Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning from China

Ehtisham Ahmad
Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning from China

May 2013

Dr Ehtisham Ahmad Visiting Senior Fellow, Asia Research Centre, LSE
Email: s.e.ahmad@lse.ac.uk

All rights reserved. Apart from any fair dealing for the purpose of research or private study, or criticism or review, no part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means without the prior permission by the publisher or author (2013).

For further information, please contact:

Asia Research Centre (ARC)
London School of Economics & Political Science
Houghton Street
London
WC2A 2AE
United Kingdom

E-mail: arc@lse.ac.uk
www.lse.ac.uk/collections/AsiaResearchCentre
Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning From China

Ehtisham Ahmad*

1. Introduction

The 18th Amendment to the 1973 Constitution of Pakistan disentangles overlapping spending responsibilities between the federation and provinces in a wide range of functions, devolving them to the latter. The legislation was also a reaction to relatively poor service delivery and living standards that had fallen continuously behind those in other countries in South Asia, and, indeed, are now lower than sub-Saharan Africa in most respects.

The Musharraf government had used this argument for its own decentralization effort—delegating power to the districts and bypassing the political centers of power in the provinces. The 18th Amendment reasserts the provinces’ power and the associated political centers of power. It is designed to weaken the center, and correspondingly make it less attractive for the military to assume power by moving against an elected Prime Minister, as it has done periodically in Pakistan’s history.

But will this major reform work effectively and ensure higher living standards for all people in all the provinces? To what extent is the need for a national identity important in ensuring that the decentralization does not cause the federation to unravel or the overall delivery of public services to deteriorate and lead to greater exclusion of the poor? These are important issues and could well determine the fate of the 18th Amendment as well as social stability in Pakistan.

Section 2 outlines developments in theory linking governance and the decentralization process. The links between the two are critical.¹ The

---

* The author is Senior Fellow, Center for Development Research, University of Bonn, and Asia Research Center, London School of Economics.
main question is whether decentralized service provision can better provide for the poorer sections of society by utilizing information that may be available at the local level in tailoring services to local preferences and making access easier. How are these responsibilities financed? Does the process impede closer economic integration between the federating provinces? We argue that positive approaches to intergovernmental reforms, as exemplified by the People’s Republic of China, are perhaps more important for countries such as Pakistan that face significant structural challenges.

Section 3 focuses on the 7th National Finance Commission (NFC) Award and key elements of the 18th Amendment. Their components are examined in relation to the main criteria for good governance, utilizing positive approaches to institutional and multilevel governance reforms. We argue that the failure of tax reforms poses serious difficulties both for the NFC and the stability of assignments arising from the 18th Amendment. These accentuate the danger of Pakistan becoming a “failed state”, highlighted by commentators prior to the NFC award or the 18th Amendment (see Haque, 2009).

In order to prevent dire consequences arising from the NFC award and the 18th Amendment in the presence of failed tax reforms and opaque governance, Section 4 outlines an agenda for urgent action that revisits archaic and inefficient revenue assignments dating back to the Government of India Act 1935. We conclude with some proposals that might be considered in the context of the next NFC award, and possibilities for another constitutional amendment on the revenue side to parallel that on the spending side. Joint action on tax policy and assignments, as well as the complete overhaul of the country’s tax administration framework are needed.

2. Normative or Positive approaches to Federalism and Decentralization?

In this section, we set the stage by reviewing the normative and positive approaches to decentralization, and examining theory and

---

1 See Burki and Perry (2000). See also Shah (2010), who also draws attention to the very important lessons that can be drawn from the Chinese experience.

2 This section draws on Ahmad (2010a) and Ahmad and Brosio (2006).
Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning From China

evidence, including the example of China. We also draw some lessons regarding preconditions for good governance in a decentralized framework, and link this to the Pakistan context in the subsequent sections.

2.1. Developments in Theory

The post-Second World War normative literature on fiscal decentralization has been much influenced by the experience of the US, and the work inter alia of Musgrave (1959) and Olson (1968). These were based on the assumption that governments are benevolent. This reflected the views of Montesquieu, and of Hamilton and Madison in the Federalist Papers, that a government should be small and its functions separated, with the center responsible for issues that affect all lower levels of government, such as defense and monetary policy. The assumption has been, particularly on the part of some bilateral and multilateral agencies, that decentralization leads to more efficient service delivery, higher growth, and poverty reduction.

Experiences outside the US, particularly in the European Union (EU) and especially in developing countries, have led critics to question the normative approach, spawning a surge in the “political economy” literature (see surveys in Ahmad & 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 “decentralized” operations. The main difference is that the assumption of “benevolent” government is dropped, and incentives facing politicians and bureaucrats become important as does the role of institutions and information flows.

Bardhan and Mookherjee (2000) write about the possibility of “capture” by vested interests (see also Ahmad & Brosio, 2011). Besley and Case (1995) introduce the concept of “yardstick competition” in which voters evaluate the performance of their local government in relation to the results achieved in neighboring jurisdictions. Given increasing mobility and information flows, 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 familiar (Salmon, 2010; Besely & Case, 1995).

The building blocks of both the 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 these instruments can vary, as we discuss below.

2.2. Decentralization Trends

The impetus to decentralize has differed in many cases. In Latin America, the shift from one-party or military rule has led to a resurgence of interest in decentralization as a means of consolidating political gains, whereas China—a large, one-party, unitary state—has actually been quite decentralized. The cross-country push to decentralize, supported by international agencies, is in line with the normative approach to decentralization on the grounds that it would lead to better service delivery and poverty reduction. However, the evidence on this is at best mixed (see Ahmad, Brosio, & Tanzi, 2008, for a discussion on the evidence in OECD countries). Table 1 gives some trends from Ahmad and Brosio (2009).

As in Pakistan, many Latin American countries have experienced some movement toward decentralization over the last 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 taken the opposite direction: countries have established more or less centralized systems for implementing value-added tax (VAT)—sometimes with the help of international agencies and particularly the International Monetary Fund (IMF)—often replacing myriad subnational taxes at the state and local levels.

