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# **Changing International Perspectives on Decentralization**

**International agencies and options for Pakistan**

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# Changing international perspectives on decentralization, the international agencies and options for Pakistan

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The passage of the 18<sup>th</sup> 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? Are there other preconditions that must also be met? In this regard, the role of international experience plays a valuable role in pointing out pitfalls and options for consideration.

Bilateral and multilateral agencies have been quite active in advising on decentralization processes. The multilateral banks have done so partly because of the belief that decentralized service provision can provide better for the poorer sections of society by utilizing 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.

The first parts of this paper examine developments in theoretical understanding in addressing the steps that might be needed to ensure that the objectives of the Constitutional reforms are met in an efficient manner. This is followed by some recent examples from around the world, for both unitary and federal states. Finally, a concluding section focuses on some of the challenges that Pakistan will have to face in order to become a fully functional and prosperous federation. In this process, there is little in the way of precedence as to how to get there from the status quo.

## 1. Normative or positive approaches?

### Developments in theory

The post-Second World War normative literature on fiscal decentralization has been much influenced by the experience of the United States, and the work inter alia of Musgrave (1959) and Mancur Olson (1968). 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 center 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 decentralization 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 “decentralized” 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)<sup>1</sup>, 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 neighboring 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).<sup>2</sup>

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

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<sup>1</sup> Bardhan, Pranab and Dilip Mookherjee, “Relative capture of government at local and national levels,” *American Economic Review*, Vol. 90 (2), 2000, pp. 135-39. See also Ahmad, E and G. Brosio (forthcoming), ***Effective Federalism and Local Finance***, Edward Elgar, International Library of Critical Writings in Economics, for a selection of papers on this subject.

<sup>2</sup> Salmon, Pierre, 2010, paper presented to the SIEP Conference in Pavia. Besley, Timothy and Anne Case, 1995, “Incumbent behavior: vote-seeking, tax-setting, and yardstick competition,” ***American Economic Review***, (85) No 1., pp.25-45.

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 centralization or assumption of powers by the center.

### **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 a large, one-party, unitary state, China has actually been quite decentralized. And in Pakistan, the Musharraf government tried to “decentralize” 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 decentralization 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).

As mentioned, most Latin American countries have experienced some movement towards decentralization 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 centralized 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 centralized 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.

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

<b>Countries</b>	<b>Main characteristics of intergovernmental relations</b>	<b>Recent reform initiatives</b>
Australia	Federal system	VAT administration by center on behalf of the states, reforms introduced in early 2000s
Belgium	Federalization based on linguistic divisions.	Transformed from unitary to federal state
Bolivia	Three-layered unitary system	Powers of municipalities have been considerably increased. Election of Governors of Departments, some demanding substantial but asymmetrical powers—associated with natural resources.
Brazil	Federal system based on three layers of government	National reform and coordination of VAT is an urgent priority, although proposals for reform since the late 1990s have not been acted on.
Canada	Federal system	Asymmetric federation ( special treatment for Quebec)
China	Highly decentralized system, within a unitary constitution. Operating like a quasi-federation	Recentralization of taxing power (1994).
Colombia	Three-layered unitary system	Extensive devolution of resources to provinces (departments) movement towards a quasi-federation.
Denmark	Unitary system with strong municipal governments	Recentralization of higher education and health since 2006
France	Regional system	Regulatory, fiscal and political decentralization initiated
Germany	Federal system with extended concurrent responsibilities	Reforms to the Federal structure initiated in a wide ranging set of issues, but little change was effected as a result of two Commissions.
Indonesia	Unitary State	Extensive decentralization of spending powers to district level administrations after the fall of the Suharto administration, accompanied by a new revenue sharing arrangement.
Italy	Unitary, with asymmetric arrangements	Fiscal, regulatory and political decentralization initiated with a new Constitution.
Mexico	Federal system with high political and low fiscal decentralization	Fiscal and regulatory decentralization since late 1980's, with devolution to States of basic education (1992) and health care (1996), although revenues remain centralized since the early 1980s.

Pakistan	Federal Constitution, with interludes of military rule	Deconcentration to districts in the early 2000s by Musharraf.  Overlapping responsibilities on the spending side unwound with the 18 <sup>th</sup> Amendment to the Constitution—most spending powers fully assigned to province. Relatively little subnational reliance on own-source revenues.
Peru	Unitary state—moving towards a quasi-federation?	Election of governors of regions—sharing of natural resource revenues. Overlapping responsibilities with relatively limited spending or revenue devolution.
Poland	Unitary	Political and fiscal decentralization with emphasis on the local level
South Africa	The post-Apartheid constitution introduced a quasi federal system	Devolution of extensive responsibilities for education and health to provinces
Spain	Regional, quasi-federal system	Transition toward a federal system.
Switzerland	Federal system	Equalization transfers from federation to cantons
United Kingdom	Regional	Introduction of regional government in Scotland and Wales

## Donors and international agencies

It is hard to ascribe the trends relating to decentralization to international agencies, particularly in the federal countries of Latin America, Mexico, Brazil and Argentina, and in the unitary states, particularly Colombia, in which fairly path-breaking work in the 1980s led to what can only be described as “inter-country” yardstick competition (see Salmon 2010, Besley and Case, 1995). There was a rush by individual countries to copy this experience, in many cases egged on by the bilateral and multilateral agencies, which may or may not have had great influence in particular cases.

