Improving governance in turbulent times

A REFORM AGENDA FOR PAKISTAN

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JANUARY 2012
Introduction: plan of talk

- Vision for Pakistan—some early debates
- The 7\textsuperscript{th} NFC, 18\textsuperscript{th} Amendment and its fiscal implications
  - Consequences of the failure of the promised tax reforms
  - What do we observe?
- Some policy reforms needed to bolster the federation with provincial autonomy
  - Institutional underpinnings
  - Need to recalibrate spending and revenue assignments
  - Address distributional issues through spending and transfers (individual and intergovernmental)
  - Access to credit subject to hard budget constraints; ratings and repayment criteria
- Summary of conclusions and action plan
Vision for Pakistan

SOME EARLY DEBATES
What sort of Pakistan?

- Iqbal decried lack of unity as a cause of Muslim backwardness
  - Pas che bayad kard
  - Asrar e khudi
  - Bottom line: self reliance even it means a lower standard of living; avoid debt traps
- Jinnah was willing to accept Cabinet Mission proposal for decentralized and relatively loose federal structure for India
- Rejected by Iqbal, and more importantly, Nehru
- In final analysis, colonial Government of India Act 1935 remained the basis for Pakistan constitutions
  - Overlapping spending responsibilities
  - Problematic revenue-assignments: encouraged game-play between crown and elected state/provincial governments
  - Facilitating central control—even the 1935 safeguards were eroded in Pakistan
Design of the 1973 Constitution

- Overlapping spending assignments maintained
- Financed by
  - Share of divisible pool
  - Split revenue bases
    - both income and sales taxes—continuing legacy of colonial Government of India Act, 1935;
    - although Pakistan inverted sales tax assignment, after independence
- No effective own-source revenues at provincial level
  - Huge vertical imbalance
  - Assigned sales taxes on services to provinces in 1973
    - In 1973, this was largely a final point tax on tangible services
    - Much before the advent of the GST
      - proposed for Pakistan by Ahmad and Stern in the early 1980s
      - partial endorsement by Qamar-ul Islam Tax Reform Commission 1983
Decentralization during Musharraf years

- Local implementation and non-party elections
  - Mechanism to by-pass established parties at the provincial levels (PML, PPP)
  - Tried before by General Ayub Khan in the 1960’s (basic democracy experiments)
- But overlapping assignments continued—not clear what districts would be responsible for
  - No own-source revenues at the local level
  - Deconcentration rather than decentralization; although some attempt to bring service delivery closer to the citizens
- 18th Amendment a reaction to this experience—handing all responsibilities to the provinces
  - Has Pakistan become more like the Cabinet-mission model?
Current Directions?

- Looser confederal structure
  - Closer to Cabinet Commission blueprint than Iqbal’s vision
  - Reinforcing ethno-linguistic divides
- Collapsing public services (Tables 1 and 2); and vertical imbalance (Chart 1)
- Potential for conflict
  - Inadequate recognition of coordination and externalities in spending assignments, unfunded mandates
  - Especially problematic division of resources
  - Poor design of revenue bases
    - Exacerbating of tax exporting/potential tax wars
    - Water
    - Natural resources
- Inadequate “equalization” in transfer design
- Potentially damaging access to uncoordinated and captive subnational credit
The 18th Amendment, NFC award and failure of tax reforms
The 18th Amendment: achievement and challenge

- Proclaimed as truly historic achievement
  - Reactions to periods of military rule
  - Inter-linkages and financing constraints not thought through
- Huge challenge, including the speed of implementation
- Likely to generate substantial transition costs
- KEY ISSUE: how is this to be financed during a period of crisis and deadlock on the tax reforms?
- Important to avoid collapse or deterioration of service delivery, especially at local levels—in order to prevent backlash
- Governance and information systems at all levels need a great deal of work
  - Where does the money go?
  - And what are the results of the spending?
The 18th Amendment