Table 1: Main traits of recent intergovernmental reforms in selected countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Main characteristics of intergovernmental relations</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Federal system</td>
<td>Center administers VAT on behalf of states; reforms introduced in early 2000s.</td>
</tr>
<tr>
<td>Belgium</td>
<td>Federalization based on linguistic divisions</td>
<td>Transformed from unitary to federal state</td>
</tr>
<tr>
<td>Bolivia</td>
<td>Three-layered unitary system</td>
<td>Municipalities’ powers considerably increased. Election of governors of departments, some demanding substantial but asymmetrical powers—associated with natural resources.</td>
</tr>
</tbody>
</table>
Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning From China

<table>
<thead>
<tr>
<th>Country</th>
<th>Main characteristics of intergovernmental relations</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>Federal system based on three layers of government</td>
<td>National reform and coordination of VAT is an urgent priority, although proposals for reform since the late 1990s have not been acted on.</td>
</tr>
<tr>
<td>Canada</td>
<td>Federal system</td>
<td>Asymmetric federation (special treatment for Quebec)</td>
</tr>
<tr>
<td>China</td>
<td>Highly decentralized system within a unitary constitution; operates like a quasi-federation</td>
<td>Taxing power recentralized (1994)</td>
</tr>
<tr>
<td>Colombia</td>
<td>Three-layered unitary system</td>
<td>Extensive devolution of resources to provinces (departments); movement toward a quasi-federation.</td>
</tr>
<tr>
<td>Denmark</td>
<td>Unitary system with strong municipal governments</td>
<td>Recentralization of higher education and health since 2006</td>
</tr>
<tr>
<td>France</td>
<td>Regional system</td>
<td>Regulatory, fiscal, and political decentralization initiated</td>
</tr>
<tr>
<td>Germany</td>
<td>Federal system with extended concurrent responsibilities</td>
<td>Reforms to the federal structure initiated in a wide-ranging set of issues, but little change effected as a result of two commissions.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Unitary state</td>
<td>Extensive decentralization of spending powers to district-level administrations after the fall of the Suharto administration, accompanied by a new revenue-sharing arrangement.</td>
</tr>
<tr>
<td>Italy</td>
<td>Unitary, with asymmetric arrangements</td>
<td>Fiscal, regulatory, and political decentralization initiated with a new constitution</td>
</tr>
<tr>
<td>Mexico</td>
<td>Federal system with high political and low fiscal decentralization</td>
<td>Fiscal and regulatory decentralization since late 1980s, with basic education (1992) and healthcare (1996) devolved to states, although revenues have been effectively centralized since early 1980s.</td>
</tr>
<tr>
<td>Pakistan</td>
<td>Federal constitution with interludes of military rule</td>
<td>Deconcentration to districts in the early 2000s by Musharraf. Overlapping responsibilities on the spending side unwound with the 18th Amendment – most spending powers fully assigned to provinces. Relatively little subnational reliance on own-source revenues.</td>
</tr>
</tbody>
</table>
### Table: Main Characteristics of Intergovernmental Relations

<table>
<thead>
<tr>
<th>Country</th>
<th>Main characteristics of intergovernmental relations</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peru</td>
<td>Unitary state—moving toward a quasi-federation?</td>
<td>Election of governors of regions—sharing of natural resource revenues. Overlapping responsibilities with relatively limited spending or revenue devolution.</td>
</tr>
<tr>
<td>Poland</td>
<td>Unitary</td>
<td>Political and fiscal decentralization with emphasis on the local level</td>
</tr>
<tr>
<td>South Africa</td>
<td>Post-Apartheid constitution introduced a quasi-federal system</td>
<td>Devolution of extensive responsibilities for education and health to provinces</td>
</tr>
<tr>
<td>Spain</td>
<td>Regional, quasi-federal system</td>
<td>Transition toward a federal system. Fiscal equalization with own-source revenues at subnational level. Asymmetric assignments for some regions.</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Federal system</td>
<td>Equalization transfers from federation to cantons</td>
</tr>
<tr>
<td>UK</td>
<td>Regional</td>
<td>Introduction of regional government in Scotland and Wales</td>
</tr>
</tbody>
</table>

Source: Ahmad and Brosio (2009).

Despite the rhetoric, the approach on the spending side—particularly in the Latin American countries—has entailed mixed and overlapping responsibilities that have not been adequately addressed. This partly reflects the centralized tendencies of the past together with a paternalistic approach, including by donors who do not trust subnational governments to make the right choices for their citizens in their area of competence (including education and social policy in general), or who feel that the lower levels lack the capability to manage their affairs effectively.

The evidence on the effects of decentralization regarding improvements in service delivery in the OECD countries is mixed (see Ahmad et al., 2008). The evidence for developing countries is not much more conclusive (see Ahmad & Brosio, 2009). The links between decentralization 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 decentralization processes of developing countries is their lack of attention to adequate own-source
revenues at the subnational level. This may be due to the normative approaches that suggest focusing first on the spending side, especially at the intermediate tier of government/states/provinces/departments.

2.3. Political Economy in Action: China

In the 1990s Chinese context of murky spending responsibilities—where state-owned enterprises (SOEs) at different levels of government carried out a lot of social spending—in a legal unitary state with no central tax collection other than customs, the center had very limited ability to levy taxes. Economic reforms in the 1980s had moved from a system of 100 percent profits taxation targeting largely SOEs (collected by local governments on behalf of the center) to a more moderate level of taxation. However, this caused the tax-to-GDP ratio to fall from more than 22 percent to about 12 percent by 1993; more alarmingly, the central government’s share of collection fell from just under 60 percent in the early 1980s to under 30 percent by 1993. This severely constrained the center from pursuing macroeconomic and redistributive policy goals.

The debate at the time was whether the normative model of federal reforms should be followed, i.e., to clarify spending responsibilities and then adjust tax assignments accordingly—the “big bang” model also being used in Russia. Alternative approaches supported the Chinese administration’s view that it would be preferable to bolster central finances by establishing a state administration of taxation (for the first time in Chinese history) responsible for collecting modern taxes, particularly VAT (see Ahmad, Gao, & Tanzi, 1995). 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-sharing system with a central administration operated from 1994, and spending assignments were to be addressed over time as the SOEs were gradually reformed. The VAT reforms in particular were spectacularly successful, raising the central government’s share immediately and helping to bring the tax-to-GDP ratio up toward 20 percent of GDP (see Figure 1). The interests of the local governments in the

---

3 See also Ahmad, Li, and Richardson (2002); Ahmad, Lee, and Kennedy (1993); Ahmad et al., (1995); Ahmad, Craig, and Mihaljek (1994); Ahmad, Craig, and Searle (1994); Ahmad (1997); Lou (1997); and Ahmad, Brixì, Fortuna, Lockwood, and Singh (2003).
tax reforms were protected by a “stop-loss” provision that ensured that all local governments would get the amounts they had received in 1993 and the new system would be phased in. All local governments shared incrementally as the new taxes were implemented (rich regions benefited concomitantly). Political economy concerns were protected by an equalization system together with a Chinese innovation—“revenue returns”.

