly centralised. Broad based

taxes like income tax, tax on corporate profits, tax on international trade etc. are with the federal government while narrow based taxes like land tax, stamp duties, tax on agricultural income, motor vehicle tax and property tax are typically with the sub-nationals. The relatively centralised tax regime in some federal counties has to be viewed in the backdrop of a very high degree of fiscal equalisation programs run by the federal governments in these countries. This is not the case in Pakistan.

4.5. Assignment of Taxes in Pakistan

4.5.1. Property Tax¹³

The national property tax base in Pakistan was estimated at Rs 70 billion (\$933 million) by the World Bank in 1996 [World Bank (2000)]. Actual collection against property tax from the four provinces was Rs 506 million in 1996 increasing to Rs 5.7 billion by 2010, still much lower than the base estimated in 1996. To generate revenue from property taxation to its full potential, major reforms in the property taxation regime are called for. These involve periodic revision of the property valuation tables, annual indexation of the property valuations, taxation of vacant properties, levy of commercial property tax rates on industrial property and taxation of rural land. The reforms required in these areas are discussed below.

4.5.1.1. Valuation of Property

Anecdotal evidence suggests that the taxed values of property are in the range of 25-50 percent of their true value. Bhal, *et al.* (2008) have examined the valuation practices in Punjab and Khyber Pakhtunkhwa. Whereas the property valuation is based on market data and expert judgment in the case of Punjab, in Khyber Pakhtunkhwa, the province is divided into four categories and the properties are classified into these areas by experts based on desirability of location and availability of amenities. As pointed out by Khan (2004), property valuation system in Khyber Pakhtunkhwa is seriously flawed: property classification was done in 2001 and that too on the basis of a survey of only Peshawar city which is clearly inappropriate for valuing property in the remote areas of the province. Overall the property valuation in both provinces is seemingly based more on expert judgment rather than on systematic analysis. The situation in Sindh and Balochistan is not likely to be much different. Too much reliance on expert judgment

¹³This section draws on Bhal, *et al.* (2008).

provides room for leakages and rent seeking. Moreover the valuation tables are outdated. To increase revenue mobilisation against the property tax the property valuations should be updated periodically based on a comprehensive survey. As the valuation survey is costly and time consuming exercise, the surveys can at best be undertaken at an interval of five years. In the intervening period, the valuation tables should be indexed based on some indicator e.g. annual inflation rate. Besides a more scientific approach should be adopted in developing the valuation tables than greater reliance on expert judgment.

The urban property is usually taxed on the improvements (i.e. construction) over the land i.e. the covered area of the property. The more appropriate base would be a combination of land and the improvements there on i.e. land area plus covered area because this would take into account the market value of the land as well. The Industrial property is currently not treated as commercial property. Moreover the valuation of industrial property under the annual rental value is arbitrary because a capitalisation rate has to be assumed. The use of capital value base is more suited for industrial property.

4.5.1.2. Taxation of Vacant Properties

In Pakistan, investment in property especially plots of land is considered a good investment and a sound hedge against inflation. Taxation of vacant property is justified for at least four reasons. One, the investment in property constitutes wealth and therefore should be taxed. Second, the taxation of the vacant property would compel the owners to put the property to some good use and thus contribute to the economy. Three, the taxation of vacant property will also help in more efficient resource allocation; for example, if the owner does not have the means to afford construction on the vacant piece of land, the taxation of such land which does not generate any return may prove too costly for the owner. In that event the owner may decide not to own the land and the piece of land will end up with someone who can better use of it. Fourth, the taxation will drive down the property prices, as only those will buy who can make some good use of it.

4.5.1.3. Tax on Rural Land

A comprehensive tax on rural non-agricultural land on the pattern of urban immovable property needs to be introduced. Before this could be done a comprehensive survey of rural property is required. Rural land, like urban land, is grossly under assessed at the time of sale-purchase to avoid payment of large transfer fee. If an annual tax on rural land is imposed the transfer fee can be done away with.

4.5.1.4. Capital Gains on Trading in Land

The sale of urban as well as rural land generates significant capital gains and a tax on this income, like the tax on capital gain from the sale of stocks, has the potential to generate large revenues for the provincial governments. The question of taxing capital gains on property has been the subject of some debate in recent years. However the potential payees being the well-to-do, a serious debate on the subject has not begun either in the policy circles or in the media. Moreover the under assessment of property value to avoid payment of large transfer fee is pervasive. If the tax on capital gains from property transactions is levied the transfer fee can be either lumped with the tax or done away with altogether.

4.5.1.5. Which Tier of Government should Levy the Property Tax?

The short answer is local bodies. The subject of property tax, as envisaged under the Local Government Ordinance 2001, should be devolved preferably in a phased manner to the local governments. This has several advantages. Accountability of the governments by the public is considered one of the chief merits of decentralisation. The subject of property taxation in the hands of local governments affords an opportunity to exercise public accountability of the local governments. The property tax payments being highly visible, the taxpayers will demand better service from the local officials. The local politicians, being closer to the public, will be obliged to respond to get re-elected. The small size of the local bodies is perhaps the appropriate size to benefit from decentralisation in the shape of greater accountability and hence better service. Moreover the local officials have greater knowledge of the local economy and are therefore in a better position to oversee the preparation of property valuation tables. These tables are to be used for determining the tax liability of the property owners.