- 18th Amendment has focused on unbundling spending responsibilities to provinces
  - Unitary structure at the provincial level
  - Local assignments still not clear
  - #140A leaves it to the discretion of Provincial assemblies
- Did not effectively address the revenue assignments—
  - apart from reinforcing the split bases for the GST, and income taxes
  - Fissures clear in the tussle over administration of the GST on services
    - Although a solution can be reached in principle, it will be unstable
    - Does not provide own-source revenues
- Right of provinces to borrow directly without reference to overall sustainability criteria
  - Together with creation of provincial banks (Sindh)
  - Will this replicate abuses under Punjab Bank? Latin American disasters?
- One-way floor on NFC transfers....
- Still no incentives for effective utilization of national resources
### Social spending -- health

<table>
<thead>
<tr>
<th>Countries</th>
<th>Total expenditure on health as % of Gross domestic product</th>
<th>Public % GDP</th>
<th>Per capita govern</th>
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<tbody>
<tr>
<td></td>
<td>2005</td>
<td>2006</td>
<td>2007</td>
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<td>Nigeria</td>
<td>6.6</td>
<td>5.5</td>
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<td>Brazil</td>
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<tr>
<td>Afghanistan</td>
<td>8.8</td>
<td>7.8</td>
<td>7.6</td>
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<tr>
<td>Iran (Islamic Republic of)</td>
<td>5.7</td>
<td>5.5</td>
<td>5.5</td>
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<tr>
<td><strong>Pakistan</strong></td>
<td><strong>2.8</strong></td>
<td><strong>2.7</strong></td>
<td><strong>2.6</strong></td>
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<tr>
<td>Yemen</td>
<td>4.9</td>
<td>5.3</td>
<td>5.3</td>
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<tr>
<td>Bangladesh</td>
<td>3.2</td>
<td>3.4</td>
<td>3.5</td>
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<tr>
<td>India</td>
<td>4.2</td>
<td>4.0</td>
<td>4.0</td>
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<tr>
<td>Indonesia</td>
<td>2.1</td>
<td>2.3</td>
<td>2.5</td>
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<tr>
<td>Thailand</td>
<td>3.5</td>
<td>3.7</td>
<td>3.7</td>
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<tr>
<td>China</td>
<td>4.7</td>
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<tr>
<td>Malaysia</td>
<td>4.1</td>
<td>4.3</td>
<td>4.4</td>
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<tr>
<td>Philippines</td>
<td>3.6</td>
<td>3.6</td>
<td>3.5</td>
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<tr>
<td>Singapore</td>
<td>3.0</td>
<td>2.9</td>
<td>3.0</td>
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</tbody>
</table>

Source: WHO, NHA Database; Note: Pakistan budgetary spending on health in 2008/9 0.6% of GDP. Per capita government spending is in US $ at the prevailing exchange rate. Public per capita spending 2010, World Bank, 2011.
Health and nutrition outcomes

- Resurgence of polio—eradicated in all parts of the world except Niger Delta
- Inability to handle infectious diseases: externalities with dengue
- Increasing nutritional vulnerability 2011 Nutritional Survey (MoH and Aga Khan University):
  - Alarming level of food insecurity (57% of households)
    - Concentration of malnutrition among women and children
    - Maternal anemia 49%; child stunting 43%; wasting 13%
    - Concentrated in Sindh, Baluchistan and FATA
  - Reflective of lack of government commitment to ensuring food security.
Education outcomes (circa 2009) worse than Sub-Saharan Africa