**Figure 1: China: Total tax revenue, local government revenue, and central government share of total revenue, 1985–2011**

Source: Ahmad, Rydge, and Stern (2013);

A new equalization transfer system was established similar to the most advanced in the world (Ahmad et al., 1994; Ahmad, 1997, 2012) but its operations were phased in over time. In the short run, a “revenue returned” system was constituted that “returned” resources to the regions generating them (over and above) the revenue-sharing arrangement. While this was criticized as increasing inequality, in reality it was an essential component of “protecting” overall growth and investment. With the freeing up of the labor market (there were now 150 million migrants working in the coastal areas), it was essential to ensure full employment and reduce poverty (Lou, 1997). This is again an example of a pragmatic “positive” action to meet the specific circumstances of a country in rapid transition, for which the normative models are of limited utility.
Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning From China

Reforms of the budget, treasury, and reporting systems were also set in motion in the late 1990s in a sequence of measures to prepare for the operations of a modern economy. A second phase of the reforms is now needed to clarify spending responsibilities at the lower levels of government, and also to examine own-source revenues and debt in a way that optimizes land and local resource use.

The Chinese reforms of 1993/94 are an excellent example of the positive approach to intergovernmental issues in action, and the importance of a new tax administration as well as a nondistortive tax, such as VAT. There was no concern that VAT would either affect the poor or hurt investment or growth. In fact, the form of VAT that was in operation for the first 15 years after implementation was the “investment” type that does not provide credits or refunds for capital purchases. This did not, however, seem to affect either investment or growth, which were spectacularly high during this period. The move to a more normal consumption-type VAT was initiated only recently as the need for efficiency became more pressing and the scope for raising revenues efficiently to around 25 percent of GDP became more difficult.

3. Preconditions for Good Governance

3.1. Overall Strategy for Sustainability

Normative approaches to fiscal federalism emphasize the sequencing in which “finance follows function.” There is considerable validity in this proposition, especially when marginal changes are envisaged. This “recommendation” is designed to avoid an unsustainable expansion in overall spending and with a view to maintaining macroeconomic stability. It is also an argument that countries should begin decentralization reforms by starting with a devolution process on the spending side first, followed by the reassignment of revenues.

The problems occur when finance does not follow function or when it encourages access to irresponsible financing mechanisms, such as borrowing without controls or accountability, or running up arrears. In such cases, a macroeconomic crisis is likely because local governments have every incentive to borrow and pass the buck to others. It is usually the central government that has to pick up the pieces, as in Latin America in the 1990s. In other countries, such as Nigeria, the absence of adequate local own-source revenues has meant that there was no incentive for local
governments to pay teachers under the devolution stipulated by the new constitution, and the functions had to be moved up to a higher level.

Additionally, under certain political economy circumstances, as in China in the early 1990s, it may make sense to start with the revenue side first to ensure that there are adequate overall revenues to match the spending needs of general government, i.e., of the central and subcentral governments and associated public sector undertakings. The 1994 reforms that facilitated substantially decentralized spending over the following two decades were predicated on an effort to consolidate central revenues, including though VAT, accompanied by automatic redistribution mechanisms such as revenue sharing, equalization, and revenue returns, all of which served different purposes. Thus, a careful redesign of the transfer system is critical if a major structural reform on the revenue side is to be attempted in a multilevel or federal country.

It is generally accepted that, in order to meet the Millenium Development Goal (MGD) objectives, a tax-to-GDP ratio of around 18 percent is necessary for all levels of government or general government (Ahmad, 2013). India and China have worked very hard to increase their tax-to-GDP ratios to around 20 percent of GDP, but given their substantive investment needs in education and physical infrastructure, and for a more environmentally friendly growth strategy, a tax-to-GDP ratio in the range of 25 percent is more likely required (see estimate for India in Figure 2; IMF, 2013).

**Figure 2: General government revenue and GDP per capita, 2012**

Note: The figure excludes oil exporters and microstates.
Pakistan’s tax-to-GDP ratio was 14.5 percent in the early 1980s, and had declined to 10 percent by 2008 at the onset of the macroeconomic crisis that led to a mega-loan from the IMF. This was predicated on fixing the tax system, especially the moth-eaten general sales tax (GST) replete with exemptions and “holes” for 65-year-old infant industries (to use a turn of phrase popularized by a prominent Pakistani economist, Dr Nadeem Ul Haque) and for friends and relatives of those in power. The tax reforms failed, leading to the suspension of the IMF program in 2011.

As the tax-to-GDP ratio slid below 9 percent in 2009, Haque (2009) correctly pointed to the dangers of Pakistan becoming a failed state. This level of tax effort barely finances debt servicing and defense, and leaves precious little for public services or investment at any level of government. Under these circumstances, a major structural shift involving a significant decentralization of spending to the provincial governments—unbundling the parallel responsibilities of government—is of little more consequence than shifting deck chairs on the Titanic.

3.2. Spending Assignments

A useful typology of spending responsibilities showing how different countries approach these issues is given in Figure 3. It addresses the subsidiarity principle, which states that assignments should be devolved to the lowest level capable of effectively providing them. This is a general principle of the EU’s legal framework, constraining the supranational level from legislation to areas where action at the national, regional, or local levels is insufficient (see “Consolidated Version of the Treaty”, 2002).

The concept has both legal and political ramifications. The focus is on scale as well as effects, including externalities, on other jurisdictions; this has given rise to actionable cases where there is a legal connotation, as in the EU.4 In political terms, the concept of subsidiarity is often taken beyond the multilevel government connotation to include the boundaries between the private sector and the role of the state (at any level). The assumption, especially by conservative commentators in the US, is that the

---

4 An interesting example is the European Court of Justice’s rejection of a case brought by the German government against the EU Directive on Deposit Guarantee Schemes (Case C-233/94).
private sector should be encouraged to provide public services as far as possible because this is expected to be more efficient than public provision.

Figure 3 shows the differing trends regarding the centralization/decentralization debate in different countries or regions. Arguments for the decentralization of functions are based largely on accountability and effective provision, given the subsidiarity principles. However, it is not enough to legislate the assignments—the lower levels have to have the capability as well as the incentive to provide services. Both are linked closely to the financing issue as well as incentives for effective provision. Thus, the argument that local governments lack “capacity” is not strictly binding if they have the financial resources to hire skilled workers.

**Figure 3: Modified subsidiarity principles**

Source: Adapted from Dafflon (2006).