In most cases, the advice given has been consistent with the “normative” approaches to decentralization. Donors have provided advice on specific components and have had a particular sequencing in mind—decide first on the spending assignments, and the financing follows, and the mix between the taxes and transfers depends on administrative ease, and attention needs to be paid to macroeconomic concerns, and debt management can cause problems and must be addressed through sub-national fiscal rules or administrative means.

Over the past two decades, the literature on political economy aspects of intergovernmental relations (see Ahmad and Brosio, 2006), has led to a different “sequencing and mix” of reforms, or of the “building blocks” of governance. Indeed, the differences between the approaches lie largely in sequencing and design of implementation strategies, than on the instruments that are common to all the approaches. In this paper, we make references to the interactions with China, which was influential in the approaches taken by IMF staff in the early 1990s, in appreciating the relevance of the positive or political economy approaches well before these became standard in the literature.<sup>3</sup>

With the unclear responsibilities for spending, poor information flows, and absence of own-source revenues, there is often little incentive for the lower levels of government to provide services effectively (Ahmad and Brosio, 2009).<sup>4</sup> Indeed, the more recent work done in the

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<sup>3</sup> In the 1990s, work by the World Bank on countries such as Russia: Christine Wallich (ed.), 1994, *Russia and the challenge of fiscal federalism*, World Bank, Regional and Sectoral Study; Indonesia: Anwar Shah and Zia Qureshi, 1994, *Intergovernmental fiscal relations in Indonesia*, World Bank Discussion Paper 239; took the standard normative approach to fiscal federalism issues, followed by advice to Mexico: Guiguale, Marcelo and Steven Webb, 2000, *Achievements and challenges of fiscal decentralization: lessons from Mexico*, The World Bank and Pakistan: Kasper Richter, 2008, *Tapping tax bases for development*, The World Bank.

<sup>4</sup> See Ahmad, Ehtisham, Giorgio Brosio, and Vito Tanzi, 2008, “Local service provision in selected OECD countries: do decentralized operations work better?” in G. Ingram and Y.H. Hong (eds), *Fiscal Decentralization and Land Policies*, Lincoln Institute of Land Policy, Cambridge, M.A.

World Bank points to the pitfalls of “partial or incomplete decentralization” (see Devarajan, Khemani and Shah).<sup>5</sup> The access to credit markets by subnational entities under these “weak political economy conditions” and poor incentive structures have led to difficulties for local governments as well as full-blown macroeconomic crises in several cases, leading to countervailing pressures for fiscal rules, subnational debt limits, and generation of standardized information flows, as dictated by the normative theory.

Unfortunately, the presence of all the necessary “building blocks” do not provide sufficient conditions that these instruments will be used, as has become quite clear with the deliberate obfuscation of budgetary in the European Union, and the repeated subnational debt crises in countries in countries such as Bolivia (described below), despite the presence of sub-national debt limits or other constraints.

In this paper, we try to identify the main trends regarding decentralization in the recent past in federal and unitary states in Latin America, while focusing on the strategies, and specific policy tools, and the interrelationships with the international agencies. We will argue that this has been an interactive process, with both countries and international agencies learning from experiences and developments in method. This process may help the international agencies to better support what is in effect a complex and difficult process of improved governance, not only in Latin America, but also in other parts of the world.

## 2. Political economy of decentralization

There was an intensification of the democratic process in the 1990s in Latin America. In some cases, this involved the end of military or one-party rule (e.g., Argentina, Brazil, Mexico, on the one hand, and in the unitary states such as Colombia, and Bolivia and Peru, as well as in the federal countries of the region—Argentina, Brazil and Mexico). While a distinction could usefully be made between the group of Federal countries, and those with unitary constitutions...there has been a movement towards quasi-federal status with the establishment of elected intermediate tiers in most cases. This has led to a convergence of policy and approach in most cases, but we retain the distinction for the purpose of this paper—as we argue that the Federal countries are less open to influence or “diktat” from the international agencies or donors.

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<sup>5</sup> See Devarajan, Shantayanan, Stuti Khemani and Shehkar Shah, 2009, “The politics of partial decentralization,” in Ehtisham Ahmad and Giorgio Brosio (eds), *Does decentralization enhance service delivery and poverty reduction?* Edward Elgar, Cheltenham, UK.



Among the unitary states, we focus on Colombia and Bolivia—and touch on Indonesia and Peru—as these have all followed a similar route towards decentralization albeit at a different pace. China, which was quite decentralized, has moved towards greater centralization, at least on the revenue side, that is more in line with the experience of the federal states that we will discuss below.

Chile has not taken the fiscal decentralization route, in the manner of its fellow Andean unitary states, but has focused on making 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, but the international agencies have not been major players in this process. This process may be described as introducing performance budgeting in a deconcentrated and unitary environment, and not “decentralization” 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 decentralize that has gripped many parts of the world.

Chile’s neighbor Peru, on the other hand, has oscillated between decentralization in the 1980s, to the centralization under Fujomori. It is a large country with marked topological differences, and considerable inequality. As the technical assistance evaluation during that period showed, lack of information available to the center on local preferences and priorities made centrally administered social stabilization 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-decentralized strategy during the last decade made a lot of sense in the Peruvian context.

The federal states of Latin America, Argentina, Brazil and Mexico, are large and important countries with distinguished economists of their own. They tend to be relatively impervious to advice from the international agencies, although this has not stopped the latter from proffering technical assistance. Although Pakistan is a federal state, its experience has been similar to Peru, with oscillations between more or less centralized operations given its periodic experimentations with military rule.