The property tax was devolved to the local governments under the local government ordinance (2001). In theory the local governments [Tehsil Municipal Associations (TMAs)] have been empowered to levy the property tax and set the rates; however the tax has not been devolved as yet to the local governments. In Khyber Pakhtunkhwa the property tax was handed over to the two districts on experimental basis for a year, but the districts turned it back. This example demonstrates that the districts are not interested in administering the property tax¹⁴

¹⁴The example of Punjab delaying the reform of property tax regime has been discussed at length in the previous chapter.

(Bhal, *et al.* (2008)]. The example has shown that the provinces are not too eager to increase revenue from the property tax. The lack of interest reflected in both the examples has a single root cause—growing resource allotments to provinces under the NFC. With ample funds at their hands the provinces do not have the incentive to undertake difficult reforms for mobilisation of revenues.

4.5.1.6. Tax on Government Owned Property

The federal government owns significant property in the provinces which is exempt from the property tax. If the provinces were to own property in the federal capital to the corresponding extent then the exemption could have been justified on a reciprocal basis, however this is not the case. Therefore there is a case for taxing the federal government's property in the provinces and vice versa.

4.5.1.7. Administrative Reforms in Property Tax Regime

In sum, to mobilise more revenues from property tax, a comprehensive reform effort is required to bring about changes in the administrative set up, tax base, tax rates, and intergovernmental arrangements (Urban unit, 2008). Valuation tables used to assess the value of a property should be periodically updated based on market surveys and the valuations should be indexed during the intervening period. Vacant properties should be taxed. Industrial property should be treated as commercial property and capital gains on property transactions should be taxed. These reforms would be successful only if these are accompanied by significant reforms on the administrative front, including phased devolution of the property taxation to the local governments.

4.5.2. Agricultural Income Tax

Agriculture is a provincial subject in Pakistan and so is the agricultural income tax. Historically agriculture has been taxed in Pakistan through the land revenue. However the land revenue being income and price inelastic, its replacement with the tax on agricultural income was considered essential. Almost nine commissions have been constituted so far to study agricultural taxation. Only two of these commissions recommended the introduction of agricultural tax [Pakistan (1959, 1960, 1963, 1970, 1975, 1986, 1988, 1989, 1993a)]. The remaining seven favoured the prevailing land revenue system [Chaudhry (1999)]. This gives an idea about the extent of controversy on the subject.

Agricultural income tax was finally imposed in Pakistan by the provinces in 1993 under the pressure of international donors. However the tax base was the ‘size of landholding’ rather than income. Though the ‘agricultural income’ as base was also added later on but still the provisions of the relevant law require that tax base would be the ‘size of land holding’ or ‘agricultural income’ depending on which one translates into higher tax. The dual base has contributed to leakages and the tax collection remains negligible. The estimates of the tax revenue potential of agricultural income tax range from Rs.40 billion to Rs.300 billion [PILDAT (2011)]; and this enormous revenue potential remains untapped due mainly to the lack of political will.

The foremost argument in favour of agricultural taxation is that the three sectors of the economy namely industry, services and the agricultural sector should be treated at par in terms of taxation. The industrial sector contributes 25 percent to the GDP and 63 percent to the tax revenues while the services sector has a share of 53 percent in GDP and 26 percent in tax revenues. However the agriculture sector with a 22 percent share in GDP contributes a mere 1 percent to the tax revenues [PILDAT (2011)]. It is thus obvious that there is a need to create a level playing field across all the productive sectors of the economy thus promoting an efficient allocation of resources.¹⁵

4.5.3. Sales tax on Services

The sales tax on services has been recently devolved to the provinces. Services are hard to tax in developing countries because these are typically provided by small firms which are largely in the informal sector and are therefore difficult to reach. Moreover the sector is poorly documented and the entrepreneurs engaged in the sector are not literate enough to maintain the documents required for the determination of sales volume and income. Thus the sales tax on services, like the tax on agricultural income, is another example of the hard to tax base assigned to the provinces.

4.5.4. Case for Devolution of more Taxes to Provinces

One of the main criticisms of the devolution of taxes like income tax to the provinces in Pakistan is that the provinces do not have the

¹⁵ One of the arguments against agricultural income taxation is that the prices of agricultural products are kept artificially depressed by the government. However this issue has been addressed to a large extent during the last decade: the government has freed up many agricultural prices in recent years though it continues to follow a support price mechanism for wheat but its price in recent years has been set much higher than the international price.

requisite capacity to collect taxes. Moreover it is also argued that the devolution of tax collection to provinces would raise the collection cost considerably. Here one can learn from the Canadian example. In Canada though the taxes have been devolved in the sense that the provinces are free to set their own rate structure, a single Canadian Revenue Agency collects the income tax on behalf of the provinces [Boadway (2007)]. A system on similar pattern can be adopted in Pakistan for all the taxes that should be with the provinces but have not been devolved on the grounds of the lack of collection capacity or increase in the collection cost. The collection of taxes by the Federal Board of Revenue, on behalf of the provinces, will take care of the low collection capacity in the provinces and a higher aggregate collection cost under the devolution. The devolution of taxes has several advantages. For example, the provinces knowing that the net revenue generated will belong in full to them would make efforts to increase the revenue from the base concerned. Also, the raising of revenue by one province can generate a strong demonstration effect, encouraging other provinces to emulate the example set by the high revenue generating province.