An important hypothesis governing accountability comes through the electoral process when voters are able to assess the performance of their “elected” rulers in relation to standards in neighboring jurisdictions (see
Salmon 1987, 2006; Besley & Case, 1995). Again, the incentives are critical and voters are more likely to be responsive if, at the margin, local governments rely on own-source revenues over which they control rates or bases.

Offsetting the decentralization trends are concerns that limit subsidiarity—mainly externalities such as spillovers (including those with environmental considerations), congestion, and economies of scale. Moreover, decentralization, especially of resource bases, can exacerbate inequalities across regions and limit the extent of interpersonal redistribution that might be feasible. In all cases, the federal, central, or supranational agencies have a role to play in coordinating and harmonizing essential policies.

The US and certain other federations maintain a unified economic space facilitated by a “commerce clause.” In the EU, the common external tariff and harmonization of country-level VATs (see the EU Sixth Directive) ensure a common economic space to minimize harmful competition. Thus, a combination of legal and regulatory frameworks is essential to ensure equal treatment and opportunity. Again, for this to work efficiently, full information is needed on who spends what and on the buildup of assets and liabilities; as the recent EU experience illustrates, inadequate attention to the standardized flow of information could jeopardize a common economic space.

### 3.3. Full Information on Transactions, Including the Uses and Flow of Funds

A key element in accountable governance is timely information on the sources and uses of funds at all levels of government. This is critical for establishing benchmarks against which the performance of governments—federal, provincial, and district—should be evaluated. Typically, it involves using the IMF’s (2001) government financial statistics (GFS) manual standards for economic classification (wages, social contributions, interest, operations and maintenance, etc.), and the UN’s Classification of Functions of Government (COFOG) for education, health, and other functions. This

---

5 A recent extension by Salmon posits that cross-country comparisons may be even more important for voters.

should provide an indication of what revenues were generated, what was budgeted, and what was spent. In principle, this information for Pakistan should have been generated by the Project to Improve Financial Reporting and Auditing (PIFRA) project, which has been implemented over ten years at a cost exceeding USD 100 million (under a World Bank loan).

Most governments provide economic and functional data for each level of administration to the IMF’s GFS yearbook. Pakistan’s GFS page for the most recent yearbook only covers information on the budgetary central government. Given that most spending is at the subnational level or is carried out by agencies associated with the central government, the data in the GFS yearbook is less than useless for policy purposes. With declining outcomes in education and healthcare—where Pakistan is now falling behind sub-Saharan Africa—and donors’ focus on the social sectors, the absence of readily available information7 in these critical areas is a serious problem. This ensures that the electorates of the districts and provinces, indeed of the country as a whole, are comparatively uninformed about relative spending by the public sector in areas of key policy importance.

In addition to the financial information on public spending that forms the basis for evaluating governments at election time, it is important to have information on the outcomes of spending by the public sector. Again, this is a critical element in the operation of “yardstick competition” and in the operation of the electoral process to discipline governments.

The cash-basis of the budget process in Pakistan also poses problems: it permits “game-play” by the respective governments in terms of pushing liabilities into the future and bringing forward credits, e.g., the securitization of revenues or asset sales that inflate short-term revenues. A typical mechanism for hiding liabilities is to shift them on to SOEs. Astonishingly, in the early 1990s the IMF agreed to ignore the liabilities being generated in the SOEs (see Ahmad & Mohammed, 2013). This would not be appropriate under the IMF’s (2001) GFS manual framework and may have contributed to the buildup of circular debt in the country.

Public-private-partnerships (PPPs) are an increasingly convenient vehicle for “kicking the can of responsibility” down the road. This is true of

---

7 For example, on the websites of the Ministry of Finance, the Federal Bureau of Statistics, or the State Bank of Pakistan.
developing and developed countries alike and contributed significantly to the fiscal problem in the EU. It has led to tighter accounting rules, especially the recognition of “public” liabilities in PPPs. Consequently, the accounting rules regarding PPPs were also tightened, leading to a need for provisioning to prevent mechanisms to circumvent liabilities.

For full accountability, it is not sufficient to be able to track and report on budgeted amounts, eventually also focusing on the results of the spending. Equally important is tracking government cash. Typically, countries maintain treasury single accounts (TSAs) into which all public funds flow and from which all spending is authorized. Although in certain cases, commercial bank accounts may be needed to facilitate payments or receive revenues, these should not contain balances. These zero-balance accounts are linked with the TSA for overnight deposit of revenues or the reimbursement of authorized payments.

At the time the government was considering an IMF program in spring 2008, Finance Minister Dar asked for the government balance sheet to be drawn up. This indicated government balances of around USD 10 billion in commercial bank accounts at low or zero interest. Although the IMF’s 2008 program had a provision for the establishment of a TSA, this has not happened—both military and political governments are disinclined to be subject to the discipline and transparency of a TSA. As for the banks, they are quite happy to lend the same money back to the government as the deficit increases and is financed by bank borrowing.

With this opaque system, it is hard to impose accountability at any level of government. There is no information on what should be spent, is actually spent, or what is happening to public funds. Yardstick competition is impossible with a poor governance structure. As important as the tax reform has been in China, the establishment of a GFS 2001-compliant budget framework, and of TSAs at the central and provincial levels, has been equally important in instituting an effective system of decentralized investment and governance.

3.4. Own-Source Revenues, Transfers, and Access to Credit

A critical part of the story of accountable governance at the subnational level concerns “own-source” revenues. This relates to the ability of a lower-level government to raise revenues by varying the rate of a reasonable tax base. Thus, in North America, state and local governments
are able to set the rates of state or local income taxes using the federal tax base. This ensures that additional revenues can be generated in case of need. There need not be a state or local tax administration, and the federal tax administration could be used to do the “heavy lifting” in relation to IT, cross-referencing information, and audits. It can be thought of as a “piggy back” or co-occupancy of a tax base, in case there are parallel administrations.

Note that shared revenues are not strictly own-source revenues and are closer to transfers, since subnational governments can do little to influence the rate or base and are merely recipients of the revenues. Additionally, taxes administered by the central tax administration can be considered own-source if the local government is able to vary the rate. Analogously, if it is difficult to vary the rate of a subnational tax base (such as the GST on services), that tax base is not an effective “own-source” revenue.

