Improving Governance in Pakistan: Changing Perspectives on Decentralisation

EHTISHAM AHMAD

Allama Iqbal stressed the need for khudi in terms of national identity and focus on self-reliance, without which there would have been no chance to break colonial bounds. The message still resonates today, in a period of economic crisis and lack of national agreement on tax reforms. International experience with decentralisation also emphasises the importance of significant own-source revenues in generating accountability and effective service delivery at all levels of government. Although the 18th Amendment of Pakistan Constitution makes significant strides towards clarifying spending responsibilities, the issue of subsidiarity is not effectively addressed, nor is the issue of implementable own-source of revenues. This runs the risk of generating unfunded mandates, further pressures and weakening of public service delivery, leading possibly to strengthening of ethnic and parochial divisions and centrifugal forces. Iqbal’s message is as important now as it was in the last century.

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The passage of the 18th Amendment to the Pakistan 1973 Constitution came by as the result of a demand from a wide spectrum of political parties that see the issue of basic spending as part of provincial responsibility in line with the federal structure of the constitution. But will this major reform work effectively and ensure higher living standards for all the people in all the provinces? To what extent is the need for a national identity important in ensuring that the decentralisation does not lead to an unravelling of the Federation or deterioration in the overall delivery of public services and the greater inclusion of the poor? In this context it is useful to touch on the philosophy of Allama Iqbal that was one of the main factors that led to an impetus for a demand for a homeland for Muslims in India. We also examine the different approaches to nation-building and fiscal federalism that have led to the creation of vibrant federations. Evaluating international experience could play a valuable role in pointing out pitfalls and options for making the decentralisation process work in Pakistan.

In Section 1, we review some elements of Iqbal’s thoughts, and the implications of this for the sort of federation that has evolved in Pakistan. Section 2 examines
developments in theoretical understanding in addressing the steps that might be needed to ensure that the objectives of improving governance through decentralisation are met in an efficient manner. Bilateral and multilateral agencies have been quite active in advising on decentralisation processes. The multilateral banks have done so partly because of the belief that decentralised service provision can provide better for the poorer sections of society by utilising the information that may be available at the local level in tailoring the services to the preferences of the population, and making access easier. Their views have evolved, as the difficulties with the first approach have been better understood. Bilateral agencies have more explicit geo-political objectives, and sometimes these translate into trying to create societies and political structures that resemble their own in the expectation that this will lead to a congruence of interests. But quite often, the support has been given to those governments that tend to agree with the donor countries, especially in times of crisis, and under these circumstances the support can often go the other way, as was seen in Pinochet’s Chile, Suharto’s Indonesia, and Zia and Musharraf’s Pakistan. This is followed in Section 3 by some recent examples from around the world, for both unitary and federal states, and the political economy issues involved in any decentralisation process.

Section 5 focuses on some of the challenges that Pakistan will have to face in order to become a fully functional and prosperous federation, and the dangers if the proposed tax reforms were to fail.

A concluding section reiterates Iqbal’s message of hope, but underlines the need for a renewed sense of national identity and unity to offset parochial self-interest and destructive rent-seeking that has become so rampant in the country.

1. “KHUDI”—AND THE PHILOSOPHY THAT LED TO THE CREATION OF PAKISTAN

Allama decried difference between people of the sub-continent, especially the Muslims, as the main case of the backwardness of the nation. He very much understood the dynamics of the politics of the time, including the colonial environments and the progress made by other groups. However, he distrusted the politicians and the rhetoric of the politicians. See Verses 1 for verses from a powerful poem “what should be done, O people of the East?”—decrying the lack of wisdom of the elders, and the lack of compassion of the youth, leading to an aimless life of servitude to others.

A second selection of verses (Verses 2) attacks the false cloak of democracy and freedom that actually binds the dispossessed in an even tighter vice. Abusing the advice from abroad, vested interests increase their dominance in the name of democracy, leading to an absence of development.

Allama Iqbal was cognizant of the need for a strong moral basis for a self-reliant society, and felt that shared values and aspirations were critical for a self-reliant process of development. It was in this context that the demand for Pakistan materialised:

• “I demand the formation of a consolidated Muslim state in the best interests of India and of Islam” (Allama Iqbal).

1This section has been prepared jointly with Dr Mahnaz Ahmad.
Verses 1: Pas chébayàdkard, ay aqwäm e shârq? (So what must be done, O people of the East?)

- Ay Himalaya, ay Attock, Ay rûd –e Gang
  - O people of Himalaya, Attock, and Indus
- Zistânataichunan bi aab o rang
  - Living without meaning for how long
- Pirmardânazfarasêt, bînasib
  - The elders without wisdom
- Naqquvanâmnazmohabbatbînasib
  - The young without compassion
- Shârq o Gharbâzâd, va ma nakhehirghair
  - East and West are free, but we follow others
- Khist ma sarmâyatamîrghair
  - Our toils for the benefit of others
- Zînâdegani bar maruqqârârân
  - Living at the will of others
- Javedâmargast, nikhoâbgarân
  - Not even deep sleep, but eternal death

The emphasis on common values and unity did not sit well with the weak federal structure for India proposed subsequently by the Cabinet Commission Mission, (May 16, 1946), as it would have led to centrifugal forces and a weak central government. For similar reasons, Nehru wanted a strong central government, and the creation of Pakistan became inevitable. Iqbal was quite distrustful of blindly copying foreign models and ideologies without thinking about the structure of society and governance that would evolve, and felt that that would engender greater dependence.

In effect, Iqbal argued for “unity, faith and discipline” as the basis for a strong and self-reliant nation. A cloak of democracy leading to divisions and disunity, as well as reliance on an external begging bowl, would have been anathema for Iqbal. This would have been equivalent to perpetuating dominance and repression under the “cloak of democracy and freedom”.

Verses 2: Siasât e hazîr: politics of the day

- Mikunad bund-e ghulâmân sakht-sar
  - Binds the disposed even tighter
- Hurriyet mikhavand our a bi basar
  - The naïve call it freedom
- Garmî e hangâmeh zamîr did
  - When they see the people’s agitation
- Pardâ bar rouye malkiyyat kashid
  - They put a cloak over international globalisation and the UN (league of nations)
- Sultanât ra jâmeh-e-aqwâm guft
  - Cloaking domination in the garb of democracy
- Dar Fazayash bal o par natavân gashour
  - One can hardly develop in this environment
- Ba kalidish beych dar natavân gashour
  - Their solutions open no doors
Iqbal’s strong belief in self-reliance and national identity permeated his political philosophy, that of “khudi” (or self). This did not equate to a focus on degenerate personal, parochial or group interests. It was much more of a sense of national identity and common values binding the people together.

Indeed, Iqbal was particularly concerned with divisions and disagreements amongst one’s own people that could be easily solved with negotiations. He would have been mortified by current state of affairs, when, during the period of crisis, no one seems to have national interest in mind. In the context of the collapse of domestic resource mobilisation, and during a period of extreme danger and unsustainable dent, textile lobbies, the urban gentry, traders and agriculturists, all point to the other and say: “tax that group first” but “do not tax me.” The inability to plug the fiscal gaps despite at least a decade of effort is tantamount to selfish interests that predominate over national priority. In particular, if there is an absence of national unity or direction —the collective khudi— then there is really no hope and even the highest mountains can be swept aside like “straw in the wind” (Verses 3).

Verses 3:

- Tākhudīdarsinē-ye millatbamūrd
  - If national khudī dies
- Kūhkahigashvabādōūrābabūrd
  - Mountains become straw and are blown away in the wind

There is a significant difficulty that arises from money metric-measures of “growth and development” that rely on “external” individualistic philosophies. Iqbal was very critical of such foreign ideologies that would accentuate self-seeking divisive behaviour and continued dependency. Even in present day Europe, the debate is now moving towards measures of “happiness” (Sarkozy commission) and not money-metric measures of GDP or growth. Given the concern for “sustainability” in Iqbal’s philosophy, self-sufficiency and living within one’s means would be at the cornerstone of his “development” strategy. While Verse 4 is couched in autarchic language, the path of freedom in a modern context lies in preventing unsustainable borrowing, and not necessarily passing up on the benefits from trade and global specialisation. The crux of his message, which also rings true in post-sub prime America, is that one should not live beyond one’s means.