4.5.4.1. Sharing of Personal Income Tax with the Provinces

Provinces offer social services like health and education to the residents. Income tax is the ideal source to provide the funds required for the provision of such generalised benefits. Rather than transferring funds generated through income tax to the provinces under the NFC award, it may be better if provinces are allowed a share in the tax on income generated from the province concerned (some countries do follow this type of regime). The federal tax on income may be reduced to make room for the provinces to generate revenue from this base. The Federal Board of Revenue may continue to collect the tax on behalf of the provinces against some collection charge. The advantage is that provincial governments are likely to make an effort to increase employment opportunities in the province as the provincial revenues will now be linked with what the residents earn. Moreover the tax being highly visible and the politicians relatively close to the people the devolution will serve the cause of accountability of the government.

4.5.4.2. Sharing of Tax on Corporate Profits with the Provinces

Like income tax, the sharing of the tax on corporate profits with the provinces will generate a provincial interest in mobilising more revenues from this tax base. The provinces will make an effort to attract businesses to their geographic jurisdiction. Theory suggests that 'race

to the bottom' phenomenon may occur if corporate taxes are assigned to sub-nationals. However the empirical evidence in this regard is weak. Moreover tax incentives are only one of the many measures that attract businesses to a specific location. Other factors that have a role in the entrepreneur's choice of a business location include institutional quality (which subsumes business friendly environment), labour availability and the required infrastructure, to mention a few.

The devolution of the tax on corporate profits under the present structure of the Federal Board of Revenue is likely to face what is known as the 'head office problem'—a firm that does business in more than one province pays tax on its consolidated profits in the province where its head office is located. This system is fine for such tax bases the revenue from which belongs solely to the federal government. But estimating provincial earnings for firms that have presence in more than one province is likely to be a difficult accounting exercise. However the countries that have devolved the tax on corporate profits to the sub-nationals have managed to overcome this problem. A variable that is most commonly used to estimate corporate profits at the regional level is 'sales volume' which can be fairly accurately estimated at the provincial level. Like the income tax, the provincial share of the corporate tax may also be collected by Federal Board Revenue for a certain collection cost.

4.6. Conclusion

How the funds required for provincial fiscal needs should be raised? Whether these should largely come as transfers from the federal government or the province should raise more themselves from own sources? This chapter has laid out a case for the latter approach as effective provincial autonomy is difficult to exercise when the provinces rely on the federal government for funds to meet their fiscal needs. The problems involved in devising a fair and acceptable resource transfer regime are evident from the deadlocks witnessed in the history of NFCs and the demand for new provinces which are rooted in the deprivation argument. Even if the merits of decentralisation like the greater incentive at the local level to mobilise revenue and the possibility of more accountability of the governments are ignored, still there is a need for greater devolution of the revenue mobilisation opportunities to the provinces. In this respect, the sharing of the income tax base and the corporate tax base between the federal government and the province concerned are viable options.

Chapter 5

DECENTRALISATION AND MACROECONOMIC MANAGEMENT

5.1. Introduction

Fiscal decentralisation has far reaching implications for macroeconomic management. With the transfer of more functions and greater funds to the provinces, the actions of the provincial governments would have a greater bearing on both the conduct and design of macroeconomic policies. At the same time, there would be a need to redesign the institutional structure for economic policy making to ensure better economic coordination between the center and the provinces. This chapter examines the role of macroeconomic policies in a decentralised setup and explores the changes that would be required in the institutional framework for macroeconomic policies.

5.2. Decentralisation: Functional Assignment and Possible Effects

In a decentralised set-up the lead role in the economic management is typically played by the central government and the constituent units influence the economic performance to varying levels depending upon the degree of decentralisation. In terms of Musgrave's trio of functional responsibilities—allocation, redistribution, and stabilisation—there is a general consensus that the former can be undertaken by any level of the government while the latter two with the potential for spillover effects should be undertaken by the central government. In practice, the sub-nationals in many countries have successfully undertaken some redistributive activities as well—for example, health and education services.

Stabilisation of the economy through monetary management is the exclusive domain of the central governments¹⁶ in all the federations, barring of course some European countries which have surrendered the task to the European Central Bank. Though the sub-nationals do not

¹⁶Besides stabilisation, other key economic roles typically played by central governments include determining the key features of the tax regime, raising major part of the revenues, determining investment policy, undertaking key investment projects, and research and development. Some federal legislative functions—e.g., legislation for insurance, patents, and copyrights—also have implications for provincial resource mobilisation.

have a role in monetary management they are influenced by the monetary stance of the central bank as it affects their borrowing cost as well as their revenues and expenditure programs. On the other hand, the expenditure policies of the sub-nationals can affect the level of inflation and hence influence the monetary management. In a decentralised set-up a large part of aggregate national spending is undertaken autonomously by the sub-nationals. This has raised the concern that the federal government may not be able to stabilise effectively with the fiscal tools. A more serious concern is that conflicting economic policies adopted by the centre and the sub-nationals can offset the stabilisation efforts of the central government as well as of the monetary authority.¹⁷ The two concerns are further heightened if the sub-nationals can borrow without checks resulting in reckless spending that can create excessive demand pressures in the economy. Moreover, as argued by Minsassian (1997), rigid revenue sharing arrangements can exacerbate the cyclical fluctuation in output. Cyclical booms in taxes will increase sub-national revenues while the recession will reduce it thus inducing changes in subnational expenditures that may amplify the changes in aggregate output.