Without an effective own-source revenue handle, it is not possible to hold a subnational government responsible for its debt or buildup of liabilities (Ambrosiano & Bordignon, 2006). This would weaken hard budget constraints, if any, and reduce local accountability. One of the biggest macroeconomic problems in Latin America during the 1990s was countries’ uncontrolled subnational borrowing, often from their own banks. Following the Brazilian lead in the late 1990s, many countries have constituted fiscal responsibility legislation at the subnational level. This too can, however, be oversold—such legislation is only as good as the systems to monitor and report on the buildup of liabilities. Moreover, hard budget constraints are critical and require, in turn, effective own-source revenues.

Even if a country has an assigned own-source revenue handle, lower levels of government may have little incentive to use it if they have access to badly designed transfers or credit for which the liability can be shifted to others. Thus, if central transfers are a function of actual deficits at lower levels (called “fiscal dentistry” in India; see Rao, 1998), they will have no incentive to use own-source revenues or spend efficiently.

It is thus clear from theory and practice that good governance at the subnational level is a complex set of policy measures where interaction matters in terms of generating appropriate incentives for accountability. It is likely that isolated reforms, such as for spending assignments in
Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning From China

isolation, may not work as anticipated and might even make matters worse.

4. Challenges for Pakistan: Stalled Reform Agenda

Although Pakistan has always been a federal country, extensive periods of military rule have led to perceptions of dominance by the center, despite attempts to “decentralize”. In the 1960s, Field Marshal Ayub Khan’s administration 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, which restored the rights and functions of the provinces—the main subnational unit of governance under the Government of India Act 1935 (the basis for both India and Pakistan’s constitutions after independence).

General Musharraf’s administration also promoted a form of so-called “decentralization” in the post-9/11 period. While it was ostensibly a mechanism to move services closer to the people and elected local officials, there was little attempt to adjust spending assignments or financing arrangements. Although the process was clearly an attempt to bypass the established political parties and power centers in the provinces, bilateral donors and multilateral banks rushed to support the process along with the Federal Board of Revenue (FBR)’s institutional reforms and government financial information systems at all levels of government. Each of these reforms had failed or was in significant difficulty by the time Musharraf left office in 2008 (see Ahmad & Mohammed, 2013).

The impetus for the 18th Amendment was primarily a reaction against a decade of military rule. It also came at a period of economic distress, after food and oil price shocks had severely affected the stability of an economy that had relied on capital inflows to generate growth and neglected domestic resource mobilization. The government’s approach to the IMF in 2008 was predicated on tax reforms—principally fixing the holes in the GST. At the same time, the NFC met to work on the 2010–14 award, keeping in view the provinces’ deplorable levels of spending on the social sectors, principally education and healthcare. The Finance Division’s Poverty Reduction Strategy Paper (PRSP) envisaged significant progress toward meeting the MDGs, for which additional resources were to have been allocated to the provinces. We argue that all three sets of reforms
were closely intertwined, and that the failure of the tax reforms has seriously jeopardized both the NFC award and the 18th Amendment.

4.1. Tax Reforms

The reform of the tax administration has been recognized as a priority since the early 1980s and the report of the Tax Reforms Commission headed by Qamar-ul Islam, which had called the then Central Board of Revenue a hotbed of corruption and rent seeking. A GST was introduced in 1990 under an IMF-supported program (but brought in through the back door, when the entire sales tax act was replaced as part of the finance bill). It was administered very arbitrarily, with the tax administration treating it like a production excise (Ahmad, 2010b), setting reference prices and continuing to give exemptions and preferences through a system of administrative orders (SROs) that provided ample opportunity for the rent-seeking and corrupt practices to continue. The ability to give preferences and exemptions and reward specific groups, while threatening to punish others without reference to Parliament, provided 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, an arm’s-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 FBR on the Argentine Revenue Authority model.

By the spring of 2008, the World Bank had classified the project as “unsatisfactory”. A functional organization structure had not been created and an IT system was prepared in-house that largely automated the old procedures. Additionally, key productive structures had been removed from the GST net with domestic zero-rating, largely to offset delays in refunds and ease pressure on these sectors from an overvalued exchange rate in a manner that would not attract the World Trade Organization’s attention. In order to appear “investor-friendly”, the audit system had been effectively abandoned in 2004/05. 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). An attempt to revive the project under the IMF’s 2008 program also failed, as discussed below.

By 2009, the GST’s efficiency in Pakistan had fallen to around 0.26 (as measured by the C-efficiency ratio; see Ahmad, 2010b, for more details), and collection had declined to 3.1 percent of GDP from 3.9 percent in the 1990s (see Table 2). If Pakistan were to achieve the C-efficiency of Sri Lanka (from around 2004 at the height of the civil war), it would more than double the collection or reach around 7 percent of GDP with a 15 percent rate. It is worth noting that the taxation of goods and services in China generates around 9 percent of GDP (Ahmad, Ryder, & Stern, 2013).

**Table 2: GST productivity – declining and low in comparison with competitors**

<table>
<thead>
<tr>
<th>Country</th>
<th>Standard rate (Year)</th>
<th>Revenue/GDP</th>
<th>Productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pakistan (1990s)</td>
<td>15</td>
<td>0.39</td>
<td></td>
</tr>
<tr>
<td>Pakistan (2005)</td>
<td>15</td>
<td>3.4</td>
<td>0.30</td>
</tr>
<tr>
<td>Pakistan (2009)</td>
<td>16</td>
<td>3.1</td>
<td>0.26</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>15</td>
<td>6.7</td>
<td>0.47</td>
</tr>
<tr>
<td>Philippines</td>
<td>12</td>
<td>4.3</td>
<td>0.45</td>
</tr>
<tr>
<td>Turkey</td>
<td>18</td>
<td>7.1</td>
<td>0.48</td>
</tr>
<tr>
<td>Lebanon</td>
<td>10</td>
<td>5.1</td>
<td>0.50</td>
</tr>
<tr>
<td>Jordan</td>
<td>16</td>
<td>10.1</td>
<td>0.62</td>
</tr>
<tr>
<td>Korea</td>
<td>10</td>
<td>6.7</td>
<td>0.67</td>
</tr>
<tr>
<td>Singapore</td>
<td>5</td>
<td>1.8</td>
<td>0.63</td>
</tr>
<tr>
<td>New Zealand</td>
<td>12.5</td>
<td>8.9</td>
<td>0.93</td>
</tr>
</tbody>
</table>

Source: International Monetary Fund, various country papers.

**4.2. The Stabilization Program**

The economic crisis of 2007/08 led to a significant rise in the budget deficit and overall debts—leading to a hemorrhaging of record high reserves. A government stabilization plan in September 2008 was based on raising the tax-to-GDP ratio by five percentage points, and its key element was the reform of the VAT that 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
that the IMF monies would be a “bridging loan” while this reform took effect. 