### 3. Unitary states

#### Colombia

Colombia was the one of the first Latin American countries to explicitly move towards decentralization—much influenced by North American examples. The restructuring of the intergovernmental fiscal system began in the early 1980s, with a Commission headed by

Richard Bird, and subsequent proposals for implementation by the Wiesner Commission.<sup>6</sup> The new Constitution of 1991 locked in the process and took it further.

As to be expected at the time, the emphasis was very much on the “normative approach.” The principle followed was to devolve spending responsibilities on the basis of the benefit principle, in order to achieve outcomes responsive to local needs and achieve better targeting and efficiency. Given that Colombia had also implemented a VAT, the Constitution put a floor on transfers from the center to the subnational governments in order to meet social spending needs. The *Situación Fiscal*, introduced in 1968 for financing departmental spending on health and education was further circumscribed by the 1991 Constitution, ensuring greater spending for health and education. The process of further specification of the use of the transfers was specified in Law 60, which required at least 60 percent of the *Situación* to be spent on education, and 20 percent for health care, and the remaining 20 percent. For the municipalities, a general-purpose transfer to municipalities (Law 33 of 1968) was effectively replaced by earmarked transfers in 1991.

While the process in Colombia was clearly “home-grown”, international agencies were brought in on a selective basis—with work on spending assignments coordinated with CEPAL/GTZ, and municipal capacity building with the assistance of the World Bank. Consultations were held with the IMF on revenue assignments, transfer design and subnational debt management.

As pointed out in a “political economy perspective” by the IMF assessment<sup>7</sup> in 1994, the functional “earmarking” is a characteristic of centralized states, and runs counter to the basic precepts of decentralized accountability. Thus, key decisions continue to be made at the central level by the competent authorities, and implemented by local agencies, almost as “agents” of the center. The resort to earmarking is often defended on account of accountability problems, as the central government (or donors, see below) are not sure that public monies will be used for “appropriate” purposes. However, the earmarking does not ensure that resources will actually be spent according to the centrally determined objective, especially in cases where implementation is decentralized and there is an absence of proper information flows and budgetary procedures are inadequate to ensure effective monitoring of outcomes or judging policy priorities correctly. Ahmad, Brosio, Spahn and Vehorn (1995) insisted that decentralized accountability could not be ensured without voter’s scrutiny of spending, incentivized by the own-taxes of the local governments and the “untied” transfers, later generalized in Ambrosiano

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<sup>6</sup> See Richard Bird, *Intergovernmental finance in Colombia*, Harvard Law School, 1984, and Wiesner-Duran, E., ***Colombia: Decentralización y Federalismo Federal***, DNP, Presidencia de la República, Bogotá.

<sup>7</sup> See Ehtisham Ahmad, Charles Vehorn, Giorgio Brosio and Bernd Spahn, 1995, ***Colombia: Reforming Territorial Taxation and Transfers***, IMF: Fiscal Affairs Department.

and Bordignon (2006). Without the effective scrutiny of the local electorate, arbitrariness and corruption are possible—termed “capture” by Bardhan and Mookherjee in the Indian context.

Indeed, in Colombia, even the normative approach ran into difficulties as the devolution of spending was meant to accompany the increasing transfers to municipalities and departments on account of decentralized education and health care. However, the “responsibility for hiring and firing teachers and health care workers remained with the center—attempts to move these functions to municipalities were thwarted by powerful unions”<sup>8</sup> (Fedelino and Ter-Minassian, 2010, p. 12). This led to increasing budgetary pressures on the central government, and increased resources for the local governments, which were leveraged to increase borrowing for all sorts of spending (Sánchez and Guttieréz, 1995).<sup>9</sup> This was not what was intended, and the government then introduced local government debt management and borrowing law (in the mid-1990s), as a precursor to Fiscal Responsibility Legislation—the latter also became very fashionable across Latin America, especially following the Brazilian experience. But the question remains whether these normative prescriptions work without a firmer underpinning of the political economy and incentives facing decision makers at all levels of government. The experiences of Latin America and now the EU would suggest that caution might be appropriate.

The Issue of sharing natural resources is intrinsically a political-economy problem. On the one hand, the national government is better able to “hedge” against unfavorable price movements, and to engage in macroeconomic stabilization and redistribution—the typical normative functions of the central government. On the other hand, natural resource-producing regions (especially those with petroleum and gas resources) tend to have sparsely populated areas that tend to be poorer than the more progressive urban areas. This tends to lead to demands for autonomy or more effective allocation of the revenues to develop these areas.<sup>10</sup> Regardless of normative and macroeconomic considerations, the political-economy considerations dominate. The Colombian arrangements allowed for the producing regions to take a large share of the natural resources, although the more recent reforms give a larger share to non-producing regions—to lessen the “resource” gaps, and also create a national consensus. As these non-producing regions may also be quite poor—the center can certainly play a role in the “redistribution” process.

Colombia is interesting, as it initiated a process of what can only be termed **international yardstick-competition** (Salmon, 2010), as a number of other unitary states began to copy the

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<sup>8</sup> Fedelino, Annalisa and Teresa Ter-Minassian, 2010, *Making Fiscal Decentralization Work: Cross-Country Experiences*, IMF Occasional Paper, 271.

<sup>9</sup> Fabio Sánchez and Catalina Guttieréz, 1995, “Colombia” in Lopez-Murphy, op cit.

<sup>10</sup> This issue has been central in the discussions in post-Suharto Indonesia, post-Saddam Iraq, post-Biafra Nigeria, and under the new Constitutions in Colombia and Bolivia.

design and implementation strategy, including the drawbacks—but this is not surprising as the advisors remained the same in most cases, and with perhaps greater influence as we shall see. This was particularly marked in the Andean countries, especially Ecuador and Bolivia, and in Peru after the fall of the Fujimori administration, again with the support of the same international and bilateral agencies, the GTZ on spending design, together with the World Bank, IADB and CEPAL.