5.3. Ensuring Fiscal Prudence

Minassian (1997) argues that decentralisation of spending responsibilities or revenue raising opportunities has implications for the conduct and effectiveness of fiscal policy by the central government. To begin with, the loss of a major tax base or loss of control over a major share of public expenditure can constrain the ability of the federal government to influence the economy through fiscal policy tools. This is especially true if the expenditures that federal government is left with are largely rigid e.g. salaries, pensions, debt servicing and may be even defense expenditures. With large spending responsibilities being with the sub-nationals some kind of a cap is required on overall sub-national expenditures in case of overheating of the economy. Even this measure may not be enough if decentralisation leads to a change in the composition of subnational expenditures in favour of expenditures with high average multiplier e.g. expenditure on public works program and transfers to agents with a propensity to consume [Minassian (1997)]. This can raise aggregate demand when the central government is trying to control it. The converse would be true if the multipliers for the subnational expenditures are lower. This suggests that a cap on specific types of expenditure may also be required.

¹⁷ In the words of Anderson (2010), this situation is characterised as “the sub-nationals pushing the accelerator when the federal government applies the brakes”.

There are various mechanisms to ensure fiscal prudence at the subnational level including disciplining by the electorate, disciplining by the market, cooperative federalism and fiscal rules such as fiscal responsibility law (FRL). Disciplining by the electorate assumes that the electorate will not reelect the fiscally imprudent politicians or governments and that the imprudence will be reflected in the easily understandable economic indicators like inflation and unemployment. It is not too difficult to see that the foremost requirement for this kind of disciplining to succeed is a well-functioning democracy in which the government truly mirrors the wishes of the electorates and is held accountable for its failures in governance and service delivery—a requirement that is not easily fulfilled in developing and less developed countries.¹⁸ Moreover if the government is a coalition of political parties with divergent interests this may further complicate the task of disciplining by the electorate as different sections of the electorate may press for conflicting demands.¹⁹

Another mechanism is the disciplining of the imprudent fiscal governments by the markets. The argument is that to run deficits the governments would have to borrow from the markets which would penalise the imprudent fiscal behaviour in the shape of higher borrowing cost and refusal to lend if the economic fundamentals are too bad. Lane (1993) specifies the following conditions for the markets to exert effective discipline on the sub-nationals: (i) The financial markets should not be required to accord a privileged position to the sub-nationals; (ii) there should not be a possibility of bailout of the sub-nationals by the central government; (iii) information regarding sub-nationals outstanding debt and debt servicing capacity should be available to the potential lenders; and (iv) the sub-nationals should have the institutional structure to respond to the market signals. These are clearly stringent conditions which are not likely to be fulfilled in developing countries including Pakistan. It is important to add here that the view that financial markets can act as a disciplining device has been badly shaken after the recent episode of global financial meltdown which has clearly demonstrated that if the financial markets are awash with liquidity and the governments can play the ponzi game (roll over debt for long enough period), the markets may continue to lend—lenders flush with liquidity tend to be myopic and as long as they are

¹⁸Even if electoral disciplining succeeds which to some extent is the case in developed countries, it needs to be supplemented by other mechanisms to ensure fiscal prudence.

¹⁹For example, a section of the myopic electorate may ask for more jobs through fiscal stimulus even at the cost of fuelling inflation.

currently paid back they tend to overlook the long term debt servicing capacity of the borrower. Similarly, market disciplining will not work if the governments are able to run fiscal deficits through borrowing from the public sector banks and even from the central bank if the latter does not enjoy independence. In addition, the governments can have recourse to borrowing from the international donor which is driven more by geo-political considerations rather than economic fundamentals. It is thus clear that the markets cannot be relied upon to discipline the governments particularly in developing and less developed countries.

Cooperative federalism is a mechanism that holds promise for disciplining not only the sub-nationals but the federal government as well.²⁰ Under the cooperative federalism the sub-nationals and the federal government actively coordinate their actions to set the key macroeconomic objectives and the fiscal parameters that underpin these objectives. A mechanism is also developed to monitor the agreed upon targets and revise the targets if the economic situation so demands. Typically such negotiations are conducted at a very senior level forum that includes the representatives of the sub-nationals and the federal government and takes decisions on important questions of economic policy e.g. setting targets for inflation rate, fiscal deficit, debt to GDP ratio and other key macroeconomic indicators. The borrowing and spending limits can also be set in absolute terms periodically. These targets can be determined at the aggregate level as well as at the subnational level. Examples of such cooperative federalism can be found in Australia, Germany and Canada to mention a few. The cooperative federalism has several merits. All the tiers of the government will own the targets set for them. The sub-nationals can discipline the federal government by questioning the rationale of the latter's fiscal policies and by conditioning their fiscal conservatism with the practice at the federal level. Moreover the cooperative federalism can help develop an understanding among the sub-nationals about the macroeconomic implications of their budgetary decisions thus furthering the cause of fiscally responsible behaviour.²¹

²⁰The institutions of cooperative federalism functioning in some mature federations have been discussed at length in Shah (2010).

²¹To be sure, putting cooperative federalism into practice is a challenging task as consensus may be hard to achieve, some sub-nationals may attempt to override the preference of others or may seek to free ride, and the centre may try to take advantage of its dominance especially when the sub-nationals largely rely on transfers from the centre. In the spirit of 'practice what you preach', Shah (2010) argues that the cooperative federalism will succeed in disciplining the sub-nationals only when the federal government itself exercises fiscally prudent management.