<table>
<thead>
<tr>
<th>Country</th>
<th>School enrollment primary (net)</th>
<th>Secondary enrollment (gross)</th>
<th>Adult literacy rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pakistan</td>
<td>66.4</td>
<td>33.1</td>
<td>55.5</td>
</tr>
<tr>
<td>India</td>
<td>91.4</td>
<td>60.0</td>
<td>62.7</td>
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<tr>
<td>Bangladesh</td>
<td>85.3</td>
<td>42.3</td>
<td>55.9</td>
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<tr>
<td>Sub-Saharan African</td>
<td>75.1</td>
<td>36.0</td>
<td>62.3</td>
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<tr>
<td>Malaysia</td>
<td>95.6</td>
<td>68.7</td>
<td>92.5</td>
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<tr>
<td>Indonesia</td>
<td>95.3</td>
<td>79.5</td>
<td>92.2</td>
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<tr>
<td>Iran</td>
<td>99.5</td>
<td>83.7</td>
<td>85.1</td>
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</tbody>
</table>

Source: World Bank, World Development Indicators, September 2011
Education lags behind comparator countries—indeed, well behind sub-Saharan Africa
- Considerable gap even with respect to primary education coverage

Yet constitution guarantees:
- “compulsory and free” education till secondary level #37(b)
- And access to technical and higher education for all on “merit” #37c
- Social benefits for the unemployed or incapacitated: very Bismarkian
  - ”provide 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
- Very clear, and no additional targeting or score cards, that are open to “capture” or “clientelism”

These are Constitutional basic rights, and actionable in court
How is additional provincial spending to be financed?

- Probably require overall a 20% tax/GDP ratio
  - to get even close to the standards in Latin America
  - Brazil is at 34%; and still does not meet these objectives
- But how will this be financed? Given the extreme vertical imbalances and moribund tax/GDP ratio
  - 2011 ratio 8.5%--down from 10% in 2008; and 14% in the mid-1980s
  - Failure of strategy to replace trade taxes by the GST
  - [Reliance on borrowing: total debt service is now 90% of tax revenues and rising ]
  - Absence of adequate provincial/local tax bases
- Strategy: larger share of divisible pool /NFC award
  - Contingent on raising the dismal tax/GDP ratio (9 to 12-15%)
  - Key element was the reform of the GST, cornerstone of homegrown stabilization program supported by IMF
    - Pakistan  C-efficiency of GST fell to .27
    - Philippines and Sri Lanka around .45
    - Integrated approach to GST advocated (President’s proposal to Friends of Pakistan, September 2008, before approach to IMF)
A digression on Musharraf tax reforms: good intentions, dreadful outcomes

- Corruption identified as major problem in the Qamar ul-Islam Commission report in mid-1980s
  - CBR then the most corrupt of Pakistani institutions
- VAT/GST introduced in 1990 under Nawaz Sharif, continued to be operated in “excise” administered mode
  - Revenue generation inadequate; at least half a dozed tax policy/administration reports by IMF in the decade
  - Tax reform/self reliance became critical after sanctions following the nuclear tests
  - Late 1990s—Shahid Husain report on revamping tax administration, integrated and arms length agency
  - Supported by $130 m World Bank loan (TARP, after 9/11)
- Main results, CBR became FBR, with new offices and cars, and business as usual
- Initial Musharraf strategy: more investment friendly trading regime, reduce tariffs, but make up by reforming GST
  - Finessed provincial issue by issuing four provincial laws authorizing FBR to operate service/excise regime
So why did it fail?--Political economy

- Misguided advice to beat up small retailers—army sent in and general strike rebuffed them
- Post 9/11: more than adequate inflow of foreign assistance, reduced incentives to generate own-revenues
- Results
  - FBR Integration not effected, nor arms length administration—
  - very convenient to use SROs to reward lackeys and punish deviants
- Feel-good policy of Government:
  - Major production sectors taken out of GST net altogether
  - 2004, audit stopped altogether, in misreading of the term “self-assessment” by new Chairman, who kicked out the IMF teams—
    - but who noticed? Why was this not a major issue for the Bank?
    - Wolfowitz told Loan Committee: these are our friends in the war on terror, just get the moneys out to them
    - IMF no better: 2007 Staff report changed to give clean bill of health to Musharraf Administration
The 2008 Stabilization Program