## Bolivia

In Bolivia in the 1990s, decentralization 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 decentralization was strongly supported by bilateral donors, as well as the international agencies (IADB, GTZ, the World Bank as well as the IMF). The influence of donors and international agencies in the Bolivian case has been quite marked.

The GTZ and USAID were deeply involved with the decentralization process, including the political aspects, and the overlapping spending responsibilities resembled those in Germany, that recent Commissions have tried to reform but have failed. 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,<sup>11</sup> reflecting the precedent from Colombia, and IMF technical assistance. 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. Another IMF mission in 1998 was launched to stem the debt difficulties of subnational governments.<sup>12</sup> 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 (supported by CAF and the World Bank). Another IMF mission in 2001 focused on debt management issues.<sup>13</sup> The mission recommended that there should be a no-bailout provision and that there should be

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<sup>11</sup> Under the 1997 budget law, debt service was limited to 25 percent of revenues, and debt stock to be lower than 250 percent of revenues. This reflected the Colombian municipal debt law.

<sup>12</sup> Pérez, L, G. Brosio, I. Coelho, J-L Ruiz, J-R Ruiz, 1998, Bolivia: *Las relaciones fiscales intergubernamentales—propuestas para mejorar el uso de recursos y el manejo macroeconómico*, FAD, IMF.

<sup>13</sup> Manoel, A., Maria Albino, and J.P. Jiménez, 2001, *Bolivia: Evolución de la descentralización fiscal y el control de la deuda de los gobiernos municipales*, FAD, IMF.

acceleration of the government financial information system to track spending, SIGMA, being rolled out by the IADB and the World Bank.

By 2001, under the enhanced HIPC arrangement, donors decided that the decentralization 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.<sup>14</sup> 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.

By 2004, yet another IMF mission,<sup>15</sup> this time taking a political economy perspective, found that there were significant deficiencies in the design of the decentralization process—particularly governing the allocation of HIPC-II funds to municipalities. While this pattern was very much in the tradition of the overlapping responsibilities and “earmarked” transfers, it provided funds 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—again reminiscent of Colombia. 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 “equalizing”, 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).<sup>16</sup> Even when considering infrastructure, which is where much of the spending took place, there was no strong evidence that access to infrastructure improved significantly.

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

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<sup>14</sup> Faguet, J.P., 2004, “Does decentralization increase government responsiveness to local needs? Evidence from Bolivia”, *Journal of Public Economics*, 88, (4), pp. 867-93.

<sup>15</sup> Ahmad, Ehtisham, Giorgio Brosio, Alicia Díaz-Zurro, I Fainboim, Renato Villela and Carlos Parente, 1994, *Bolivia: improving budget and decentralization processes*, IMF, FAD.

<sup>16</sup> Inchauste, Gabriela, 2009, “Decentralization in Bolivia: has it made a difference?” in Ehtisham Ahmad and Giorgio Brosio (eds.), *Does decentralization enhance service delivery and poverty reduction?* Edward Elgar.

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 recentralization 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 decentralization 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 centralized rule. As shown by Faguet (2004), clearly the possibility of improvements in living standards has been demonstrated, even if this cannot be generalized at this stage (2009). Thus, going back to centralized rule is not a political-economy option, and the focus, for instance of the 2004 IMF mission was 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 decentralization and the centralized 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 centralization was characterized 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 decentralize 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 stabilization of Fujimori came with considerable centralization, buttressed by the introduction of a VAT, with a central tax administration. As an adjunct to the economic stabilization, the early Fujimori period was characterized by an attempt to also provide for social stabilization, seen as an essential element in the fight against the Shining Path (*Sendero*) guerrillas.

IMF technical assistance at this time, other than for the establishment of SUNAT and the design of the VAT, focused on the social program implementation. A mission in 1992 highlighted the weaknesses of trying to provide social assistance in a top-down manner without the means of identifying local preferences, and in a situation where deconcentrated local governments were relatively weak, and lacked own-source revenues, or clearly defined functions. Centrally determined and financed programs, such as FONCODES<sup>17</sup>, were often 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 center lacked the full information to make allocations, and there often was a lack of clarity between the spending by specialized agencies like FONCODES and the operations of line ministries and local administrations.

The war on the Shining Path terrorists had a negative impact on activity levels, particularly in the sierra and the selva, exacerbating the labour-market distortions, and the accelerated migration of male working-age population towards the coast and Lima. This had significant implications for the types of interventions needed for the vulnerable in the sierra and selva (largely female headed households, the elderly and children), and the sorts of investment-based income support that was on offer. Indeed, there were several examples of “bridges in the middle of no-where without connecting roads at either end, built by contractors from Lima with relatively few linkages with the local labour market.”<sup>18</sup> The 1994 missions warned that the criteria for the allocation of funds, together with the weak monitoring mechanisms, meant that the really poor would likely not benefit, and that the local governments would have an incentive to maintain their rankings in the poverty map (*mapa de pobreza*) in order to continue to receive investment funds.<sup>19</sup> The strong recommendation made by the 1994 missions to establish a transparent system to monitor spending, involving a Treasury Single Account, and a government financial information management system, was given lip support by the Fujimori administration, but despite the significant technical assistance launched by the IADB, the IMF (using the Brazilian model and Brazilian consultants) as part of the follow-up, the measures were effectively abandoned within a few years with no results. It is clear, with hindsight that

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<sup>17</sup> This was a fund for social stabilization 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, Políticas Públicas y Gestión del Gasto Público***, IMF, FAD, and Ehtisham Ahmad, J. Amieva-Huerta, and Jim J. Thomas, October 1994, Peru: ***Pobreza: Mercado de Trabajo y Políticas Sociales***, IMF, FAD.