Verses 4:

- “Āncheazkhā-k-i tóast, ay mard-i-horĀanforoush, waānbepoosh, waānbekhōr”
  - freedom lover! Sell, wear and eat what you can grow (and finance)

In terms of the theme of the conference, the implications of Iqbal’s philosophy is on national identity and the avoidance of centrifugal stresses by parochial and selfish
interests, and not necessarily on centralisation or decentralisation per se. The focus is more on appropriate incentives and economic sustainability as growth strategies, and compassion and inclusion of the poor and the dispossessed. These may be feasible in either a centralised or decentralised framework—the latter, for instance, in a system of subsidiarity. However, he would have been as critical of mindless decentralisation, leading to corruption and “capture” by political elites as Tanzi (2002), or Bardhan and Mookherjee (2000). The focus in Iqbal, as much as in the modern approaches to fiscal federalism would be on effective service delivery in a political economy perspective.

2. NORMATIVE OR POSITIVE APPROACHES TO FEDERALISM AND DECENTRALISATION?

Developments in Theory

The post-Second World War normative literature on fiscal decentralisation has been much influenced by the experience of the United States, and the work inter alia of Musgrave (1959) and Mancur Olson (1969). These were based on the presumption that governments are benevolent. This reflected the views of Montesquieu, and of Hamilton and Madison in *The Federalist Papers*, that government should be small, and the functions should be separated with the centre responsible for issues that affect all lower levels of government, such as defence and monetary policy. The presumption has been, particularly on the part of some bilateral and multilateral agencies, that decentralisation will lead to more efficient service delivery, higher growth and poverty reduction.

Experiences outside the United States, particularly in the European Union and especially in developing countries, have led to a questioning of the normative approach, spawning a surge in the “political economy” literature [see surveys in Ahmad and Brosio (2006); Oates (2008); Lockwood (2009)]. This reflects an earlier debate, associated with De Tocqueville and John Stuart Mill, which focused on the actual workings of government and an evaluation of the pros and cons of “decentralised” operations. The main difference is that the assumption of “benevolent” government is dropped, and incentives facing politicians and bureaucrats become important, as do the role of institutions and information flows. Bardhan and Mookherjee (2000), write about the possibility of “capture” by vested interests. Besley and Case (1995) introduce the concept of “yardstick competition”, in which voters evaluate the performance of their local governments in relation to the results achieved in neighbouring jurisdiction. Given increasing mobility and information flow, the yardstick competition idea has recently been extended to relate to countries, as citizens in one country examine what results are achieved in other countries with which they are quite familiar [Salmon (2010)].

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2 This section draws on Ahmad (2011) and Ahmad and Brosio (2006).


The building blocks of both normative and positive traditions are similar—spending and taxation assignments, design of transfers, debt management and information flows and instruments for implementation. However, the sequencing and mix of the instruments might vary, as we discuss below. The situation becomes a little more complex when it comes to examination of the spending assignments. While the US Federalist tradition recommended a separation of powers, this is indeed needed for increased accountability. The critique of the normative approaches, however, comes from the European collaborative tradition, that also lends itself to centralisation or assumption of powers by the centre.

Decentralisation Trends

The impetus to decentralise has differed in many cases. In Latin America the shift from one-party or military rule has led to a resurgence of interest in decentralisation as a means of consolidating political gains, whereas a large, one-party, unitary state, China has actually been quite decentralised. And in Pakistan, the Musharraf government tried to “decentralise” using the normative precepts, but in political economy terms, the actions were calculated to bypass the provinces and the power of the political parties that tended to have a provincial focus. International agencies tended to support the normative approach to decentralisation on the grounds that this would lead to better service delivery and poverty reduction—but the evidence on this is at best mixed [see Ahmad, Brosio, and Tanzi (2006) for a discussion of the evidence in OECD countries, and see Table 1 for some trends from Ahmad and Brosio (2009)].

Like in Pakistan, many Latin American countries have experienced some movement towards decentralisation in the past two decades, often as a reaction to periods of one-party or military rule. This has been more marked on the spending side than on the revenue side. With respect to the latter, the trend has been in the opposite direction, as countries have established systems of more or less centralised systems for the VAT, sometimes with the help of the international agencies and particularly the IMF, often replacing a myriad of subnational taxes at the state and local levels.

On the spending side, despite the rhetoric, the approach particularly in the Latin American countries has been one where there are mixed and overlapping responsibilities that have not been adequately addressed. These partly reflect the centralised tendencies of the past, together with a paternalistic approach (including by donors) that do not trust the sub-national governments to make the right choices for their citizens in their area of competence (including education and social policy in general), or feel that the lower levels lack the capabilities to manage their affairs effectively. In many cases, these concerns are probably quite valid, and we shall discuss the experiences of some Federal and Unitary countries, and the approaches taken by some of the donors in this regard.
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3. POLITICAL ECONOMY OF DECENTRALISATION: INTERNATIONAL EXPERIENCES

In Pakistan, the impetus for the 18th Amendment is a reaction against a decade of military rule, including the abandonment of the focus on district and local level service delivery. This is similar to the experience in Latin America, with an intensification of the democratic process in the 1990s. In setting the stage on international experience, we focus on Colombia and Bolivia—and touch on Indonesia and Peru—as these have all followed a similar route towards decentralisation albeit at a different pace. China, which was quite decentralised, has moved towards greater centralisation, at least on the revenue side.

Chile has not taken the fiscal decentralisation route, in the manner of its fellow Andean unitary states, but has focused on improving the efficiency of the spending process, with greater accountability of the actors involved in the spending chain. To some extent this could be seen as an extrapolation of the “Chicago doctrine” of the Chilean economists. This process may be described as introducing performance budgeting in a deconcentrated and unitary environment, and not “decentralisation” as in the other countries. Perhaps in a country with a relatively small and homogeneous population, this approach may be more effective and make more sense than the rush to decentralise that has gripped many parts of the world. This may also make sense when there is a strong national identity that overrides local ethnic or other differences.

Chile’s neighbour Peru, on the other hand, has oscillated between decentralisation in the 1980s, to the centralisation under Fujomori. It is a large country with marked topological differences, and considerable inequality. The lack of information available to the centre on local preferences and priorities made centrally administered social stabilisation difficult, and exacerbated labour market fragmentation. Further, weaknesses in budget processes and oversight mechanisms, permitted members of the administration to use public investment funds as a means to reelect Fujimori, or divert resources into their own pockets. Hence, the return to a phased-decentralised strategy during the last decade made a lot of sense in the Peruvian context.

Although Pakistan is a federal state, its experience has been similar to Peru, with oscillations between more or less centralised operations given its periodic experimentations with military rule. In this section, we describe some of the intergovernmental fiscal reforms in unitary states, that also involved the VAT, particularly in Peru and China, as well as some federal countries—Mexico and Brazil.

Unitary States

Bolivia

In Bolivia in the 1990s, decentralisation was held as an integral part of enhancing service delivery for the poor as part of the process of recovering from an economic crisis. The decentralisation was strongly supported by bilateral donors, as well as the international agencies (IADB, GTZ, the World Bank as well as the IMF). The IADB and the World Bank supported the unbundling of these responsibilities, and the development of the Government financial information system (GFMIS), or SIGMA.
In 1997, the onset of subnational indebtedness prompted action by the IMF, and debt limits were imposed on municipalities. However, it failed to get to grips with the underlying political economy difficulties, that generate the imbalances in the first place, and the games played between different levels of government. Steps were taken in 1998 to stem the debt difficulties of subnational governments. This infrastructure did not prevent the recurrence of subnational debt difficulties following the period of economic and political crisis (1999-2002).

Debt problems continued, given the difficulty in tracking subnational operations, and agreements had to be reached between the central and concerned local governments to ensure an orderly adjustment—including changing the debt composition and establishing a no-bailout provision, together with the more effective tracking of government spending through the government financial information system, SIGMA, being rolled out by the IADB and the World Bank.