Federal countries vary in terms of the institutional structure designed for the fiscal coordination. The United States does not have a formal institutional set up for fiscal coordination between the federal government and the states. The electorates are thought to favour governments and candidates that demonstrate fiscal conservatism and markets are believed to penalise governments that behave imprudently. Though Canada, like the US, also places great reliance on disciplining by the electorates and the markets, the federal government has established an elaborate mechanism for inter-jurisdictional coordination including intergovernmental conferences²² and the council of federation which is an interprovincial consultative body. In Switzerland, the 'common budget directives', applicable to all sub-nationals, foster intergovernmental coordination. The directives are aimed at securing fiscal conservatism. In Germany, the Financial Planning Council and the Cyclical Planning Council act as the intergovernmental coordinating bodies. The Australian Loan Council coordinates states' borrowings with their fiscal needs and the overall macroeconomic policy. The council provides information on the public sector borrowings to the markets.

5.4. Fiscal Responsibility Law

The conditions under which the cooperative federalism may succeed are strict, and even more restrictive are the conditions required for the success of disciplining by the electorate and the markets. Consequently, numerous countries have developed fiscal rules that include a limit on subnational borrowing, allowing subnational borrowing only for specified purposes, typically investment (the golden rule), and the maintenance of debt within a certain specified limit. These rules are at times embedded in the constitution to contain the subnational expenditures and borrowings. The rules have been in vogue since long and have been more recently grouped together under the nomenclature of the fiscal responsibility law. The advantages of the rules-based approach are transparency, equal treatment to all and an implicit check on political bargaining. The rules can also be effective in securing a political commitment to fiscal prudence especially in countries having divisive political institutions and coalition governments.

Some countries, like Spain and some states in the United States do allow borrowings for liquidity needs but subject to the conditions that such borrowings should be repaid within the fiscal year. The

²² The participants include first ministers, finance ministers and treasurers.

European Union in an effort to create the monetary union has established the ceilings on debt level of the individual member countries and has prescribed maximum limits for inflation and the fiscal deficit of the members. The provision regarding no bailout of the sub-nationals, except under defined exceptional circumstances, has also been included in the Maastricht treaty. The experience of the European monetary union suggests that the rules may not be enough at securing stability and that some fiscal coordination forum is required to complement the rules. In Switzerland, fiscal rules play an important role in fiscal management at the subnational level; cantons and communes are required to run balanced budgets inclusive of debt servicing and can borrow only for capital projects and even these borrowings have to be approved by the popular referenda. The German constitution accords budgetary independence to the federal government as well as to state governments but requires that both levels of government must take into account the conditions for maintaining fiscal equilibrium.

5.5. Institutional Framework for Fiscal Discipline in Pakistan

With decentralisation comes the need to put in place an institutional framework that can help achieve fiscal discipline through better coordination between the centre and the provinces.²³ The Fiscal Responsibility and Debt Limitation act (FRDL) is applicable only to the federal government and that too is largely ineffective because no penalty has been prescribed in the law for breach of the prescribed limits. Both the electoral channel as well as the financial markets are unlikely to function as disciplining devices in Pakistan. Democracy has remained episodic and elections are rarely fought and won on economic issues. The financial markets in Pakistan lack depth and the banks remain eager to lend to the government. The central bank is not as independent as it should be and finds it difficult to refuse to lend to the federal government. The federal government owns the largest bank in the country and has sufficient stakes in other banks to influence their lending behaviour. Two provincial governments also own banks. In this scenario, it is difficult to see how the financial markets can discipline either the federal or the provincial governments in Pakistan.

Against this backdrop cooperative federalism seems a plausible alternative. A high level intergovernmental forum comprising the federal and provincial finance ministers may be

²³Though Ministry of interprovincial coordination has been created in Pakistan, it will primarily deal with non-economic issues.

constituted. The forum may set targets for key fiscal indicators especially the fiscal deficit and debt levels before the announcement of the federal and provincial budgets. The forum may meet periodically to monitor the targets, take stock of the overall prevailing economic situation, and suggest corrective measures if different levels of government are off the targets. The advantage of this mechanism is that not only the federal government would closely watch the fiscal performance of the provinces but the provinces too will keep an eye on federal government's fiscal actions. The fact that the domestic debt has grown astronomically in the last four years (2007-11) and the debt maturity has drastically worsened²⁴ is enough to show that a watchdog over the fiscal behaviour of the federal government is also required.²⁵

It is important to emphasise that sole reliance on cooperative federalism is not likely to yield the desired outcomes and that this mechanism would have to be complemented by appropriate fiscal rules. This is because the spirit of cooperation required for the success of the forum may not come about easily as exemplified by the past deadlocks over the NFCs. This would especially be the case if the different political parties are at the helm of affairs at the federal and provincial level in which case the possibility of opposition for the sake of opposition cannot be ruled out. The fiscal rules in the shape of fiscal responsibility law are already in vogue at the federal level and this can be a useful starting point to devise appropriate fiscal rules for the provinces. In doing so, the fiscal responsibility law itself may be revised in the light of independent research. For example, the debt to GDP ratio of 60 percent prescribed in the Fiscal Responsibility and Debt Limitation Act (FRDL) has been adopted from the corresponding rule designed for the euro area countries. No research based on the economic fundamentals of Pakistan has gone into determining the maximum prescribed Debt to GDP ratio. The structure of Pakistan's economy is quite different from the structure of the euro area countries and therefore the level of sustainable debt might also be different. It is therefore essential to determine the sustainable level of fiscal deficit and debt based on rigorous research using domestic data and the same may be incorporated in the proposed fiscal responsibility law.