- Fixing the VAT was a cornerstone—get tax/GDP back to around 15% in five years
- Appeared to be “owned” by government—taken to Friends of Pakistan in September 2008
- Core of IMF Program
  - Arms length administration
  - Information generated by VAT used for CIT (interactions critical to address informality)
- Protection for vulnerable assured under the program—left to Bank
- World Bank to concentrate on Treasury Single Account, and Energy Sector
  - TSA: in 2008, over $10 billion in unused government bank accounts
  - Reason why Dar did not want to go to the IMF
  - But could not be touched
  - Bank could not find the balances!!
- Energy sector—mistaken policies advocated in 1990s, inappropriate governance model continue to plague the public accounts
- Social Safety Net: BISP—is this a Bank contribution of $500m to the reelection campaign of the government?
  - Clientelism and capture?
Is there an alternative to a proper GST/VAT?

- Unfortunately, not many non-distortionary handles
  - Without reversing the trade and investor-friendly environment of the Shaukat Aziz years
  - Direct taxation of agriculture attractive politically, but unlikely to yield much revenues
  - But wealth or gross asset taxes, distortionary but used in Latin America in similar circumstances, could be considered as a “presumptive” tax offset against CIT, PIT/zakat liability

- Proper and arms length VAT only instrument to generate an additional 4-5% of GDP in a reasonable period
  - Plus the additional information leading to improvements in the CIT and personal income taxes

- Current law is so deficient, that back-door tinkering, e.g., through more SROs or ordinances will not do
  - If vested interests cannot be met squarely, the reform will not work
  - Qamar-ul Islam was right
GST reforms opposed by those who should benefit

- Never in the interests of the bureaucrats presenting and making a case to Parliament or stakeholders
- Real opposition is to income tax—would become clear with a proper GST—opposed from within the ruling coalition
- Could be stopped/subverted by any one province
- Vested interests oppose losing benefits and point to any other sectors for taxation
- In effect, impossible to remove “special deals for friends and relatives of those in power”
- Consequence:
  - GST generates neither revenues,
  - nor information on the “value added chain”
  - Continues to operate as an excise—increasing the incentives to evade; causing informality—
  - The poor design and implementation justifies Stiglitz critique
- Only condition offered by current government to secure IMF loan, formally abandoned by the same government
The Carbon Tax—linkages with spending decisions

- Following Ahmad and Stern (2009), a carbon tax was proposed
  - Idea to generate additional revenues to assist with industrial restructuring
  - Needed to use part of the additional revenues to "compensate/protect the poorest"
  - Accepted, and generates over 1% of GDP

- But what did they do wrong?
  1. Called it a carbon surcharge—to avoid sharing with the provinces
     1. Struck down by Supreme Court, as there is no tax on which it can be a surcharge—renamed it a petroleum levy
  2. Not in the divisible pool
  3. No allocations for industrial restructuring; or earmarks for the poor
  4. Straightforward deficit reduction plug!!
What’s left of the NFC award?

- **Much heralded award**
  - But contingent on the tax reforms
  - Allocations to provinces, and indemnities (e.g., to Punjab) do not make sense without the additions to the tax/GDP ratio needed
  - Assumed that the VAT reforms would be implemented
  - Generate 1% GDP surplus at the subnational level (2010/11)

- **Now largely defunct**
  - 2010/11 budget contained 50 percent wage increase wiped out the surplus at pre-2008 levels of provision
  - No room for taking on new spending, or improving the allocations for health or education
  - Proper accounting for accrued, cash deficits, arrears—
    - adding to the circular debt (refusing to pay for centrally provided utilities);
    - borrowing from captive banks—problems for Punjan and Sindh banks
### Federal Transfers to Provinces: actual (to 2011) and potential under 7th NFC (% of GDP)