By 2001, under the enhanced HIPC arrangement, donors decided that the decentralisation process was proceeding sufficiently well for the debt relief to be directed to municipal governments for health care, education and infrastructure spending, based on selective evidence. There was also sufficient reliance on the efficacy of the SIGMA being developed to be able to effectively track the subnational spending, or so it was believed.

However, an assessment of the political economy perspective, found that there were significant deficiencies in the design of the decentralisation process—particularly governing the allocation of HIPC-II funds to municipalities. Funds were allocated in areas where the local governments had little or no responsibility—particularly education and health care, as the departments hired the staff, that were paid for directly from the central budget. The local governments were not particularly inclined to use funds for these purposes, and with limited own-source revenues, there were no incentives to do so efficiently. Plus, the transfer system was not particularly “equalising”, and the attempt to pacify the natural resource producing regions through hydrocarbon revenue sharing was not especially effective. Moreover, the SIGMA information system had been poorly designed, and even if it had been properly designed, had little chance of providing the discipline that was missing in the previous institutional framework.

A careful empirical analysis by a Bolivian economist found, using successive household level surveys, that the use of the HIPC-funds by local governments had virtually no correlation with improvements in living standards [Inchauste (2008)]. Even when considering infrastructure, which is where much of the spending took place, there was no strong evidence that access to infrastructure improved significantly.

1 Under the 1997 budget law, debt service was limited to 25 percent of revenues, and debt stock to be lower than 25 percent of revenues. This reflected the Colombian municipal debt law.
The issue with natural resources in Bolivia is that the petroleum resources are generated in regions that are ethnically distinct from the majority indigenous population of the altiplano, which tend to be among the poorest. This tends to fan separatist tendencies in the producing regions (as was the case in Biafra in Nigeria, and Aceh in Indonesia). There is a tradeoff between macroeconomic management or the redistributive functions of the central government, and the political economy consideration of keeping the country together. It is natural that the latter will dominate, and the macroeconomic and redistributive functions will need to be adapted effectively in order to accommodate—to some extent this has been true of Indonesia as well as Iraq [Ahmad (forthcoming)]. In Bolivia, in late 2007, hydrocarbon tax transfers to regions were cut by 60 percent, in a centralisation move designed to facilitate “redistribution” transfers to poorer municipalities. It was also an attempt to “reassert” control over the regions with separatist tendencies [Fedelino and Ter-Minassian (2010)]. Such a move would be inconceivable in modern day Iraq or Indonesia, and would certainly fan rather than reduce secessionist tendencies in these countries—showing that there may not be a unique solution to the sharing of natural resource revenues, and much depends on the specific context, which may change over time.

Overall, despite the limited success to date with the decentralisation in Bolivia, the attempt has been to seek way to make it work better in a heterogeneous country, giving voice to the disadvantaged people who saw little benefit during extended periods of centralised rule. As shown by Faguet (2004), clearly the possibility of improvements in living standards has been demonstrated, even if this cannot be generalised at this stage (2009). Thus, going back to centralised rule is not a political-economy option, and the focus, has to be to examine the missing elements to make the process work better, particularly the own-source revenues at lower levels to enhance incentives for better accountability, and information flows that bolster the process.

Peru

As argued in Ahmad and García-Escribano (2010), Peru provides a laboratory for examining the effectiveness of decentralisation and the centralised rule, as successive administrations have oscillated between the extremes. Mayors were popularly elected prior to the period of military rule between 1968 and 1979. The subsequent period of extreme centralisation was characterised by increasing disparities between the coast (particularly Lima) and the poorer regions of the sierra and selva. The 1979 constitutional reforms reinstated municipalities. However, the attempts to decentralise functions during the first García period in the 1980s were hampered by weak administrative and economic management, and plagued by extensive rent seeking and diversion of resources at all levels of government. Combined with the chaos associated with the macroeconomic crisis and hyperinflation, there was little evidence of a reduction in regional disparities or poverty. In contrast, the stabilisation of Fujimori came with considerable centralisation, buttressed by the introduction of a VAT, with a central tax administration (SUNAT). As an adjunct to the economic stabilisation, the early Fujimori period was characterised by an attempt to also provide for social stabilisation, seen as an essential element in the fight against the Shining Path (Sendero) guerrillas.
A key reform initiated by Fujimori was the establishment of SUNAT. After a period of hyperinflation, and the collapse of the tax/GDP ratio to under 8 percent and a hopelessly corrupt tax administration, Fujimori fired the tax administration and established SUNAT with some staff from the Central Bank, together with technical assistance from the IMF. A key element was the design and implementation of the VAT, which brought the tax/GDP ratio quickly above 12 percent, as well as social stabilisation with focused on “protecting” the poorest and most vulnerable. Centrally determined and financed programmes, such as FONCODES,10 were the major source of activities for local governments. While these were, in principle, designed to reflect local priorities, there were few mechanisms to coordinate at the local or central levels, assess tradeoffs and establish priority spending. The centre lacked the full information to make allocations, and there often was a lack of clarity between the spending by specialised agencies like FONCODES and the operations of line ministries and local administrations. The deconcentrated local governments were relatively weak, and lacked own-source revenues, or clearly defined functions.

The Toledo administration in 2002 revived the decentralisation process. The second García administration in 2006 also decided to move forward this decentralisation process. There was a political-economy recognition that a dispersal of power among regional and local governments provides insurance against a centralised abuse of power and resources. Ahmad and García-Escribano (2010)11 suggested that considerable work is needed to develop a coordinated approach to spending and revenue assignments to ensure better governance and accountability at all levels—given the political economy constraints in Peru. This also entails an improvement in information flows, and a redesign of transfer mechanisms that “equalise capabilities” without creating disincentives.

As in the Colombian (and Indonesian) contexts, decisions on sharing of the natural resource canons in Peru preceded the devolution of spending or other own-source revenue raising powers, paripassu creating issues relating to both macroeconomic stabilisation and inter-regional redistribution. But perhaps this is the price to be paid in terms of decentralising powers and functions in a multi-ethnic and diverse country.

China

In the early 1990s Chinese context of murky spending responsibilities (a lot of social spending was performed by state owned enterprises belonging to different levels of government) in a legal unitary state, with no central tax collection other than customs, the centre had no ability to administer taxation. The Chinese economic reforms of the 1980s had moved from a system of 100 percent profits taxation of largely state owned

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10This was a fund for social stabilisation that provided financing for education, health and infrastructure needs at the municipal level. See Ehtisham Ahmad, Juan Amieva-Huerta, J.L. Ruiz and Jerry Schiff, April 1994, Peru: Pobreza, PoliticasPublicas y Gestion del GastoPublico, IMF, FAD, and Ehtisham Ahmad, J. Amieva-Huerta, and Jim J. Thomas, October 1994, Peru: Pobreza: Mercado de Trabajo y PoliticasSociales, IMF, FAD.

enterprises (collected by local governments on behalf of the centre) to a more moderate level of taxation. However, this had the consequence that the tax to GDP ratio fell from more than 22 percent to about 12 percent by 1993, and more alarmingly, the central government share of collections fell from just under 60 percent in the early 1980s, to under 30 percent by 1993. This severely constrained the centre in pursuing macroeconomic and redistributive policy goals.

The debate at the time was whether the normative model of federal reforms should be followed: clarify spending responsibilities, and then adjust tax assignments accordingly—this was the “big bang” model (as in Russia). Alternative approaches at the time supported a view from the Chinese administration that it would be preferable to bolster central finances with the establishment of a State Administration of Taxation (for the first time in Chinese history), responsible for the collection of modern taxes, particularly the VAT. This view was accepted by the leadership, which was keen to avoid the difficulties that were apparent by then in Russia following the collapse of the Soviet Union—another example of international yardstick competition.