The revised VAT law was meant to remove distortions in the GST—especially the domestic zero-rating and exemptions that were largely designed to benefit special interest groups and, pari passu, consumers of luxury textiles and oriental carpets. The other main objective had been to create the basis for an arm’s-length tax administration based on self-assessment and effective audit, minimizing the problems of direct contact between the tax administration and taxpayers and also the difficulties with the issue of refunds, which had created considerable rent seeking. A critical additional objective was to remove the tax administration’s ability to confer benefits on the chosen few through the notorious SRO system; the new law required any such change to be submitted to Parliament and that the FBR would be stripped of this power.

The “streamlined” VAT law would also have replaced multiple rates (from 17 to 26 percent) and the cascading associated with reference prices by a single rate and considerable simplicity, including the elimination of SROs, but it was badly sold to the public and to Parliament. This was partly due to opposition from the vested interest groups that had benefitted from the holes in the GST, and partly due to the tax administration’s reluctance to relinquish its “rent-seeking powers” and the loss of the SRO handles. Although the Senate passed a corrupted version of the VAT bill (retaining some draconian powers for the FBR), 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 have been largely unaffected by the GST, but will surely be crushed by the resort to deficit financing and borrowing from the banking system.

In order to “rescue the IMF program”, 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

8 The former head of the Argentine Revenue Authority was hired by the World Bank to prepare a plan to enable a reformed VAT to be implemented in a reformed FBR by summer 2010—the key date under the IMF program (Silvani, Biber, Crandall, Grant, Reos, & Seymour, 2008). By 2011, this effort had been abandoned. The original USD 135 million loan was not fully drawn. The World Bank now plans to revive the project with a USD 300 million loan. The problems lay in the incentive structures facing officials and politicians and not the financing constraints.
order the SROs that had led to the exemptions. This option faced no legal difficulty. It would not have raised much additional revenue and may even have led to less revenue in the short run, but it would clearly indicate that the authorities intended to tackle vested interests seriously. The 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 1 April 2011.

SRO283 provided all sorts of exemptions and lower rates on all manner of final and intermediate goods—184 items in all—and recreated the “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 has effectively abandoned the logic of the arm’s-length administration that was the basis of the Shahid Husain proposal. Indeed, the use of third-party information from the National Database and Registration Authority (NADRA) is being accessed and selectively used. Without adequate safeguards, there will be enhanced scope for reinvigorated rent-seeking in an administration reliant on the SRO culture. It is extremely dangerous to leave tax making powers in the hands of an unaccountable tax administration, and it negates the basis of a parliamentary system.

The SRO powers also reduce the trust of the federating provinces in the FBR since they effectively reduce the overall revenues that should accrue to the provinces through the divisible pool. This is also the subject matter of the NFC, which we address next.

4.3. The 7th NFC Award

The provinces have long been responsible for the bulk of spending on health and education. Given long-standing budgetary constraints, however, this spending has fallen far short of what is considered necessary to meet minimum standards, let alone the MDGs—indeed, outcomes in both sectors have fallen behind all other South Asian countries. Total spending on health and education in 2007/08 was 5.4 percent of GDP, which the PRSP aimed to increase to 6.8 percent of GDP by 2011 (Pakistan, Finance Division, 2010, p. 331). The main vehicle for this was an increase in the provinces’ share of the divisible pool, given that they did not have adequate own-revenue sources.
The calculation made by the finance minister at the time was that, with the proposed tax reforms, an increasing total pie would leave sufficient resources in the hands of the center even as the provincial share was increased from under 47 percent in 2008/09 to 56 percent in 2010/11 and 57.5 percent thereafter. The logic was understandable, even as Pasha, Pasha, and Imran (2010) warned that the projections might be optimistic.

As it happens, the collapse of the 2008 tax reform proposals, taken by the government to the Friends of Democratic Pakistan and then to the IMF, proved to be calamitous for the NFC award. First, it opened up a gap almost immediately between the provinces’ expected and actual revenue-sharing transfers—from 1.3 percent of GDP in 2010/11 to 2.9 percent by 2013 (Table 3). This gap is in relation to the spending assignments that were in place in 2009, and does not factor in the 18th Amendment (which we discuss in the next section).

### Table 3: NFC projections 2010–14 (percentage of GDP)

<table>
<thead>
<tr>
<th>Item</th>
<th>2009/10</th>
<th>2010/11</th>
<th>2011/12</th>
<th>2012/13</th>
<th>2013/14</th>
<th>2014/15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Divisible pool (actuals)</td>
<td>3.8</td>
<td>4.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total provincial resources</td>
<td>4.56</td>
<td>6.2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal tax collections projected by NFC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NFC provincial shares expected</td>
<td>10</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>Tax collections (actual) 2010/11</td>
<td>8.7</td>
<td>8.5</td>
<td>8.5</td>
<td>9.0</td>
<td>10.1</td>
<td></td>
</tr>
<tr>
<td>Revised NFC divisible pool</td>
<td>4.87</td>
<td>4.89</td>
<td>4.89</td>
<td>5.18</td>
<td>5.81</td>
<td></td>
</tr>
<tr>
<td>Provincial funding gap</td>
<td>-1.29</td>
<td>-2.01</td>
<td>-2.59</td>
<td>-2.88</td>
<td>-2.82</td>
<td></td>
</tr>
<tr>
<td>Education and health (PRSP II)</td>
<td>6.79</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Government of Pakistan (2010); and author’s own calculations.

The second difficulty was that the failure of the tax reforms left far too little in the hands of the federal government. Thus, for 2010/11, the share of the divisible pool in the hands of the federation was around 4 percent of GDP. Debt servicing alone was 5.6 percent of GDP in the same year (IMF, 2011).

It had been clear that the reforms promised under the 2008 IMF program involved an integrated GST, building on the Musharraf
government’s arrangement to ensure a common administration but removing the exemptions and zero-ratings that had been introduced by the previous regime. At the time the NFC award was being finalized, a Ministry of Finance team had worked on drafting a revised GST/VAT law that was to be presented to Parliament by end-December 2009. Yet the NFC award finalized in December 2009 reiterated that the GST on services was a provincial subject and that collection could also be provincial. Although there was an attempt to paper over the gaping cracks and ensure that the FBR would continue to administer those services that entered inter-industry transactions, affecting cross-provincial ones—especially banking and insurance, telecommunications, and trade-related services—the proposals did not stick and the whole structure collapsed.