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<tbody>
<tr>
<td>Divisible pool</td>
<td>3.41</td>
<td>3.96</td>
<td>3.93</td>
<td>3.60</td>
<td>3.81</td>
<td>4.79</td>
<td></td>
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<tr>
<td>Total</td>
<td>4.74</td>
<td>5.20</td>
<td>4.94</td>
<td>4.43</td>
<td>4.56</td>
<td>6.20</td>
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<td>Tax collections projected</td>
<td>10.00</td>
<td>11.00</td>
<td>12.00</td>
<td>13.00</td>
<td>14.00</td>
<td>15.00</td>
<td></td>
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<tr>
<td>NFC provincial shares expected</td>
<td>6.16</td>
<td>6.84</td>
<td>7.41</td>
<td>7.98</td>
<td>8.55</td>
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<tr>
<td>Tax collections (actual 2010/11; and in revised medium-term forecast)</td>
<td>8.50</td>
<td>9.00</td>
<td>10.00</td>
<td>10.10</td>
<td>10.10</td>
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<tr>
<td>Revised NFC divisible pool</td>
<td>5.13</td>
<td>5.70</td>
<td>5.76</td>
<td>5.76</td>
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<tr>
<td>Provincial funding gap</td>
<td>-1.37</td>
<td>-1.71</td>
<td>-1.71</td>
<td>-2.22</td>
<td>-2.79</td>
<td></td>
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<td>Education and health (PRSPII)</td>
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<td>6.79</td>
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So what happens to the devolution?

- It is unfunded, at a time when additional costs are likely (over full level of functional spending by all levels of government)
  - Status quo ante is not financed
  - Impossible to generate 1 percent surplus (pre 18th Amendment)
  - Overall decline in resources will lead to abandonment in PRSP II improvement targets in education and health care
  - Very likely increasing financing gap at the subnational level as responsibilities are fully transferred

- Result:
  - Deterioration or collapse in public service delivery
    - Major disruption at the minimum
    - Arrears, circular debt
  - Now provinces have been encouraged to borrow directly, bypassing the center
    - Establishment of provincial “captive” banks--NPLs
    - Repeating the mistakes from Latin America
Vertical imbalances

Average excluding Pakistan = 41 percent

Source: Euraud, Karpowics and Lusinyan (2011) and staff calculation
1/Vertical fiscal imbalance is defined as the share of sub-national own spending (excluding transfers paid) not financed through own revenue (excluding transfers received).
Vertical imbalances a major constraint?

- Yes, if the federal tax reforms have no traction
- But in principle, not a major constraint, if as in Australia:
  - there are adequate own-source revenues at margin,
  - appropriate level of federal taxation for the divisible pool
  - Appropriately designed transfers
Should revenue assignments be revisited?

Yes, own-source revenues needed for greater accountability at all levels of government
Arguments concerning tax assignments

- **Traditional intergovernmental theory**
  - Assign immobile tax bases to lower levels
  - More mobile to center, reinforce the administration constraints

- **Modern political economy approaches**
  - Mobile tax bases accentuate sub-national discipline, hence attractive from political economy perspective
  - Variation in rates critical in establishing provincial accountability
What constitutes own-source revenues?

- Some control over rate structure at margin is the distinguishing feature.
- Thus, shared-revenues, or where the rate is set by another level (even if administration is local) is NOT own-source revenue.
- Good examples of own-source revenues:
  - Piggy back on Federal PIT/ VAT
  - Canadian dual VAT
  - IRAP (Italy) for regional governments
  - Local property taxes, e.g., in the US
More significant obstacles

- **Political economy constraints to tax administration and tax policy reforms**
  - Rent seeking by FBR, in conjunction with cronies of administration
  - Enshrined in SROs
  - Law drafted in collaboration with IMF/Bank sought to eliminate this, create arms’ length administration
    - Sought end to special deals for “favoured sectors” and individuals
    - But these were friends of people in important positions!!