The new tax system operated immediately from 1994, and the spending assignments were to be addressed over time as the SOEs were reformed gradually [see Ahmad, et al. (1994); Ahmad, Qiang, and Tanzi (1995) and Ahmad, Li, and Richardson (2002)]. The VAT reforms in particular, were spectacularly successful, raising the central government share immediately, and helping to bring the tax/GDP ratio up towards 20 percent of GDP. The interests of the local governments in the tax reforms were protected by a “stop-loss” provision that ensured that all local governments would get the amounts that they received in 1993, and the new system would be phased in.

A new equalisation transfer system was established similar to the most advanced in the world [Ahmad, et al. (1994) and Ahmad (1997)], but its operations were phased in over time, and a declining “revenue transfers” system was constituted in order to protect the employment and growth potential of the coastal regions [Lou Jiwei (1997)]. Reforms of the budget, treasury and reporting systems were also set in motion in the late 1990s, in a sequencing of measures to prepare for the operations of a modern economy. A second phase of the reforms is now needed, to clarify the spending responsibilities of the lower levels of government, and also examine own-source revenues and debt in a way to optimise land and local resource use.

The Chinese reforms during 1993-4 were an excellent example of the positive approach to intergovernmental issues in action, and the importance of a new tax administration as well as a non-distortive tax, such as the VAT. There was no concern that the VAT would either affect the poor or hurt investment or growth. In fact, the form of the VAT that was in operation for the first 15 years after implementation was the

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12 Ahmad, Ehtisham, GaoQiang and Vito Tanzi (1995) Reforming China’s Public Finances. IMF, Washington, DC, and also published by MOF, PRC.

“investment” type VAT that does not provide credits or refunds for capital purchases—this did not, however, seem to affect either investment or growth, that have been spectacularly high during this period. The move to a more normal consumption-type VAT was only initiated recently.

Federal Countries

The return to democratic and multiparty rule in the federal countries was complicated by the multilevel government structures, especially in Brazil. Despite many difficulties and challenges (faced in common with Argentina and Mexico, including the international economic crises, as well as the periodic difficulties with sub-national debt) the Brazilians implemented some essential institutional reforms, including robust information management systems, that have stood them well over the years, including with the implementation of the Fiscal Stabilisation Pacts. These have been harder to replicate in Argentina, Mexico or Peru, or Russia for that matter, with the consequence that these countries remain much weaker than Brazil in managing crises involving subnational governments.

As in the unitary states, the centralising effects of implementing a VAT (the Brazilian VAT is an exception)\(^\text{14}\) have been accompanied by the suppression of subnational own-taxes. This goes against the spirit of the democratisation reforms, and has been partially offset by an effort to establish greater spending autonomy by lower levels of government. But without major own-source revenues at the margin, this has tended to be with rather less accountability than ideal, laying the seeds for future sub-national crises. This process is complicated with the legacy systems of extensive earmarking, and overriding of local preferences, especially though not exclusively in Brazil.

Ironically, the centralising effect of the conditional cash transfers, especially Oportunidades and the Bolsa Família, which in the Brazilian case supplanted state level programmes has gone in the opposite direction. Ironically, the conditional cash transfers have been strongly supported by the World Bank,\(^\text{15}\) which also has been one of the agencies most in favour of decentralisation—especially in terms of the effectiveness of service delivery as well as claims that it might reduce corruption.\(^\text{16}\) It appears that the overlapping system of responsibilities has helped in facilitating the greater central role in social protection, and a case could be made to justify centralisation of this function. But, as the actions relating to conditional cash transfers involve both primary health care and education, the case becomes quite complex. That said, the role of the international agencies in influencing policy in the large federal countries in Latin America, or India, must be open to question.\(^\text{17}\)

\(^{14}\)The Brazilian VAT, which is composed of a federal and lower government level VATs, is no role model, leading to production distortions and evasion possibilities, and successive administrations have been trying to reform it without success over the past ten years.


\(^{17}\)Large federal countries such as Pakistan, which have been recipients of significant World Bank assistance over the years, have also tended to do what they want to, and have selectively used or distorted Bank advice to further parochial goals.
We examine the contrasting cases of federal countries, Brazil and Mexico, in this section, followed by a discussion relating to Pakistan.

**Brazil**

As in Peru, Brazil has oscillated between centralisation and decentralisation over time. However, the 1988 Constitution moved the country firmly towards greater decentralisation, with states and municipalities getting effective controls over major revenue bases and an increasing share of centrally collected revenues, as well as greater controls over expenditure management and access to credit, including through banks owned by the subnational governments. All this occurred within the typical Latin American context of overlapping spending responsibilities [Afonso and de Mello (2001)]. These contributed to an inevitable financial and macroeconomic crisis that had to be dealt with in a coordinated manner. In this section we describe some of the key elements that have “rescued” and strengthened Brazilian federalism, although deep-seated problems remain and need to be addressed within a “positive” or “political economy” context.

The 1988 Constitution introduced a multi-level VAT, with states having access to control over rates and base (including setting of exemptions) of a broad based high yield VAT (ICMS), the federal VAT base was limited to industrial goods, and municipalities were assigned a sales tax on municipal transport and property. This disjointed VAT assignment has been criticised as creating distortions, impeding inter-state trade, and opening up evasion (also known as “invoice tourism”). Proposals to move towards a Canadian-style dual VAT, among others, have been on the anvil for at least 10 years, but it has proved quite difficult to introduce a change that involves states that are controlled by different parties making coordinated reforms. However, the strength of the current arrangement is that sub-national governments have control over a major tax base at the margin—this makes it feasible to impose hard-budget constraints on the sub-national governments, as no bailout provisions then become credible.

Although a larger share of federal revenues was to be transferred to the subnational governments, this was largely earmarked, accentuating the overlapping rigidities in the Brazilian assignments. It also reduced the scope for the federal government in making macro-adjustments—as the revenue effort needed for a specified level of adjustment increases proportionately (as it is not evident that the lower levels of government would agree to make the same level of adjustment as needed by the federation). Because of the sharing arrangements, the federal government has resorted to raising revenues that are not shared with lower levels—such as payroll and turnover taxes that encourage the development of informal labour markets and negatively affect competitiveness [Afonso and de Mello (2001)]. This pattern effectively replicates the Mexican pattern of financing sources for an increasingly important federal conditional cash transfer programme (the Bolsa Familia, that is modeled on the Oportunidades programme—see below).

In addition to the control over own-revenues at the State level, the second major structural advantage that Brazil has over other Latin Federations is that it has an effective

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19See Tanzi (2010).
mechanism to monitor spending at federal and subnational levels. This is through the GFMIS (SIAFI) that was introduced soon after the Constitutional change, along with an effective Treasury Single Account. This tracking of spending, together with credible sanctions that are facilitated by own-source subnational revenues, has made it possible to address sub-national debt problems in a coordinated manner.

Despite the increasing share in federal revenues following the new constitution, imbalances at the sub-national level appeared quickly, aided no doubt by the unclear spending responsibilities. Captive lending by banks owned by state governments added to the problems, as many subnational governments financed their deficits by borrowing from their state banks, in a period of high inflation, in anticipation of federal bailouts. Although the states and municipal governments had a small operational surplus at the start of the decentralisation process (0.7 percent of GDP in 1991), consistently high deficits in the following years led to a tripling of the stock of subnational debt through the decade (to over 21 percent of GDP by the late 1990s). Federal assumption of the subnational debt was accompanied by the agreement leading to the Fiscal Responsibility Law (FRL), and restoration of hard budget constraints at the sub-national level. This also involved elimination of borrowing from and privatisation of state-owned banks, and strictly enforced restrictions on additional borrowing, including imposition of ceilings for borrowing for investment (the “golden rule”).

The success of the FRL in Brazil has led to an “international yardstick competition” response by international agencies to replicate this in other countries, including in Latin America, as well as in countries like Pakistan and Nigeria. In the absence of the basic preconditions, including subnational own-source revenues, and full information flows on sub-national operations, the success of Brazil has not been so easily replicated, as seen in the Bolivia and Pakistan contexts.