The failure of the tax reforms implies that there is no conceivable way of reaching the 15 percent of GDP target for the overall tax-to-GDP ratio by 2014/15; the budget strategy paper issued in 2012 brought the target down to 10.1 percent of GDP. This is catastrophic for the federal government since the increasing cost of borrowing alone will far exceed the federation’s share of the post-7th NFC divisible pool. This can only hasten the collapse of the federal government forecast by Haque (2009).

Unfortunately, the situation in the provinces is no better. As mentioned above, a shrinking resource pie relative to expectations puts the pre-18th Amendment goals out of reach, e.g., as enunciated in the PRSP-II (see Pakistan, Finance Division, 2010). The 18th Amendment merely adds to the unfunded mandates, which can only lead to further erosion in public services and gaps vis-à-vis the MDGs.

4.4. The 18th Amendment

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 tax reforms do not succeed, given the vociferous opposition by the vested interests that have benefitted from exemptions and zero rating,9 the entire devolution process

---

9 This has been couched in “populist” terms as affecting the interests of the poor—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
will run into trouble, as has the current NFC award. This seriously risks the implosion of the existing intergovernmental fiscal system.

Shah (2012) provides a very comprehensive assessment of the benefits and challenges arising from the 18th Amendment. We focus here on the issue of unfunded mandates, which could lead to an implosion of public institutions and services, as well as the very real dangers posed by increasing barriers to interprovincial trade. Both are extremely damaging to the concept of an integrated federation, and we consider each in turn.

4.5. Unfunded Mandates

The unfunded mandates have been exacerbated by the new responsibilities added to the pre-18th Amendment spending assignments in relation to the assigned own-revenue bases and shared revenues and transfers. As discussed above, the provinces and local governments lacked the necessary resources, prior to the 18th Amendment, to effectively provide for their responsibilities at that time. Without the tax reforms, the NFC award is just a mirage in the desert.

4.6. Subsidiarity and Spending Assignments

The 18th Amendment eliminated the Constitution’s concurrent lists, giving provinces sole powers in a number of areas, including health and education. The speed at which the spending functions were devolved meant that inadequate attention was given to the role of “subsidiarity”, the role of regulations, and the coordination of functions with associated externalities, such as primary healthcare, university education, climate change and environment, and natural disasters.

Almost immediately, the provinces discovered that they could not finance the very heavy expenditures that had been incurred by the Higher Education Commission, and made a reference to the Council of Common Interests to return the function to the federation. Unfortunately, financing for the function was no longer available, and the federation attempted to move the function under a line ministry rather than an independent commission, as had been the case prior to the 18th Amendment. Some commentators suspect that this might have been linked to the Higher

poor with the removal of these extraordinary benefits for the pampered sectors and a downward revision and consolidation of the GST’s rate restructure.
Education Commission’s refusal to certify the questionable educational credentials or degrees of a large number of lawmakers (of all major parties).

In other areas too, such as preventive healthcare and pharmaceutical standards, once a function with widespread externalities is dismantled and handed over to subnational governments, it is likely that there will be conflicting or confusing standards that could increase the likelihood of epidemics. If the provinces cannot handle the function, it is exceedingly difficult to reestablish the previous institutional arrangements at the national level, not to mention that the federation now has to borrow to meet its current expenditures and is caught in a debt trap.

The 18th Amendment unwound the steps taken by the Musharraf government to constitute a third tier of government, passing virtually all powers to the provinces and leaving it to provincial assemblies to decide whether or not to devolve further. This reaction to a desirable reform by the military government (made, albeit, for the wrong reasons) is understandable, but not well thought out. The functions and operations of the third level of government should be clearly delineated, as well as the role of the federation in keeping with the subsidiarity principles outlined above.

In addition, more work is needed to improve effective service delivery at the district or local levels, and to counter the possible inadequacy of local incentives in providing for the most vulnerable, e.g., the aged without extended family support, single women, and minorities. It is likely that the local or provincial government has less interest in providing services or protection to minorities, such as the Hazaras in Balochistan, who are nonetheless full citizens of the country and entitled to the same privileges and safety as any inhabitant of Islamabad or the exclusive neighborhoods of Karachi or Lahore. This could lead to significant miscarriages of justice and equity in the future; indeed, it is happening with alarming frequency—reminiscent of North’s warning of failure in the context of limited access states.

The expectations raised by the 1973 Constitution bear no relation to what can be financed. It guarantees:

---

10 See North, Wallis and Weingast (2009).
• “Compulsory and free” education till secondary level [#37(b)]
• “Access to technical and higher education for all on merit” [#37c]
• The “basic necessities of life, such as food, clothing, housing, education and medical relief for all such citizens, as are permanently or temporarily unable to earn their livelihood on account of infirmity, sickness or unemployment” [#38d].

The social benefits for the unemployed or incapacitated are very Bismarckian. The guarantees are very clear, with no additional targeting or score cards that are open to “capture” or “clientelism.” These are constitutional basic rights and actionable in court, but in order to finance these rights, a revenue-to-GDP ratio commensurate with the more advanced developing countries, such as Chile or Brazil, is needed—i.e., 25 percent or more. This is also the goal that China is pursuing. However, it appears almost completely out of reach under the present configuration of policy and administration in Pakistan.

4.7. Barriers to Trade and Integration

On the spending side, as pointed out by Shah (2012), the absence of a national standard setting capability might be a severe constraint to establishing a common integrated market. On the revenue side, the sales tax on services, if applied at one of the few ports by the respective province without providing credit to purchasers in other provinces, could become an effective import duty on cross-provincial trade. This is a potential conflict with the commerce clause in the Constitution.

4.8. Revenue Reassignments

A 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 does not count as effective own-source revenues.

In keeping with the Government of India Act 1935, Pakistan’s current constitution maintains the concept of split revenue bases, both for sales as well as incomes. This has opened up vast avenues for tax
avoidance and evasion—such as the abuse of the agricultural income exemption. Moreover, with the rent seeking in the FBR, there is little confidence in its ability to keep the provinces’ interests in mind in performing its functions.

The 18th Amendment reiterates the right of the provinces to administer the GST on services, if they so desire—the revenues belong to them in any case. This makes it very difficult for a provincial government to vary the rate structures without making their GST almost impossible to implement for fear of it degenerating into an instrument for “provincial tax wars” or impediments to trade. There is also a danger with credit invoices issued by one province to be honored by others or the federation—this would be akin to the “invoice sightseeing” that has become a serious problem in Brazil, and would magnify the “flying” invoices that are already a serious problem with zero-rating in Pakistan’s case (and that is with a single administration).