<sup>18</sup> Including one in the middle of the Urubamba valley—the local mayor justified this as a means of getting funds from Lima.

<sup>19</sup> This situation is reminiscent of the current debate relating to the use of EU Structural funds (under Law 488), with weak monitoring, audit and controls (EU-OLAF), and with the relevant politicians having no “accountability” for the effective use of these funds.

the greater transparency was not high on the preference function of the administration—but this is not always apparent to agencies keen to deliver technical assistance.

Regrettably, given the weak monitoring mechanisms, these investment-based transfers were misappropriated in the latter half of the Fujimori regime towards his reelection campaign, and in outright fraud. This was subsequently illustrated in the trials of Fujimori advisor, Montesinos.

The Toledo administration in 2002 revived the decentralization process. The second García administration in 2006 also decided to move forward this decentralization process. There was a political-economy recognition that a dispersal of power among regional and local governments provides insurance against a centralized abuse of power and resources, as experienced during the Fujimori years. Ahmad and García-Escribano (2010), based on insights from an IMF mission in 2005<sup>20</sup> using the political-economy perspective, 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 “equalize 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, *pari passu* creating issues relating to both macroeconomic stabilization and inter-regional redistribution. But perhaps this is the price to be paid in terms of decentralizing 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 center 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 enterprises (collected by local governments on behalf of the center) 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 center in pursuing macroeconomic and redistributive policy goals.

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<sup>20</sup> Ehtisham Ahmad, Katherine Christopherson, Mercedes García-Escribano, Alicia Díaz-Zurro, and Carlos Parente, 2005, Peru: **Modernizing Budget Processes, Institutions and Information Systems**, FAD, IMF; and Ehtisham Ahmad and Mercedes García-Escribano (2010), “Constraints to Effective Fiscal Decentralization in Peru” forthcoming in Jorge Martinez-Vasquez and François Vaillancourt, (eds), **Obstacles to Decentralization: Lessons from Selected Countries**.



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 recommended by the Bank (as in Russia). IMF technical assistance<sup>21</sup> 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 would operate immediately from 1994, and the spending assignments would be unraveled over time as the SOEs were reformed gradually (see Ahmad et al, 1994 and a joint report with the Ministry of Finance, Ahmad, Qiang and Tanzi, 1995—see also Ahmad, Li and Richardson, 2002)<sup>22</sup>. The interests of the local governments 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 equalization 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 optimize 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 provided a lot of the insight used subsequently by IMF staff, often in conjunction with Bank staff (some of the joint work was in Indonesia, 1999, Nigeria, 2000, China 2003, and Mexico, 2006).

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<sup>21</sup> Ahmad, Ehtisham, Gao Qiang and Vito Tanzi, 1995, *Reforming China's Public Finances*, IMF, Washington DC, and also published by MOF, PRC.

<sup>22</sup> Ahmad, E and K-Y Lee and A. Kennedy, 1993, *The reform of intergovernmental fiscal relations, macroeconomic management, and budget laws*; IMF: FAD, Ahmad, E., G. Qiang and V. Tanzi, 1995, Ahmad, E., J. Craig, D. Mihaljek, 1994, *China: on the determination of a grants system*, FAD, IMF, and Ahmad, E., J. Craig and R. Searle, 1994, *China: formulating and estimating grants*, FAD, IMF, Ahmad, Ehtisham, 1997, *Financing decentralized expenditures*, Edward Elgar, and Lou Jiwei, 1997, “Constraints in reforming the transfer system in China,” in Ahmad (1997); and Ahmad, E., H. Bixi, M. Fortuna, B. Lockwood and R. Singh, 2003, *China: reforming fiscal relations between different levels of government*, FAD, IMF.

## Indonesia

The Suharto administration made significant improvements in service delivery—although these were really deconcentrated operations of a centralized regime. These achievements were supported by the World Bank (see Shah et al., 1994). The political response to the end of the Suharto regime was an effort by his successors to placate disaffected peripheral regions by “decentralizing spending responsibilities”, and sharing natural resource revenues, even at the risk of loss of macroeconomic controls (Ahmad and Mansoor, 2001). In order to keep the unitary nature of the constitution, the decentralization process focused on districts and municipal rather than regional governments, to minimize the risk of separatist tendencies.

It nonetheless proved quite difficult to achieve an acceptable sharing arrangement for petroleum resources, especially with the group of districts in Aceh, and an asymmetric solution was finally arrived at after protracted negotiations. The Indonesian political economy arrangement shows that a solution can be derived, along with greater acceptability by the population, even though the design still needs a great deal of additional work in order to ensure incentives for the provision of better local service delivery.

## 4. 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 Stabilization 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 centralizing effects of implementing a VAT (the Brazilian VAT is an exception<sup>23</sup>) have been accompanied by the suppression of subnational own-taxes. This goes against the spirit of the democratization 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

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<sup>23</sup> 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.

systems of extensive earmarking, and overriding of local preferences, especially though not exclusively in Brazil.