International agencies have tried to replicate some Brazilian (and Mexican, see below) success stories in the area of social protection—particularly conditional cash transfers. In the post decentralised world, prosperous states blocked federal spending in poorer states for fear of losing federal funds. This shifted the focus to poor areas within states, so that poor areas in rich states would benefit from greater financing than poorer areas in poor states, accentuating overall inequalities. However, given the overlapping responsibilities on the spending side, the federal government was able to enter into joint ventures in the social area, including preventive health care, primary and secondary education and income support. Since 2003, during the period of the Lula administration, the federal and subnational initiatives have been rolled into the Bolsa Família.21 In effect, overlapping and ineffective social benefit programmes at the subnational level have been rolled into a federal programme. While this addresses the issue of uniformity of treatment across the country—a deficiency pointed out by Afonso and de Mello (2001) it comes at the cost of a recentralisation effort in areas of basic subnational competence and responsibility.

While Brazil appropriately learnt from the Mexican example with Oportunidades, it is not clear that this was specifically recommended by the international agencies (although both

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20For details of the FRL, see Afonso and de Mello (2001).
21This includes the Bolsa Escola, that supplanted several municipal programmes, Bolsa Alimentação, AuxílioGás, CartãoAlimentação and the cash transfer component of Programa de Erradicação do TrabalhoInfantil. See http://www.mds.gov.br/bolsafamilia.
the World Bank and the IMF are now instrumental in spreading the gospel concerning Oportunidades type conditional cash transfers.\textsuperscript{22} The critique of the effective financing arrangements for the Oportunidades programme (see below) will also apply to the Bolsa Família. A reform of the financing arrangement remains contingent on the political economy constraints will involve the VAT and revenue-sharing arrangements, and will involve not just the tax reforms but also the redesign of equalisation and earmarked transfers.

**Mexico**

In the Mexican context, the underpinnings of the decentralisation reforms were not as strong as in Brazil. This involved centralisation on the revenue side involving the VAT, and inadequate information systems to monitor and evaluate spending at the federal and subnational levels. The subnational debt crises in Mexico also affected macroeconomic stability, as in Brazil, but did not lead to the same level of institutional reforms as in the Brazilian case.

The Mexican introduction of the VAT led to the removal of 30 federal excises and turnover taxes as well as 300+ state and local taxes [Gil Diaz (1987)].\textsuperscript{23} As in Argentina and Brazil, the tax reforms were accompanied by the introduction of (fairly complicated and non-transparent revenue sharing mechanisms. The loss of effective controls over revenues at the margin from the states was not appreciated in terms of policy or theory, and remains problematic in terms of the accountability of subnational governments. Gil Diaz noted early on that the formula for sharing should be revised so that it “does not pit states against each other, the formula must be one that does not generate a pie that must be divided so that somebody’s gain is someone else’s loss.”\textsuperscript{24} However, the greater reliance on shared revenues had the effect of “sharing up a pie” and the ensuing inter-state conflict began to be reflected almost immediately in a tussle over relative shares. Gil Diaz also noted the reduced incentives for state governments to maintain efficient tax administrations. In a sense, although the political economy literature of fiscal federalism had not gained much currency, policy-makers were often quite aware of the political economy consequences of their actions.

The Mexican VAT was also problematic in its inadequate revenue-raising aspect, as it tried to meet distributional objectives through a series of exemptions and zero-ratings, as well as lower rates for border regions (some which occurred several hundred miles away from any border. This impacted on its efficiency, resulting in one of the worst VATs in Latin America. However, when Gil Diaz became Secretary of Hacienda in the late 1990s (in the Fox Administration), he was unable to reform the VAT, given the interlocking set of vested interests in the exemptions and zero-ratings, as well as those resulting from the design of the revenue-sharing system. At this stage, it became clear that the reform of the VAT is effectively an exercise in intergovernmental political economy, especially as one party PRI-dominated rule was replaced by a multi-party arrangement with PRI in the opposition and different parties controlling different states.

In the Mexican context, overlapping responsibilities further obfuscated responsibilities, and this was exacerbated by the economic crisis in the mid-1990s, where borrowing by state investment projects, without federal guarantees, led to a worsening of

\textsuperscript{22} The World Bank case for conditional cash transfers is nicely put in Fiszbein and Shady, 2009, and that of the IMF in Fedelino and Ter-Minassian, 2010, who claim this to be an example of international best practice, p. 85.


\textsuperscript{24} Gil Diaz, F., op cit., p. 348.
a banking crisis, precipitating the need for a federal bailout. Subnational debt limits were imposed, but the absence of a standardised budgeting and reporting framework at all levels of government remains a major constraint.

Institutional arrangements remain weak. In 1996, Mexico tried to introduce a Brazilian style GMIS (SIAF). The design also called for a TSA. By 2001, the system had failed, and even to this day after considerable additional support from the IMF and the World Bank, a proper GFMIS has not been implemented at the Federal level. The Treasury reforms appear to have been abandoned and along with this the likelihood of achieving the standardisation of information flows and controls needed for effective management (in the Brazilian mode). It is clear that there is significant opposition to the greater clarity that comes about with the Brazilian expenditure management model, and successive Mexican Finance Ministers since 1996 have tried but failed to implement this basic reform.

Ahmad, et al. (2007a) had stressed the importance of political economy considerations in suggesting greater clarity on the spending assignments, as well as tangible own-source revenue handle for the states. Following the Chinese example, they stressed that any tax reform that impacted on state transfers would have to indemnify the states from losses, and provide them with a share in the benefits to ensure political support for the reforms. A proposal for a dual VAT, or an IRAP-style state tax handle, was to have been accompanied by a reform of the revenue sharing and simplification of the transfer system. However, the government was more interested in bolstering federal revenues, and used the intuition of Ahmad, et al. (2007a) to introduce a federal ImpuestoEmpresarial a TasaUnica (IETU), at the same time simplifying and adjusting federal revenue shares to ensure that no state lost revenues from the reform. This subnational stop-loss provision was critical in the Chinese 1994 tax reforms, and was effectively copied by Mexico in 2007. However, the subnational tax handles and intergovernmental reforms agenda remain substantially unaddressed.

An effective cash transfer system, Oportunidades (initially called Progresa) was introduced to replace tortilla and gas subsidies. It is a federal programme linked to nutritional, educational and health care outcomes, has been reportedly very successful (Coady and Parker, 2002)\(^2\), and has been the basis for the World Bank’s strong advocacy of such programmes in Latin America and elsewhere [Fiszbein and Schady (2009), op cit]. However, this programme is financed by a distorting payroll tax [Levy (2008)], given the problems that the federal government has in raising general revenues with the “holes” in the VAT and the income taxes. In an economy rife with evasion and avoidance, and the presence of informal labour markets, Oportunidades reinforces incentives for greater informality. Also the size of the benefit has risen over time, as successive ministers have sought to put compensatory measures for all sorts of interventions on top of this scheme. Finally, state governments are aggrieved as they see this programme as cutting across their areas of responsibility in education and health care—further obfuscating the overlapping and murky spending responsibilities. Thus, there are a number of contradictions that need to be addressed in order to ensure that the programme continues to provide effective social assistance in a sustainable manner that does not distort incentives and limit growth potential.

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What is the Evidence on Decentralisation?