The split base of the GST relating to goods and services is unique to the Subcontinent, and has its origins in the Government of India Act 1935 that assigned the sales tax on goods to the states/provinces. After independence, the goods part was taken over by 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 realized. 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 subnational 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 to function on behalf of the federation and the provinces (as had been initiated by the Musharraf administration) to collect an integrated GST for the federation and all the 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 this arrangement, given the severe trust deficit associated with the FBR. A complex alternative mechanism was proposed to work 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 and there is very little confidence in the current FBR’s ability to operate on an arm’s-length basis.

By now it is clear that the current system underpinning the 18th Amendment is not sustainable. A more stable solution is needed that provides the provinces with significant tax handles that also generate greater accountability for subnational spending. Marginal changes to tax rates will not do. Also, as the post-NFC discussion on the GST illustrates, agreements are not easy to reach and are unstable. Ideally, a new arrangement should be sought and another constitutional arrangement on the revenue side introduced to preserve the thrust of the 18th Amendment and positive elements on the spending side. Both policy options and new administrative arrangements need to be examined—this is a significant research agenda that should also involve the next NFC award.

It is not possible to initiate sensible reforms in the tax policy agenda without an arm’s-length tax administration that has the trust of the federating units. Similarly, such an administration cannot be conceived without overhauling the tax policy framework and the associated assignments to different levels of government. This is as complex a task as the 18th Amendment, but should be more carefully designed before being rushed through Parliament. However, there is nothing like an economic crisis to concentrate minds and create the political will to carry out serious reforms, so if there is the opportunity, it should be taken. Some of the lines of reform can be gleaned from the successes in China and the difficulties faced in other federations such as Brazil and India, who are also stuck with inefficient split bases and find it hard to overcome the vested interests that coalesce around the benefits conferred.

4.9. Policy Options

A fundamental principle guiding the tax policy agenda should be that the major tax bases should be consolidated, and that both the provinces and districts should be assigned tax handles that allow flexibility to set rates at the margin. This flexibility is the crux of own-source revenues and the foundation for accountability in both revenue generation and spending.

At the national level, the major tax bases could be consolidated along the following lines:
Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning From China

- **Income taxes.** All sources of income are income and should be treated equally to avoid distortions, tax shelters, and handles for rent seeking and corruption. This implies that the following:

  - **Personal income tax.** All sources of income should be included in the tax base, including agriculture, property, and foreign source income. The provinces and districts should be allowed to “piggyback” on the full base; this will give them more revenues than at present and does not require separate administrations, just the setting of rates.

  - **Corporate income tax (CIT).** The holes and preferences should be closed, and the rate reduced to 25 percent, as in China and many other countries. A gross assets tax should be constituted in the short run to plug the gaps, and this should be creditable against CIT liability. The CIT could continue to go into the divisible pool.

  - **GST.** This should be treated as an integrated tax and administered as an arm’s-length agency. It should have a single rate and no exemptions other than on unprocessed food. The sharing arrangements could include the following:

    - **Fully entering the divisible pool.** This would allow 57.5 percent of the hopefully better-performing GST to go to the provinces, thereby fulfilling the objectives of the 7th NFC award.

    - **Australian model.** In Australia, the VAT is centrally collected but 100 percent is returned to the states through an equalization system run by the Commonwealth Grants Commission on which the states are equally represented. This option closes both horizontal and vertical gaps and is compatible with maintaining incentives for subnational efficiency. If this model is chosen, the divisible pool could be scrapped since the personal income tax piggyback (and similar arrangements for the CIT as in the US) would provide for own-source revenues.

    - **Sharing arrangements.** This is the Chinese model, which gives rich provinces an opportunity to share in the country’s growing revenue generation. However, it needs to be accompanied by an equalization framework in order to provide incentives for the poorer provinces that do not generate revenues, given the lower volume of transactions.
• **Carbon tax.** This should replace the petroleum levy, as originally designed, and should also be shared with the provinces (see Ahmad & Stern, 2009).

• **Excises.** Some excises could be established at the national level and feed into the divisible pool. Others could be purely provincial, provided they do not affect interprovincial commerce.

• **Property taxes.** These should be assigned to the districts/municipal governments as far as rate setting is concerned, although the provinces could be responsible for the cadaster, land register, and valuation.

• **User charges and tolls.** These should be largely local, although the old octroi should not be resurrected.

The above options provide provinces with both additional revenues as well as own-source tax handles, without the need for separate administrations. In the Pakistan context, however, it would be necessary to establish an arm’s-length tax administration that was acceptable to the provinces.

4.10. **Administration**

The trust deficit vis-à-vis the FBR/Central Board of Revenue has only grown since the warnings of the Qamar-ul Islam Commission in the 1980s. The failed attempt to implement the Shahid Husain report under the World Bank’s USD 135 million Tax Administration Reforms Project (TARP) highlights the incentive problems inherent in the current structure. The World Bank’s proposal to throw more money at the problem through the USD 300 million TARP II is likely to meet the same fate since neither the authorities or the donors recognize the incentive incompatibility of the existing arrangement, and the political economy difficulties in making the current model work.

TARP and the rescue of TARP in 2009 could not reform the existing FBR to make it operate on an arm’s-length basis. With its ability to use NADRA data, the FBR has become truly intrusive and quite dangerous given that rent-seeking opportunities have been magnified out of all proportion. An FBR that can issue SROs at will, overriding tax laws without reference to Parliament and in the absence of any consultation with the provinces whose revenue shares are compromised, is a nonstarter.
Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning From China

for the sort of tax administration that needs to underpin a new intergovernmental framework in Pakistan.

It may be necessary to start on the tax administration afresh, with a completely new staff (as was the case in Peru in the early 1990s). The entity may need to be detached from the Ministry of Finance, with its own responsible and accountable minister (as in China), and placed under a board with representation from the provinces. As the Peruvian example shows, a new administration can be constructed quite quickly as long as the roles and modus operandi are clear from the outset.

Given the implosion of public services and growing failures to keep minorities and other citizens secure, the intergovernmental and governance framework needs to be subject to urgent review and action. There is much to learn from China. Significant additional work is needed to recalibrate spending responsibilities and, particularly, to completely redesign the tax assignments and administration for the 18th Amendment to work effectively without unraveling the federation.

References


Can the New Intergovernmental Structure Work in Pakistan in the Presence of Governance Challenges? Learning From China


International Monetary Fund, (2011), Pakistan: Staff report for the 2011 Article IV Consultation, Washington, DC.