²⁴Khan (2011).

²⁵When the federal government borrows from the IMF, the latter in some sense does act as a watchdog. But this type of check on the federal government is only episodic and is often weakened by geo-political considerations.

5.6. Decentralisation: Impact on Quality of Macroeconomic Management

There is a wide agreement in the literature that an independent central bank is more effective in keeping inflation in check and maintaining an arms-length relationship between the government and the financial markets. Shah (2010) argues that a decentralised structure with diverse and conflicting interests of the constituents is more likely to promote independence of the central bank. Moreover greater clarity in the roles of the different tiers of the government also facilitates central bank independence. On the fiscal side a major cause of concern is the possible errant behaviour of the central government and the sub-nationals. Though there is some weak evidence that inter-jurisdictional competition helps curb the large size of the government (see for example Brennan and Buchanan, 1980) but still the possibility of 'leviathan' cannot be ruled out in an environment of rent seeking and corruption. As discussed earlier, mature federations have developed effective institutions for coordination among the different tiers of the government. Moreover fiscal rules have also been developed to check the fiscal imprudence of the federal government and the sub-nationals. With these mechanisms in place, fiscal decentralisation is likely to help improve the institutional framework for macroeconomic management.

5.7. Macroeconomic Management: Medium-Term Budgetary Framework (MTBF)

To ensure macroeconomic stability and efficient utilisation of government resources the Medium-Term Budgetary Framework (MTBF), a three years rolling plan, has been put in place at the Federal level. The aim of the MTBF is to: (i) enhance fiscal discipline; (ii) link the government's strategic priorities with the medium-term budget; and (iii) improve efficiency and effectiveness in Governments spending.

To achieve these objectives the MTBF draws up:

- (i) A Medium-Term Fiscal Framework which draws upon the macroeconomic framework [using a financial programming framework (FPF)]
- (ii) A Budget Strategy paper
- (iii) Output Based Budgeting

Managing the risk of macroeconomic imbalances is basically done through the Financial Programming Framework. Each year, starting in January, a Committee headed by the Chief Economist, Planning Commission, and comprising senior officials of the Ministry of Finance, State Bank, Federal Board of Revenue, Statistics Division

and invited technical experts draw up the FPF. This Committee reviews and agrees on the forecasts for the next three years on: (a) real economic growth; (b) fiscal (projected revenues, expenditures and fiscal deficits); (c) monetary (money supply); and (d) balance of payments (projected exports, imports and remittances).²⁶

The Financial Programming Framework (FPF) makes assumptions on the expected development and non-development expenditures of the Provincial governments as well as their expected revenues.

An important shortcoming of this approach is the absence of representatives from the respective provincial Finance Departments and Planning and Development Departments. Therefore the Three-Year-Rolling-Macroeconomic Framework that emerges can suffer from errors especially as regards total aggregate demand being generated as well as the projected fiscal deficit. This shortcoming can adversely affect the projected economic growth as well as projected inflation.

To ensure harmony and consistency in drawing up the Medium-Term Budgetary Framework it is therefore important that at a minimum the Chief Economists of the respective Provincial Planning Boards and senior representatives of the Finance Departments should be represented on the Committee drawing up the FPF. This would ensure better overall macroeconomic outcomes in the new devolved structure of government.

5.8. Macroeconomic Management: Adjusting to Supply Shocks and Unexpected Expenditures

The challenges for economic policy makers is to ensure macroeconomic stability in the face of volatility in global prices of oil and food grains as well as higher than allocated expenditures on defense and security given the insurgency on the western borders. This makes it difficult to keep to targeted macroeconomic variables especially the fiscal deficit. Here again with the shift in resources towards the provinces as a result of the 7th NFC award the provinces may need to cut down on their targeted expenditures and post a fiscal surplus as against a higher than targeted fiscal deficit by the federal government.

²⁶ FPF captures the interaction between Government budget and other sectors of the economy. It is not a formal economic model but a consistency framework with selected economic variables (e.g. GDP growth to be generated elsewhere and imported into the model).

These important economic adjustments require much more active coordination between the economic policy makers at the Federal and Provincial level.

5.9. Planning for Development

The public sector investment in Pakistan includes the development expenditure undertaken by the Federal Government through the federal Public Sector Development Programme (PSDP) and through the Annual Development Programmes (ADP) of the provincial governments. The PSDP (federal/provincial) is the main instrument in the hands of the government to make development interventions and channelise funds to the priority sectors. There is a well-developed detailed mechanism for approving development projects under the PSDP and the ADPs. Given the devolution of 17 federal ministries to the provinces under the 18th amendment the possibilities of intervention by the federal government have shrunk considerably. It is therefore essential that capacity of the provincial planning and development set-up should be considerably strengthened.

5.10. Rethinking the Role of the Planning Commission

The Planning Commission at the Federal Level serves as the principal body entrusted with drawing up the national growth and development strategy implemented through a series of Five Year Medium-Term Development Plans further broken down in Annual Plans (Federal) and Annual Development Plans (Provincial).