- **Never any real commitment to address the underlying tax issues**
  - Attempts to retain discretionary FBR role reintroduced in law presented to Parliament, with some draconian measures
  - New SRO 283 (aptly dated April 1, 2011) betrays confusion on GST in the FBR—some exemptions suppressed in budget, now restored
  - Finishes off any chance of fixing the GST
Ending rent-seeking in tax design

- Consolidate split bases (PIT, GST)
- Plug holes and eliminate exemptions and special privileges
  - Foreign source income exemption should be removed
  - Minimum asset tax, 2%, offset against CIT/PIT/zakat liabilities
- Simplify taxes and handle distributional issues with well-designed social policy, and intergovernmental transfers
- Create arms-length administration on agency basis, working for federation and provinces
  - SBP model
  - Reporting to CCI?
- Accountability at SNG level, through better incentive structures and information generation
Opposition to tracking of spending and transparency

- **Why the opposition to the TSA?**
  - Supporting friends in banks and sectors
  - Entirely consistent

- **Why is the GFMIS not an integral part of the MOF?**
  - Really no interest in change
  - Manual systems still operate, easier to fudge
  - Electronic systems relegated to ex post feel good for international agencies

- **Disastrous IT systems in tax administration**
  - TARP declared non-performing by Bank in February 2008
    - But FBR had not even begun to create conceptual design of new system—merely computerizing existing processes
    - Nor had the integration been seriously considered
Need for a radical reform agenda

INCLUDING PROPOSALS FOR THE NFC
Assignments to strengthen federation and service delivery

- May have to go back to Iqbal’s vision of a people working in unison, with faith and discipline, rather than fighting each other

- Stronger coordination function, together with subsidiarity principles
  - Clarity on what should be local (sub-provincial) responsibility
    - Water supply and sanitation; urban transport; primary education and basic health care?
  - Externalities and coordination requiring central actions
    - Higher education; health care
    - Climate change

- Role of metropolitan areas in fostering growth linkages
  - Cities with the status, functions and resources of provinces
  - Ratings and access to credit with hard budget constraints
  - Beijing, Shanghai; Bogota; as opposed to the bottlenecks of Karachi
Diffuse conflict over administration for main taxes

- New common tax administration
  - Integrated and arms length for all major domestic taxes
  - Under CCI? State Bank model with autonomy and accountability for management

- Manage both federal and provincial assignments

- For provinces:
  - Move to piggy-back or joint occupancy of the full GST/VAT (similar to proposals being developed for India—Ahmad and Poddar)
  - Same for the PIT/CIT
  - Larger base, control over the tax rate at margin (within a band, say)
  - Administration not an issue
Institutional arrangements for transparency

- Implement TSA
  - Run aid moneys through TSA in correspondent accounts, with zero balance arrangements in commercial banks

- Revamp PIFRA
  - Should be the core of the MOF
  - Streamlined processes and procedures
  - Focus on more efficient ministry—including macroeconomic management and debt as part of a new Treasury
Intergovernmental
1. Assignments of broad based revenues to provinces may accentuate disparities
2. May need to be introduced together with an explicit equalization framework
   1. China and Australia: based on revenue capacities and spending needs
   2. Possible to indemnify “losers”—Chinese “absolute revenue guarantees”, and phase in reforms over time
3. In the short-run, supplement with performance-based transfers for central/donor objectives

Interpersonal
- Link to gainers and losers
- Role of minimum benefit under the constitution versus Conditional Cash Transfers

Accountability—stop passing the buck to others/future generations
- Tighten limits on provincial borrowing
- Access to credit: subject to overall limits for general government and based on credit ratings and hard budget constraints
- Losses in provincial banks?
Consolidation of revenue bases: both Consumption and Income
  - More efficient administration of GST; and income taxes (including from capital gains and agriculture)

Dual income tax as well as dual GST would provide larger own-source revenues to the provinces
  - Control over rates at the margin more important than “administration”

End external income exemption

Minimum asset tax creditable against PIT/CIT/zakat

Property taxes then could be reassigned to the local level
  - Provincial cadastres/land records

A new equalization framework

Mechanism for coordination of local debts and borrowing