Ironically, the centralizing effect of the conditional cash transfers, especially Oportunidades and the Bolsa Família, which in the Brazilian case supplanted state level programs has gone in the opposite direction. Ironically, the conditional cash transfers have been strongly supported by the World Bank,<sup>24</sup> which also has been one of the agencies most in favour of decentralization—especially in terms of the effectiveness of service delivery as well as claims that it might reduce corruption.<sup>25</sup> 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 centralization 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.<sup>26</sup>

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 centralization and decentralization over time. However, the 1988 Constitution moved the country firmly towards greater decentralization, 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)<sup>27</sup>. 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.

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<sup>24</sup> See Fiszbein, Ariel and Norbert Schady, 2009, *Conditional cash transfers—reducing present and future poverty*, The World Bank.

<sup>25</sup> See Gurgur, Tugrul and Anwar Shah, 2001, “Localization and corruption: panacea or Pandora’s box?” in Ahmad and Tanzi (2001).

<sup>26</sup> 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

<sup>27</sup> See Afonso, José Roberto and Luiz de Mello, 2001, “Brazil: An evolving federation,” in Ahmad and Tanzi (2001), op cit.

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 criticized as creating distortions, impeding inter-state trade,<sup>28</sup> 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 program (the Bolsa Família, that is modeled on the Oportunidades program—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 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

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<sup>28</sup> See Tanzi (2010).

municipal governments had a small operational surplus at the start of the decentralization 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 privatization of state-owned banks, and strictly enforced restrictions on additional borrowing, including imposition of ceilings for borrowing for investment (the “golden rule”).<sup>29</sup>

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 decentralized 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.<sup>30</sup> In effect, overlapping and ineffective social benefit programs at the subnational level have been rolled into a federal program. 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 recentralization 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 the World Bank and the IMF are now instrumental in spreading the gospel concerning Oportunidades type conditional cash transfers)<sup>31</sup>. The critique of the effective financing arrangements for the

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<sup>29</sup> For details of the FRL, see Afonso and de Mello (2001).

<sup>30</sup> This includes the *Bolsa Escola*, that supplanted several municipal programs, *Bolsa Alimentação*, *Auxílio Gás*, *Cartao Alimentação* and the cash transfer component of *Programa de Eridação do Trabalho Infantil*. See <http://www.mds.gov.br/bolsafamilia>.

<sup>31</sup> 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.

Oportunidades program (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 equalization and earmarked transfers.

## Mexico

In the Mexican context, the underpinnings of the decentralization reforms were not as strong as in Brazil. This involved centralization 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).<sup>32</sup> 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.”<sup>33</sup> 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

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<sup>32</sup> Gil Diaz, F., 1987, “Some lessons from Mexico’s Tax Reforms,” in DMG Newbery and NH Stern, *The Theory of Taxation for Developing Countries*, Oxford University Press for the World Bank.

<sup>33</sup> Gil Diaz, F., *op cit.*, p.348.

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 a banking crisis, precipitating the need for a federal bailout. Subnational debt limits were imposed, but the absence of a standardized 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) for which Brazilian experts were engaged through the IMF. 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. A joint IMF-SHCP report (with World Bank participation) in 2007<sup>34</sup> called for significant improvements in intergovernmental fiscal relations in Mexico, including standardized reporting and information flows. This was predicated on a completion of the reforms within SHCP and the Treasury, including a common budget classification to be used by all agencies of the SHCP (MOF) and the Federal Government, **before** attempting to persuade States and local governments to adopt the same standards. Despite yet another technical assistance mission in 2007,<sup>35</sup> attempts to complete the 1996 reforms appear to have been abandoned and along with this the likelihood of achieving the standardization 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

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<sup>34</sup> Ahmad, E., J.A. González Anaya, E. Revilla, C. Berthaud, R. Blavy, G. Brosio, J. Draaisma, M. García-Escribano, I. Garrido, B. Lockwood, 2007a, Mexico: ***Options for the Reform and Strengthening of Intergovernmental fiscal relations***, IMF, FAD; and SHCP, Mexico.

<sup>35</sup> Ahmad, Ehtisham, Mercedes García-Escribano, Joe Keeley and Mario Pessoa, 2007b, Mexico: ***Selected Treasury Reforms for a Modern Hacienda***, IMF, FAD, Washington DC.

interested in bolstering federal revenues, and used the intuition of Ahmad et al (2007a) to introduce a federal *Impuesto Empresarial a Tasa Unica* (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 program linked to nutritional, educational and health care outcomes, has been reportedly very successful (Coady and Parker, 2002)<sup>36</sup>, and has been the basis for the World Bank's strong advocacy of such programs in Latin America and elsewhere (Fiszbein and Schady, 2009, op cit). However, this program has been criticized by its founder, Santiago Levy (2008)<sup>37</sup> for design difficulties—it is financed by a distorting payroll tax, 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 program 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 program continues to provide effective social assistance in a sustainable manner that does not distort incentives and limit growth potential.

## Pakistan

In the 1960s, the Pakistan 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 “decentralization” in the post 9/11 period. While this was ostensibly a mechanism to get services closer to the people, and elected

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<sup>36</sup> Coady, David, and Susan Parker, 2002, “A cost effectiveness analysis of demand and supply-side education interventions: the case of PROGRESA in Mexico,” IFPRI Discussion Paper 127.

<sup>37</sup> Levy, Santiago, 2008, *Good intentions, bad outcomes: social policy, informality and economic growth in Mexico*, The Brookings Institutions.



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 had been ousted from power in 2008.