The Public Sector Development Programme (PSDP) at the Federal level is the main instrument through which the government allocates its development expenditures amongst different sectors in support of the macroeconomic targets set out in the Annual Plan as well as in support of the private sector which is the main engine to driving economic growth.

Previously of the total i.e. Federal, Provincial and local PSDP, around 70 percent was implemented through the Federal Government, 20 per cent by the Provincial governments and less than 10 per cent at the local level. Post 7th NFC and 19th constitutional Amendment now 60 percent is with the Provincial Governments and 40 per cent with the Federal government.

The Provincial governments now also have access to direct borrowing from the multilateral donor agencies mainly the World Bank and the Asian Development Bank (ADB). In this new situation the role of the Planning Commission may need some re-thinking. There may be merit in the Planning Commission concentrating its resources on

long gestation infrastructure projects (energy and water) and the Provinces on social sectors and medium to small sized infrastructure projects. Also a greater role needs to be assigned than at present in development resources being allocated at the local level.

5.11. Conclusion

This chapter has explored how fiscal decentralisation can affect macroeconomic management in a federal structure like Pakistan. The transfer of expenditure and revenue responsibilities from the centre to the provinces can have far reaching implications for macroeconomic stabilisation which typically lies in the domain of the centre. Unless mechanisms are developed to rein in the provincial budgets, provincial actions especially through borrowing may threaten overall macroeconomic stability. The chapter has also examined that what type of institutional structures would be suitable in Pakistan for keeping the fiscal behaviour of the federal government and the provinces within prudent limits, and it is argued that cooperative federalism and fiscal rules together will serve the cause of good fiscal management in Pakistan.

Chapter 6

SUMMARY AND CONCLUSIONS

The fiscal and administrative structure of Pakistan has been considerably decentralised after the 18th amendment and the 7th NFC Award. This booklet has highlighted opportunities and challenges that fiscal federalism entails for Pakistan and has spelled out alternative options for maximising the gains from fiscal decentralisation. The coverage includes the institutional structure and the criteria for intergovernmental resource sharing, revenue generation by the provinces, institutional framework for intergovernmental coordination, and implications of fiscal decentralisation for macroeconomic management.

To begin with, while the new distribution of functions between the centre and provinces is broadly similar to the typical practice observed in federal countries, there remains a need to rethink the appropriate jurisdiction for some functions such as interprovincial trade, environment, and signing of international treaties. Functional jurisdiction at times overlaps in such a manner that concurrent jurisdiction of the federal and provincial government becomes essential. Though the 18th amendment has abolished the concurrent list but it has rightly introduced a new form of concurrency by strengthening the role of the Council of Common Interest. More functions, for example environment, interprovincial trade, pricing of wheat and signing of international treaties may be placed under the domain of the Council of Common Interest.

The institutional setup for the distribution of resources across different levels of government is an important component of the administrative structure in a federation. In Pakistan, the frequent deadlocks over the revenue sharing arrangements have underscored the fact that intergovernmental forums such as the National Finance Commission (NFC) alone are not sufficient to devise equitable revenue sharing arrangements. Instead, a better approach would be to devise a two tier institutional framework consisting of an independent agency of experts and an intergovernmental forum. The independent agency would be a committee of experts the members of which would be chosen without regard to provincial affiliation. Based on careful analysis and research, the agency can determine what type of federal revenues should form the 'divisible pool' i.e. the pool of federal revenues that can be distributed, and then recommend who gets how much from the 'divisible pool', and recommend the assignment of

revenue sources to the federal government and the provinces. The agency can forward its recommendations to the National Finance Commission—a purely intergovernmental body comprising the federal and provincial ministers of finance only—which would pay due regard to the political factors and other sensibilities. If the NFC decides not to accept some or all of the recommendations of the independent agency it would be required to fully justify the decision. The NFC would then send its recommendation to the government for final approval and announcement of the award. This two-step approach is likely to put an end to the deadlocks which have marred the history of revenue distribution among constituent units in Pakistan.

A resource sharing mechanism that is acceptable to all the constituent units and that provides adequate incentives for resource mobilisation is essential for the success of fiscal federalism. In this respect, though the shift from population share as the sole element of the revenue distribution criteria to the multiple indicator criteria is a welcome step, there is still room for improvement in the resource sharing mechanism. First and foremost the revenue distribution criteria have no provision of conditional/matching grants which are essential for securing homogeneous minimum national standards in respect of essential needs. The conditional/matching grants can play an important role in reducing disparity among regions thus helping to assuage a sense of deprivation that prevails in some regions. Second, though the revenue distribution criterion is similar in spirit to the need indicator criterion, some important elements like school enrollment, infant mortality and demographic structure of the population have been missed. Third, weights to different elements of the criteria are assigned in the spirit of striking a political compromise rather than through careful analysis. Ideally, the assignment of weight to an element of a criterion should be based on a detailed and careful assessment of the factors that influence the expenditures, and need-indices should be developed based on such assessment. Whereas the inclusion of revenue generation in the revenue distribution criteria is a step in the right direction, the revenue generated by the provincial governments from their own tax sources should form the basis of revenue distribution. The sudden jump in the magnitude of unconditional block transfers to the provinces is likely to weaken the revenue generation efforts of the provinces. Own revenue generation by the provinces in Pakistan is one of the lowest among the federal countries and the distribution design does not provide much of an incentive to the provinces to increase their revenue generation.