The evidence on the effects of decentralisation regarding improvements in service delivery in the OECD countries is mixed, as reviewed by Ahmad, Brosio, and Tanzi (2008). And, the evidence for developing countries is not much more conclusive, as reviewed in Ahmad and Brosio (2009)—see Table 2. The links between decentralisation

Table 2

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Countries of Reference</th>
<th>Period of Reference</th>
<th>Fiscal Variables of Reference</th>
<th>Growth Variables of Reference</th>
<th>Decentralisation Index</th>
<th>Main Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Akai and Sakata</td>
<td>US counties</td>
<td>1993-2000</td>
<td>GDP growth rate</td>
<td>Fiscal with emphasis on tax autonomy</td>
<td>Growth is positively related to tax autonomy and specifically to non-bailouts.</td>
<td></td>
</tr>
<tr>
<td>Arze del Granado MartinezVasquez and Mc Nab</td>
<td>45 countries developing countries</td>
<td>1973-2000</td>
<td>Ratio of education and health expenditures to total public expenditures</td>
<td>Fiscal decentralisation</td>
<td>Likely increase of expenditure for health and education.</td>
<td></td>
</tr>
<tr>
<td>Ebeland Yilmaz</td>
<td>19 OECD countries</td>
<td>1997-99</td>
<td>Public sector’s expenditures share of GDP</td>
<td>GDP growth rate</td>
<td>Increased spending in poorer areas.</td>
<td></td>
</tr>
<tr>
<td>Faguet and Sanchez</td>
<td>Bolivia and Colombia. Samples of municipalities</td>
<td>Mid 1990s early 2000s.</td>
<td>Fiscal decentralisation</td>
<td>Increased spending for education and expanded enrolments. Increase of subnational expenditure and reduction of national expenditure.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jin and Zou</td>
<td>17 industrial and 15 developing countries</td>
<td>1980-1994</td>
<td>Subnational, national, and aggregate government size: the ratio of total expenditure at corresponding level to GDP Investment road and education</td>
<td>Fiscal and regulatory decentralisation</td>
<td>Better adaptation of investment to local needs. Growth initially increases but then declines with decentralisation.</td>
<td></td>
</tr>
<tr>
<td>Solé-Ollé and Esteller-Moré</td>
<td>Spain (44 provinces)</td>
<td>1977-1998</td>
<td>Fiscal and regulatory decentralisation</td>
<td>Better adaptation of investment to local needs. Growth initially increases but then declines with decentralisation.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Thiessen (2000)</td>
<td>26 mainly developed countries</td>
<td>1975-1995</td>
<td>Annual growth rate of real gross fixed capital formation (as indicator of physical investment) Growth rate of per capita GDP Total factor productivity growth</td>
<td>Fiscal decentralisation</td>
<td>Better adaptation of investment to local needs. Growth initially increases but then declines with decentralisation.</td>
<td></td>
</tr>
<tr>
<td>Thiessen (2003)</td>
<td>14 and 21 high-income OECD countries</td>
<td>1973-1998</td>
<td>Average annual investment share in GDP Log difference GDP per working-age person Average annual total factor productivity growth</td>
<td>Fiscal decentralisation</td>
<td>Better adaptation of investment to local needs. Growth initially increases but then declines with decentralisation.</td>
<td></td>
</tr>
</tbody>
</table>

Source: Ahmad and Brosio (2009).
and preference matching and with growth are often examined together. The studies confirm that any relationship, if it can be established, is at best weak and tenuous.

Perhaps the greatest lacuna in the decentralisation processes of developing countries, especially in Latin America (with the exception of Brazil), is the lack of sufficient action on adequate own-source revenues at the sub-national level. This may have been due to the normative approaches that suggest focusing first on the spending side, especially at the intermediate tier of government/states/provinces/departments. The same pattern is observed from Indonesia to Pakistan.

4. CHALLENGES FOR PAKISTAN

In the 1960s, the administration of Field Marshal Ayub Khan had experimented with a system of basic democracies—setting up an electoral college at the local level that also formed the basis of development activities in their regions. This effort at political “deconcentration” was abolished under the 1973 Constitution that restored the rights and functions of the provinces—that had been the main sub-national unit of governance under the 1935 Government of India Act, and had formed the basis for the Constitutions in both India and Pakistan after independence.

The Musharraf administration promoted a form of so called “decentralisation” in the post 9/11 period. While this was ostensibly a mechanism to get services closer to the people, and elected local officials, there was little attempt to adjust the spending assignments or financing arrangements, as in Indonesia (see above). While the process was clearly an attempt to by-pass the established political parties and the power centers in the provinces, the bilateral donors and multilateral banks rushed to support the process, along with the institutional reforms of the Federal Bureau of Revenue, and the government financial information systems (GFMISs) at all levels of government. Each of these reforms had failed, or was in significant difficulty, by the time that Musharraf left office in 2008.

Tax Reforms

The reform of the tax administration has been recognised as a priority since the early 1980s, and the Report of the Tax Reforms Commission headed by Qamar-ul Islam that called the then Central Board of Revenue as a hotbed of corruption and rent seeking. The GST that was introduced in 1990 under an IMF supported programme (but brought in through the back door, when the entire sales tax act was replaced as part of the finance bill). It was administered in a very arbitrary manner, with the tax administration treating it like a production excise [Ahmad (2010)], setting reference prices and continuing to give exemptions and preferences through a system of administrative orders (SROs) that provided ample opportunities for a continuation of the rent-seeking and corrupt practices that bothered the Qamar-ul Islam Committee in 1983. However, the ability to give preferences and exemptions and reward specific groups, and threaten to punish others without reference to Parliament, gave convenient handles to politicians of successive weak administrations to make friends and influence people. At the end of the 1990s, a committee led by former World Bank official, Shahid Husain, recommended the creation of an integrated revenue administration, using the modern principles of self assessment, arms’ length functional administration with minimal contact with taxpayers, and
consequently limited opportunities for rent seeking. This was supported by a large World Bank loan to create the new Federal Board of Revenue (FBR) on the Argentine Revenue Authority model. By the spring of 2008, the World Bank had classified the project as “unsatisfactory”. The functional organisation structure had not been created, an IT system was prepared in-house largely automating the old procedures, key productive structures had been taken out of the GST net (with domestic zero-rating, largely to offset delays in refunds and the pressures on these sectors from an overvalued exchange rate in a manner that would not attract attention from the WTO). In order to appear “investor friendly”, the audit system had been effectively abandoned in 2004-5. It is no wonder that the GST failed to raise revenues, as had been expected under the strategy to replace tariffs by the GST (the plan had been to replicate the Singapore strategy that had very effectively used this method).

The Pakistan efficiency of the GST by 2009 had declined to around .26 (as measured by the C-efficiency ratio, [see Ahmad (2010) for more details], and the collection had declined to 3.1 percent of GDP, down from 3.9 percent in the 1990s (see Table 3). If Pakistan were to achieve a C-efficiency of Sri Lanka (from around 2004 at the height of the civil war), it would more than double the collection, or get to around 7 percent of GDP with a 15 percent rate. It is worth noting that the Chinese VAT generates around 9 percent of GDP, and still has some scope for increase, given that the local business tax has still to be folded into the VAT net [Ahmad (2008)].

The economic crisis of 2007-2008 led to a significant rise in the budget deficit and overall debts—leading to a haemorrhaging of record high reserves. A government stabilisation plan of September 2008 (see Table 4) was based on raising the tax/GDP ratio 5 percentage points, and formed the basis of the submission to the IMF. The argument was that the government needed roughly two years to revive and implement the Shahid Husain plan to restructure the FBR, and the IMF monies would be a “bridging loan” while this reform took effect.27

Table 3

<table>
<thead>
<tr>
<th></th>
<th>Standard Rate</th>
<th>Revenue/GDP</th>
<th>Productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pakistan (1990s)</td>
<td>15</td>
<td>3.4</td>
<td>.39</td>
</tr>
<tr>
<td>Pakistan (2005)</td>
<td>16</td>
<td>3.1</td>
<td>.26</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>15</td>
<td>6.7</td>
<td>.47</td>
</tr>
<tr>
<td>Philippines</td>
<td>12</td>
<td>4.3</td>
<td>.45</td>
</tr>
<tr>
<td>Turkey</td>
<td>18</td>
<td>7.1</td>
<td>.48</td>
</tr>
<tr>
<td>Lebanon</td>
<td>10</td>
<td>5.1</td>
<td>.50</td>
</tr>
<tr>
<td>Jordan</td>
<td>16</td>
<td>10.1</td>
<td>.62</td>
</tr>
<tr>
<td>Korea</td>
<td>10</td>
<td>5.7</td>
<td>.67</td>
</tr>
<tr>
<td>Singapore</td>
<td>5</td>
<td>1.8</td>
<td>.63</td>
</tr>
<tr>
<td>New Zealand</td>
<td>12.5</td>
<td>8.9</td>
<td>.93</td>
</tr>
</tbody>
</table>