The newly elected Parliament pushed through a reform of the Constitution, with the 18<sup>th</sup> 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 18<sup>th</sup> 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 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 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 to collect an integrated GST for 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 FBR effectively operating the crediting and refund mechanisms associated with the GST—the only agency capable of doing so. But the vested interests are opposing fixing the loopholes in the GST introduced by the Musharraf government. This risks an untenable situation in which there will be insufficient financing available for the devolved functions, and could trigger a significant backlash against the devolution process.

## 5. Assessments

### What is the evidence on decentralization?

The evidence on the effects of decentralization 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). 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. The interested reader is referred to the above reviews for the relevant references, to be able to make up their own minds.

Perhaps the greatest lacuna in the decentralization 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.

### Role of the role of the international agencies

The international and bilateral agencies continue to believe that decentralization remains a panacea for improved service delivery, but the Bank is not taking any chances with the endorsement of the systems of centralized conditional cash transfers modeled on Oportunidades in all parts of the world.

In general, it is easy to exaggerate the role played by the international agencies and donors in influencing policy, particularly in the larger countries. Several, like the Chinese and Brazilians listen politely to different points of views and then do their own thing, often making use of the “conflicting” messages from the international agencies. The situation is somewhat different in the smaller countries using sectoral loans, or operating in IMF programs, where the leverage applied is generally stronger.

The effectiveness of the advice given and that of the decentralization process itself are entirely different matters. But sometimes the “building blocks” fail to deliver, even at the central level—e.g., coordinated information through the GFMISs in Pakistan, Mexico, and Bolivia. The positive approaches sometimes help to understand why not, and thus could help to improve policy advice and effectiveness of technical assistance in the future or in other countries.

## Bilateral donors

Bilateral donors tend to replicate the context of their home countries—US Aid funded advice tends to reflect the US-centric view of the world, where local governments work effectively, and the task for public policy is to ensure the efficient magnitude of cooperation across local governments in providing wide-area services and minimizing externalities and spill-over effects (e.g., through *mancomunidades*, in the Latin American context).<sup>38</sup> Moreover, local government elections tend to create stable democracies as well as bulwarks against “undesirable” forms of government. However, these are issues of secondary importance, as the support to Pinochet in Chile and Musharraf in Pakistan have illustrated over the years. An additional difficulty has been that the local governments are not really responsible for basic health care or primary education as they would be under a US-centric view of things. This may be partially due to a different set of institutional and historical circumstances, but also advice from other bilateral and multilateral agencies.

The GTZ has been instrumental in disseminating the complicated and overlapping systems of assignments that have been used in Germany, despite the fact that recent commissions in Germany have been trying to unravel these with rather limited success. Examples of the mind-boggling complexity are to be seen in several GTZ documents.<sup>39</sup> The result, for example in Bolivia, was that the HIPC scheme channeled funds to municipalities for functions in which they had really only marginal competence—particularly, basic education or primary health care.

A greater difficulty is that with the use of the HIPC funds, or those from the Bank or IDB, or GTZ or USAid, there are generally different reporting and accounting requirements. It is, thus, not surprising that local governments have difficulty in conforming with these rather disparate and incompatible norms. This gives rise to what is then known as “institutional and capacity constraints” in the decentralization process—although the local governments may be perfectly capable of following a simple and standardized tracking and reporting function—if only there were one standard.

## The development banks

It is also not surprising that the development banks should initially take the normative perspective—reflecting the US-centric view of the world (Burki and Perry, 2000).<sup>40</sup> This focuses on the clarity in spending assignments, appropriate revenue assignments, appropriate transfer design and efficient public financial and debt management, emphasizing no bailout conditions.

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<sup>38</sup> There have been major US Aid funded programs on decentralization, for instance both in Bolivia and Peru. Similarly, GTZ has been very active in the Andean countries, often in collaboration with CEPAL.

<sup>39</sup> See for instance, GTZ CONAM 2001, *Competencias: ¿Qué descentralizar?*; see also Aghon, Gabriel and Gerald Krause-Junk, 1996, *Decentralización fiscal en America Latina*, CEPAL/GTZ.

<sup>40</sup> See Burki, S. Javed., and Guillermo Perry (eds), 2000, *Decentralization and accountability in the public sector*, The World Bank.

While these “building blocks” are relevant in any system of intergovernmental fiscal relations, whether US-centric or not, without the positive approach it is difficult to see whether or not sensible advice on any of the blocks might be followed, and if so, is it compatible with conflicting advice in the same or other blocks. By the mid-to late 1990s, the role of insitutional variables and interactions with the building blocks was much better appreciated (Litvack, J. Ahmad, and Bird, 1997).<sup>41</sup>

After continuing Bank work on service delivery, the positive and political economy aspects came to the fore after the 2004 World Development Report, as Devarajan and his colleagues began to pursue these aspects more systematically.<sup>42</sup> But at the same time, there were other parts of the Bank continuing with the “normative” tradition, as advice on Mexico and Pakistan showed.

The greatest lack of consistency in the Bank is the joint advocacy of the centralized conditional cash transfers as well as decentralized operations, following either normative or positive approaches. But then the Bank staff are fairly autonomous, and it is hard to get a “Bank view” on particular issues.

The IADB, while also initially following a “normative” approach, relied more heavily on senior academics with policy-making experience from the region. Hence, their focus was much more closely grounded on experiences of the countries concerned, and first hand knowledge of the shortcomings and difficulties (e.g., Lopez-Murphy, 1995). By placing the “building blocks” of fiscal federalism within the context of what might be feasible and what generally works, the IADB showed greater flexibility at an earlier stage than its Washington neighbours.