Effective provincial autonomy is difficult to exercise when the provinces rely on the federal government for funds to meet their fiscal

needs. Also, the problems involved in devising a fair and acceptable resource transfer regime are evident from the deadlocks witnessed in the history of NFCs and the demand for new provinces which are rooted in the deprivation argument. Instead of reliance on federal transfers, a better approach may be to allow the provinces to raise their own resources, and in this respect the sharing of income and corporate tax bases between the federal government and the provinces are viable options.

The transfer of expenditure and revenue responsibilities from the centre to the provinces can have important implications for macroeconomic stabilisation which is the main responsibility of the centre. To ensure that fiscal policies of the provinces and the federal government are aligned so as to maintain overall macroeconomic stability, there is a need for an institutional mechanism that can ensure intergovernmental coordination of macroeconomic policies. In this regard, cooperative federalism supplemented with sound fiscal rules can be instrumental in promoting fiscal prudence by all the constituents.

If managed properly, the decentralisation of expenditure and revenue responsibilities holds significant promise in achieving better development outcomes through improved resource mobilisation, enhanced efficiency in service delivery and better accountability. However, these gains are conditional on developing an appropriate resource sharing mechanism that is equitable and at the same time maintains adequate incentives for the provinces to raise their own resources. This would have to be supplemented by strengthening the institutional structures for resource distribution and economic management across all tiers of the government as well as for intergovernmental coordination so as to ensure greater prosperity for all the constituent units in the federation.

Appendix Table 1

Federal and Concurrent Functions

1956	Federal Functions		Concurrent functions	
	1973	After the 18th Amendment	1956	1973
		PART I		
Defense & Associated Industry	Defense & Associated Industry	Defense & Associated Industry	Civil and criminal law	Civil & Criminal law
Foreign Affairs	Foreign Affairs	Foreign Affairs	Scientific and industrial research	Evidence and oath
Nationality	Nationality	Nationality	Poisons and drugs	Marriage and divorce
Currency & Banking	Currency & Banking	Currency & Banking	Publishing and the Press	Wills, intestacy and succession
Post and telecommunications	Post and telecommunications	Post and telecommunications	Labour relations and social security	Bankruptcy and insolvency
Patents and copyright	Patents and copyright	Patents and copyright	Refugees and evacuee property	Arbitration
Stock exchange	Stock exchanges	Stock exchanges	Economic and social planning	Contracts
Corporations	Corporations	Corporations	Monopolies	Trust and trustees
Navigation and shipping	Navigation and shipping	Navigation and shipping	Iron, steel, coal, and minerals	Transfer of property
Major ports	Major ports	**	Arms and explosives	Actionable wrongs
Federal services	Federal services	Federal services		Removal of prisoners
Elections	Elections	Elections		Preventive detention
Federal Taxes	Federal Taxes	Federal Taxes		Arms, fire-arms and ammunition
Foreign and inter-provincial trade	Foreign and inter-provincial trade	Foreign and inter-provincial trade		Explosives
Federal taxes	Taxes on income	Taxes on income		Narcotics
	Taxes on corporations	Taxes on corporations		Prevention of contagious diseases
	Sale taxes	Sale taxes except sales tax on services*		Mental illness
	Capital Value Tax	Capital Value Tax		Environmental pollution
	Taxes on minerals	Taxes on minerals		Population planning
	Taxes and duties on the production capacity of any plant	Taxes and duties on the production capacity of any plant		Welfare of labour
	Terminal taxes	Terminal taxes		Trade unions
	Fees	Fees		Boilers
Minerals	Minerals			Regulation of labour and safety in mines
Public Debt	Public debt	Public debt		Unemployment insurance
Federal pensions	Federal pensions	Federal pensions		Shipping and navigation on inland waterways
	Federal Ombudsmen	Federal Ombudsmen		Mechanically propelled vehicles
	Libraries, museums	Libraries, museums		Electricity

Continued—

Appendix Table 1—(Continued)

Migration	Migration	printing presses
Education of Pakistan's national abroad	Education of Pakistan's national abroad	Evacuee property
Nuclear energy	Nuclear energy	Historical monuments
Air navigation & Lighthouses	Air navigation & Lighthouses	Standards of education
Carriage of passengers and goods by sea or by air	Carriage of passengers and goods by sea or by air	Islamic education
Narcotics	Narcotics	Zakat
Insurance	Insurance	Censorship
National planning and national economic coordination	**	Tourism
National highways and strategic roads	National highways and strategic roads	Professions
Census	**	Auqaf
Establishment of standards of weights and measures	Establishment of standards of weights and measures	
Police force belonging to any Province	**	
Salaries of Government executives	Salaries of Government executives	
Custom duties	Customs duties	
Excise duties	Excise duties	
Succession to property	**	
Estate duty	**	
Jurisdiction and powers of all courts	Jurisdiction and powers of all courts	
	International treaties and agreement*	
PART II	PART II	
Railways	Railways	
Mineral oil and natural gas	Mineral oil and natural gas	
Development of industries	Development of industries	
Council of Common Interests	Council of Common Interests	
	Electricity*	
	Major Ports*	
	Census*	
	police force belonging to any Province*	
	Professions*	
	Higher Education: Standards and research*	
	Inter provincial coordination*	

**Omitted by the 18th amendment.

*Substituted by 18th amendment.

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