27The former head of the Argentine Revenue Authority was hired by the World Bank, and prepared a plan to enable a reformed VAT to be implemented in a reformed FBR by summer 2010, the key date under the IMF programme [Silvani, Carlos, Edmund Biber, William Crandall, Wyatt Grant, Orlando Reos and Geoff Seymour (2008) Pakistan: A Tax Administration Review. The World Bank].
<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Revenue</strong></td>
<td>1809</td>
<td>1954</td>
<td>2507</td>
<td>3058</td>
<td>3670</td>
<td>4384</td>
</tr>
<tr>
<td><strong>Tax Revenue</strong></td>
<td>1308</td>
<td>1378</td>
<td>1841</td>
<td>2326</td>
<td>2886</td>
<td>3531</td>
</tr>
<tr>
<td>Federal</td>
<td>1251</td>
<td>1319</td>
<td>1777</td>
<td>2253</td>
<td>2802</td>
<td>3436</td>
</tr>
<tr>
<td>of which: FBR</td>
<td>1250</td>
<td>1319</td>
<td>1777</td>
<td>2253</td>
<td>2802</td>
<td>3436</td>
</tr>
<tr>
<td>Provincial</td>
<td>57</td>
<td>59</td>
<td>64</td>
<td>74</td>
<td>84</td>
<td>95</td>
</tr>
<tr>
<td><strong>Non-tax Revenue</strong></td>
<td>501</td>
<td>576</td>
<td>667</td>
<td>731</td>
<td>784</td>
<td>853</td>
</tr>
<tr>
<td>Federal</td>
<td>411</td>
<td>481</td>
<td>544</td>
<td>591</td>
<td>622</td>
<td>668</td>
</tr>
<tr>
<td>Provincial</td>
<td>90</td>
<td>95</td>
<td>122</td>
<td>141</td>
<td>162</td>
<td>185</td>
</tr>
<tr>
<td><strong>Total Expenditure</strong></td>
<td>2391</td>
<td>2536</td>
<td>3153</td>
<td>3730</td>
<td>4319</td>
<td>5010</td>
</tr>
<tr>
<td><strong>Current Expenditure</strong></td>
<td>1919</td>
<td>2115</td>
<td>2545</td>
<td>2917</td>
<td>3308</td>
<td>3745</td>
</tr>
<tr>
<td>Federal</td>
<td>1402</td>
<td>1598</td>
<td>1905</td>
<td>2179</td>
<td>2465</td>
<td>2791</td>
</tr>
<tr>
<td>Interest Payments</td>
<td>523</td>
<td>618</td>
<td>752</td>
<td>849</td>
<td>948</td>
<td>1074</td>
</tr>
<tr>
<td>Others</td>
<td>879</td>
<td>980</td>
<td>1152</td>
<td>1329</td>
<td>1517</td>
<td>1718</td>
</tr>
<tr>
<td>Provincial</td>
<td>517</td>
<td>517</td>
<td>640</td>
<td>738</td>
<td>843</td>
<td>954</td>
</tr>
<tr>
<td><strong>Development and Net Lending</strong></td>
<td>472</td>
<td>421</td>
<td>608</td>
<td>812</td>
<td>1011</td>
<td>1264</td>
</tr>
<tr>
<td>Federal</td>
<td>322</td>
<td>271</td>
<td>368</td>
<td>499</td>
<td>611</td>
<td>740</td>
</tr>
<tr>
<td>Provincial</td>
<td>150</td>
<td>150</td>
<td>240</td>
<td>314</td>
<td>400</td>
<td>525</td>
</tr>
<tr>
<td><strong>Budget Deficit</strong></td>
<td>–582</td>
<td>–582</td>
<td>–646</td>
<td>–672</td>
<td>–649</td>
<td>–625</td>
</tr>
<tr>
<td>% of GDP (mp)</td>
<td>–4.7%</td>
<td>–4.3%</td>
<td>–4.0%</td>
<td>–3.6%</td>
<td>–3.1%</td>
<td>–2.6%</td>
</tr>
<tr>
<td><strong>GDP (mp)</strong></td>
<td>12280</td>
<td>13493</td>
<td>16008</td>
<td>18494</td>
<td>21077</td>
<td>23675</td>
</tr>
</tbody>
</table>

| Total Revenue                | 14.7%         | 14.5%               | 15.7%  | 16.5% | 17.4% | 18.5% |
| Tax Revenue                  | 10.7%         | 10.2%               | 11.5%  | 12.5% | 13.7% | 14.9% |
| Federal                      | 10.2%         | 9.8%                | 11.1%  | 12.2% | 13.3% | 14.5% |
| of which: FBR               | 10.2%         | 9.8%                | 11.1%  | 12.2% | 13.3% | 14.5% |
| Provincial                   | 0.5%          | 0.4%                | 0.4%   | 0.4%  | 0.4%  | 0.4%  |
| **Non-tax Revenue**          | 4.1%          | 4.3%                | 4.2%   | 4.0%  | 3.7%  | 3.6%  |
| Federal                      | 3.3%          | 3.6%                | 3.4%   | 3.2%  | 3.0%  | 2.8%  |
| Provincial                   | 0.7%          | 0.7%                | 0.8%   | 0.8%  | 0.8%  | 0.8%  |
| **Total Expenditure**        | 19.5%         | 18.8%               | 19.7%  | 20.2% | 20.5% | 21.2% |
| Current Expenditure          | 15.6%         | 15.7%               | 15.9%  | 15.8% | 15.7% | 15.8% |
| Federal                      | 11.4%         | 11.8%               | 11.9%  | 11.8% | 11.7% | 11.8% |
| Interest Payments            | 4.3%          | 4.5%                | 4.7%   | 4.6%  | 4.5%  | 4.5%  |
| Others                       | 7.2%          | 7.3%                | 7.2%   | 7.2%  | 7.2%  | 7.3%  |
| Provincial                   | 4.2%          | 3.8%                | 4.0%   | 4.0%  | 4.0%  | 4.0%  |
| **Development and Net Lending** | 3.8%      | 3.1%                | 3.8%   | 4.4%  | 4.8%  | 5.3%  |
| Federal                      | 2.6%          | 2.0%                | 2.3%   | 2.7%  | 2.9%  | 3.1%  |
| Provincial                   | 1.2%          | 1.1%                | 1.5%   | 1.7%  | 1.9%  | 2.2%  |
| **Budget Deficit**           | –4.7%         | –4.3%               | –4.0%  | –3.6% | –3.1% | –2.6% |


The revised VAT law was meant to remove the distortions in the GST—especially the domestic zero-rating and exemptions that were largely designed to benefit special interest groups, and paripassu, consumers of luxury textiles and oriental carpets. The other main objective had been to create the basis for an arms’ length tax administration based on self-assessment and effective audit, minimising the problems of direct contact between the tax administration and taxpayers, and also the difficulties with the issue of
refunds that had created considerable rent seeking. A critical additional objective was to remove the ability of the tax administration to confer benefits on the chosen few through the notorious SRO system, and the new law required any such change to be submitted to Parliament and that the FBR would be stripped of this power. Finally, given that the GST law had been brought in through the back door and was full of “holes”, and the newly elected Parliament had warned the Government that no significant fiscal reform should be sneaked in again through finance bill, it was decided that a new law on the VAT should be submitted to Parliament.

The “streamlined” VAT law which would also have replaced multiple rates (from 17 to 26 percent) and cascading associated with reference prices, by a single rate and considerable simplicity, including elimination of SROs, was badly sold to the public and the parliament. This was partly due to the opposition from the vested interest groups that had benefited from the holes in the GST, and partly due to reluctance on the part of the tax administration to relinquish its “rent seeking powers” and the loss of the SRO handles. Although a corrupted version of the VAT bill (retaining some draconian powers for FBR) was passed by the Senate, there was enough opposition to the bill in the lower house to stall it on the absurd grounds that it would “crush the poor”, without empirical or analytical support. In reality, the poor would be largely unaffected by the GST, but will surely crushed by the resort to deficit financing and borrowing from the banking system that would surely result, and indeed this has occurred.