## The IMF

The position of the IMF is much more complex. In the early 1990s, FAD senior staff took the position that the subject of intergovernmental fiscal relations was off-limits to its staff, largely because the subject is “essentially political,”<sup>43</sup> and the IMF does not interfere with issues political, and that these are best left to the Bank. However, requests for technical assistance on the “building blocks” of federalism gathered pace as the transition economies of Eastern Europe, Central and East Asia began their economic reforms, with which the IMF was closely involved. There was also a realization that the operations at the sub-national level might affect

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<sup>41</sup> Litvack, Jenny, Junaid Ahmad and Richard Bird, 1998, *Rethinking decentralization in developing countries*, World Bank Sector Studies Series.

<sup>42</sup> World Bank, 2004, *World Development Report: making services work for poor people*; Ahmad, J., S. Devarajan, S. Khemani, and S. Shah 2006, “Decentralization and service delivery,” in Ahmad and Brosio (2006); and Devarajan, S., S. Khemani and S. Shah; “Political economy of partial decentralization,” in Ahmad and Brosio (2009).

<sup>43</sup> Quote ascribed to Milka Casanegra-Jantscher, Head of the Tax Administration Division.

overall macroeconomic stability. Consequently, a number of missions were launched, including in China (1993), as well as Peru (1994) and Colombia (1994, 1995). As described above, these were largely “positive” in nature, focusing on the art of the possible and practicable, as opposed to what might be recommended by the normative theories (see the discussion above on China, where the Bank’s advice was more in line with the normative theory).

At the same time, a three-year staff assessment was launched that examined the “building blocks” as well as summaries of country experiences—this was published under the name of Mrs. Ter-Minassian, who was responsible for initiating the work in the first place. It is odd that the IMF’s own advice had been positive in substance, but the Ter-Minassian volume was essentially normative in its tone, and in the summary thematic chapter. Perhaps this was designed to deflect the criticism that the work was becoming too political—but it also reflected the rather rigid delineations between divisions in the Fiscal Affairs Department that happen to correspond to the fiscal federalism “building blocks” of macroeconomic coordination; tax policy and administration, expenditure policy and public financial management. It was often difficult to see the interrelationships between these areas. Yet, the technical assistance that followed the publication of Ter-Minassian (1997) continued in the positive tradition. This included work on Indonesia, Nigeria, China and Mexico—all of which also had participation by World Bank staff.

At the request of the Executive Board, and in honour of the retirement of Vito Tanzi in 2000, another retrospective was held (see Ahmad and Tanzi, 2001)—but was not published by the IMF—hence it did not receive the attention of Ter-Minassian (1997). Ahmad and Tanzi (2001) was essentially positive in tone and analysis, particularly a forceful paper by Tanzi himself (Tazi 2001) that focused on the effects of the decentralization process rather than simply the building blocks. Following the publication of the Handbook of Fiscal Federalism, a collaborative effort was launched between the IMF, the World Bank, and UNDP, with participation of bilateral donor agencies, to examine the consequences of the new theories for policy and the position that might be taken by the international agencies. This too was published outside the IMF (see Ahmad and Brosio 2009), largely as an academic assessment.

Finally, the IMF presented to the Board an assessment of where the institution stands on fiscal federalism, mindful of the fact that the Board is not keen on an expansion of the mandate of the IMF—this was published in Fedelino and Ter-Minassian (2010). While this paper recognizes the role of political economy, its structure remains “safely” normative and couched in terms of the traditional “building blocks.” The more difficult but important questions as to why some advice is implemented and why other advice fails, or is not implemented, are not addressed.

## Retrospective on the international agencies

The influence of the international agencies on fiscal federal outcomes is probably exaggerated, as in reality countries do what is in the interest of the ruling parties, politicians and bureaucrats. This may also explain why so often “sound” advice given to countries, that are capable of implementation, often fails. The incentives to implement may not exist.

In other cases, where there has been progress, there may be a more altruistic motive to decisions that are made. Probably, international “yardstick competition” is the most effective incentive for countries to improve public policy making and effectiveness of service delivery.

In reality, in the Pakistan context, the bilateral aid agencies and development banks have rushed to provide assistance as requested by particular governments of the day, especially when the international atmosphere was conducive to supporting these governments—especially during the 1980s, and in the immediate post 9/11 period. It is also the case that the governments of the day have “used” the well meaning and innocent advice from these agencies in order to further their own political objectives. It is an unproven counterfactual that had the agencies known that their advice might be “used” for purposes other than those that were innocently intended, whether they might have adapted their support and counsel—although the evidence is that contrary views from within and outside their organizations were just simply ignored.<sup>44</sup>

It is to be hoped that perhaps international agencies and academic advisors still have a role to play in distilling international experiences and presenting these to countries, such as Pakistan. And that they might keep in mind the specific institutional and historical context of the countries concerned, and understand why and what it is that makes countries undertake reforms.

## 6. Making the federal structure work in Pakistan

The devolution process that has begun with the 18<sup>th</sup> 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 benefitted by exemptions and zero rating at this point in time,<sup>45</sup> the entire devolution process would run into

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<sup>44</sup> To the credit of the World Bank, staff in early 2008 termed the long-standing reform of the Federal Board of Revenue to be “non-performing and unsatisfactory.” A subsequent rescue and salvage operation was launched afresh.

<sup>45</sup> This 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

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 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 will be more complex than Dr. Tanzi would like, and 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. This may have to involve “piggy-backing” or dual arrangements, such as the “IRAP” that meet the needs of large and complex provinces. Such measures would need to be accompanied by an equalization 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.

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extraordinary benefits for the pampered sectors and a downward revision and consolidation of the rate restructure of the GST.

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