In order to “rescue the IMF programme”, the government proposed a Plan B in March 2011, to remove the main “exemptions” under the GST, but without the full overhaul of the law. This was to remove by administrative order the SROs that had led to the exemptions. This option faced no legal difficulty. However, this would not have raised much additional revenue, and may even have led to less revenue in the short run, but would clearly indicate the seriousness of the authorities to tackle vested interests. This reform lasted less than a fortnight, as the vested interests coalesced, and the proposals were replaced with a far worse situation with the SRO283, issued on April 1, 2011.

SRO 283 provided all sorts of exemptions and lower rates to all manner of final and intermediate goods—184 items in all, and recreated “cascading” that is the antithesis of a GST. Finally, item 185 stipulated that any other exemptions that might be needed in the future would be included without having to issue an additional SRO—this is SRO making ad absurdum. More problematic is that the FBR effectively reversed the logic of the functional tax administration by inserting audit in the regional offices, giving immense power to tax assessors that now also have access to information from the database of the National Database Registration Agency (NADRA). Without adequate safeguards, there will be enhanced scope for rent seeking in a reinvigorated administration reliant on the SRO culture.

From the perspective of repaying the IMF, any action on the GST now is too late, raising the specter of reliance on taxes that are less investment and growth-friendly, or inflationary credit expansion and continued borrowing from the banking system crowding out the private sector.
Decentralisation

The story on decentralisation is more hopeful in some respects, yet suffers equally by the failure on tax reforms.

The newly elected Parliament pushed through a reform of the Constitution, with the 18th Amendment during 2010. This eliminated the concurrent lists of the Constitution, giving provinces sole powers in a number of areas, including health and education. This reform was preceded by the award of the National Finance Commission that increased the provincial share in federally collected revenues, predicated on an increase in the tax/GDP ratio given the proposed reform of the GST and other taxes. The 18th Amendment reiterated the right of the provinces to administer the GST on services, if they so desired—the revenues belong to the provinces in any case.

The split base of the GST relating to goods and services is unique to the sub-continent, and had its origins in the 1935 Government of India Act that assigned the sales tax on goods to the states/provinces. After independence, the goods part was taken over the Federal Government in Pakistan, and the more difficult element on services was left to the jurisdiction of the provinces, reiterated in the 1973 Constitution. As there was no GST or VAT at that time, the complexity of this assignment was not realised. Thus, Pakistan finds itself in a unique position as being the only country in the world trying to implement a GST on services at the sub-national level, without the administrative machinery to do so. Even if it had the administrative machinery, this would be a herculean task.

A cooperative solution would have been to permit the FBR (or a new administration on the Peru model, serving all levels of government) to collect an integrated GST for the federation and all provinces, close loopholes and deliver a larger pie to the provinces directly, as well as through the common divisible pool. After all, this was the basis of the NFC award. However, one province rejected the proposal. A complex alternative mechanism was designed to get around this difficulty, with the current FBR effectively operating the crediting and refund mechanisms associated with the GST—the only agency capable of doing so. But, as discussed above, vested interests opposed fixing the loopholes in the GST. This risks an untenable situation in which there will be insufficient financing available for the devolved functions, and will result in unfunded mandates. This could trigger a significant backlash against the devolution process.

The speed at which the spending functions were devolved meant that there was inadequate attention given to the role of “subsidiarity”, the role of regulations, as well as coordination of functions that have associated externalities, such as primary health care, university education, climate change and environment and natural disasters. In addition, more work is needed on the effective service delivery aspects at the local levels, and the possible inadequacy of local incentives in providing for the most vulnerable—e.g., the aged without extended family support, single women, and minorities. This could lead to significant miscarriages of justice and equity in the future.

A more fundamental problem lies in the absence of effective own-source revenues at the provincial or local levels. As seen in the Latin American and East Asian cases, this is the Achilles’ heel of the devolution process in many countries, leading to a loss of accountability and responsibility for local service delivery. A share in the divisible pool,
or the unstable assignment of the GST on services do not count as effective own-source revenues.

Clearly, significant additional work is needed to make the 18th Amendment work without unravelling the Federation.

5. ALLAMA IQBAL AND MAKING THE FEDERAL STRUCTURE WORK IN PAKISTAN

The devolution process that has begun with the 18th Amendment presents a great opportunity to change the way that public policy is formulated in Pakistan, and hopefully to make it more responsive to the needs and desires of the population. However, if the GST reforms do not succeed, given the vociferous opposition by the vested interests who have benefited by exemptions and zero rating at this point in time, the entire devolution process would run into trouble, as would the current NFC award. This seriously risks the implosion of the existing intergovernmental fiscal system. Indeed the GST itself has ironically been made out to be the most “hated” tax—by the very groups that should welcome the removal of distortions and the creation of a level playing field.

But the intergovernmental reform may be able to muddle along, even given the lack of attention given to the revenue assignment issue. At the outset, the ideal-type single an integrated VAT, and cooperative and simple revenue-sharing arrangement described by Dr Tanzi in his distinguished lecture [Tanzi (2010)] is just not feasible in the Pakistan context, nor in most complex and multi-level federations. However, as Ahmad (2010) has shown, the patchwork needed to make the Constitutional assignment to provinces of the services base under the GST is not stable, can be blocked by any one province in isolation, and could generate tax wars between provinces. This will necessitate innovative solutions, that are more stable, but which provide provinces with significant tax handles that are needed for greater accountability for sub-national spending and fiscal arrangements.

Inevitably, the solutions may mirror the need to integrate the GST along the lines discussed in the context of the Indian Finance Commission, and recommendations for reforming the Brazilian system, involving “piggy-backing” or dual VAT arrangements. Such measures would need to be accompanied by an equalisation framework for the poorer provinces in order to reduce the disincentives and distortions that are inherent in the current revenue sharing and transfer design mechanisms. This would represent a significant research agenda that could usefully be followed by policy/research teams in preparation for the next Finance Commission.

Perspectives of Allama Iqbal

Allama Iqbal would have been appalled by the display of “khudi” in Pakistan over the past three years since the restoration of the “democratic process” and the economic crisis. Unfortunately, the khudi on display is more akin to the narrow and parochial

28This has been couched in “populist” terms as affecting the interests of the poor—whereas in fact a properly functioning tax system would reduce the government’s borrowing requirements and the current inflationary pressures. It is also unlikely that relative prices would change adversely for the poor with the removal of these extraordinary benefits for the pampered sectors and a downward revision and consolidation of the rate restructure of the GST.
calculus of politicians of all shades looking at their own selfish party interests at the cost of the country’s short and long-term interests. In evidence also is the khudi of officials of the tax administration ready to sabotage any circumspection of their powers of influence, rent seeking and extortion. The khudi of Iqbal, representing shared national interest and identity is not much in evidence.

The inability or unwillingness to fulfil promises and assurances made to the international community in order to secure IMF and other multilateral and bilateral loans feeds into the stereotype of an unreliable polity and administration. The paralysis in the face of economic crisis, possible debt defaults and unsustainability of the fiscal stance is reflective of Iqbal’s warning of a democratic process that cloaks domination in the garb of freedom, but binds the dispossessed even further—effectively representing the death of national khudi (see Verses 2 and 3 above).

The likely centrifugal forces that could be unleashed by an unbalanced decentralisation process that is unfunded and that does not enhance service delivery, accountability and responsibility is an even greater danger—as again foreseen by Iqbal (Verses 1). One can only hope that the national motto of “unity, faith and discipline” is renewed in a time of extreme crisis, eschewing reliance on foreign assistance or milking geopolitical location to extract rents, thus breaking the “begging bowl” as had been claimed by Prime Minister Shaukat Aziz when the last IMF programme was terminated prematurely. Perhaps the cooperative spirit that led to the 18th Amendment will also result in a ray of hope to make it work, and for the “national khudi” to be rekindled. This is the ray of hope that Iqbal refers to in Verses 5 below.

Verses 5: A Ray of Hope?

- Jānhaimohramasrārshud
  - A new life has been breathed into the people
- Khavarazkhābgarānbīdarshūd
  - Waking them from a deep sleep
- Jazbehūtizouradēand
  - New aspirations have been given
- Bandhatkohnēhrabegushadēand
  - Old chains have been broken

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