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Fiscal Federalism In Pakistan: A Radical Departure And Some New Challenges

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The Development Policy Research Centre (DPRC) is a knowledge centre structured around core socioeconomic development themes with the objective of carrying out cutting edge multi-disciplinary research. The centre combines the disciplines of social sciences and law to strengthen evidence-based policymaking.

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1 Introduction

There have been far reaching developments in recent months on federalism in Pakistan. In March 2010, the parliament passed the 18th Amendment to the 1973 Constitution repealing the 17th amendment that had empowered the President as the Chief Executive of the country at the expense of the Prime Minister, the chosen leader of the parliament. Importantly, the 18th amendment gives powerful new tools to the federating entities in Pakistan to manage their fiscal affairs as they pursue their development objectives. This required a substantial makeover of the system of fiscal transfers between the Center and the federating unit. The result is the seventh National Finance Commission Award that is a radical departure from the past practice.

The changes in mandated responsibilities of the federating units and the supporting system of fiscal transfers have to be seen in the context of three development outcomes that have fueled political tensions. First, Pakistan has experienced growing, and increasingly unacceptable, regional inequality in economic growth and prosperity. Second, even though the quality of basic infrastructure compares well with countries at its level of income, social outcomes in Pakistan have been unflattering and threaten to further increase regional disparity. Third, the fiscal space to correct for these imbalances remains thin as the state's capacity to raise revenue remains poor despite several attempts at reform.

This paper summarizes the federal structure of Pakistan and reviews the system of fiscal transfers from the perspective of vertical and horizontal equity. It then highlights and assesses the changes introduced by the 18th amendment and the seventh National Finance in terms of the two equity perspectives. The paper also comments on how the changes might impact several key challenges such as encouraging more prudent sub-national expenditure management, motivating revenue effort by the federating entities and improved management of natural resources. The implications for the third tier i.e. the local government system are also commented on. Finally, some comments are offered on the institutional arrangement, the Council of Common Interest (CCI), for overseeing the new system to ensure that it delivers in terms of progress on greater regional equity in income growth, improved social outcomes, and better fiscal management.

2 The Federal Structure in March 2010

Pakistan became a Constitutional Federation in 1956 comprising four provinces[1], seven tribal agencies, six frontier regions, Gilgit-Baltistan and the Capital Territory of Islamabad[2]. As a Constitutional Federation, provinces and other federated units are represented in the central legislature, with significant policy/economic development responsibilities at the sub-national level (Inman & Rubinfield, 2009). There is also a third tier of local governments (comprising district, tehsil and union administrations) that was introduced under the devolution[3] plan in 2001. Within this setup, empowering provinces, tribal areas and other federating units to conduct their fiscal affairs prudently, while maintaining a united federal republic, has remained a challenge.

Pakistan has developed an elaborate fiscal arrangement, in the form of the National Finance Commission (NFC) award, which prescribes a formula based distribution of resources and sharing of the tax bases between the centre and the lower, provincial and municipal, levels of government. To exercise these functions, the different tiers of government are allocated funds to carry out responsibilities as per the federal and concurrent lists that elicit expenditure assignments at each tier of governance. The provinces carry out their policy-making role with financial resources that consist of both transfers from the federal government via the NFC award and tax revenue collected by the provincial governments.

The federal fiscal design has resulted in complexities in taxation and expenditure. On taxation, multiple levels of authority lead to the issue of incentives in levying taxes. Furthermore, the existence of multiple levels of taxing authority has augmented the issues of tax design not found in unitary states (Broadway, Roberts, & Shah, 1994). Furthermore sub-national governments (both provincial and local) in Pakistan have insufficient funds as most of the revenue is collected by the federal government, which results in an imbalance between the power of revenue generation (in the form of tax collection) and expenditure. The four provincial governments in Pakistan account for 28% of all government expenditures but only 8% of the tax collected[4]. The excessive dependence of the provincial governments on federal transfers and centralization of revenue collection has resulted in what is called a vertical fiscal imbalance across governments and remains one of the central issues of public finance in Pakistan, necessitating a system of intergovernmental transfers.

[1] Punjab, Sindh, Khyber Pakhtoon Khwa (KP) and Balochistan
[2] http://www.forumfed.org/en/where/pakistan.php
[3] This form of decentralization, also known as devolution, is the most advanced form of decentralization and transfers powers and responsibilities to public bodies elected by their constituencies (Dafflon & Madies, 2009)
[4] Adapted from Watts (2005). Chapter 7: Fiscal Decentralization: Strengthening Provincial Finances (BNU Report)

3 Intergovernmental Transfers in Pakistan

3.1 A Necessity

Intergovernmental fiscal transfers are a dominant feature of sub-national finance in most countries. Such transfers are often necessitated when the federal government realizes a serious mismatch between the levels of spending expected from local governments and the revenue potential from tax and non-tax sources assigned to local jurisdictions (Schroeder & Smoke, 2003). In the case of Pakistan, there is a serious imbalance in the sub-national expenditures and revenue generation as in Table 1.

Table 1: International Comparison of National and Sub-National Revenue & Expenditure Shares		
	Revenue Share	**Expenditure Share**
Australia		
National Government	69	54
Sub National Government	31	46
Brazil		
National Government	69	54
Sub National Government	31	46
Canada		
National Government	44	37
Sub National Government	56	63
India		
National Government	66	45
Sub National Government	34	55
South Korea		
National Government	95	50
Sub National Government	5	50
Pakistan		
National Government	92	72
Sub National Government	8	28

Source: Adapted from Watts (2005). Chapter 7: Fiscal Decentralization: Strengthening Provincial Finances (BNU Report)

Due to the mismatch in expenditure obligations and revenue raising capacities, intergovernmental transfers have become a necessity for Pakistan. Such transfers and sharing of resources is embedded within the constitution and supported by a series of legislative rules and regula tions. Inter-governmental transfers typically include revenue shares, grants, straight transfers provincial revenues collected by federal government and transferred to provinces after deducting collection charges (eg royalties on gas and crude oil) and loans. Figure 1 provides an overview of the basic mechanisms for distribution of resources in Pakistan.

3.2 Revenue Sharing through the NFC

3.2.1 The National Finance Commission

Revenue sharing is the dominant form of federal-provincial fiscal relations for financing operating expenditures[5] and takes place through the National Finance Commission (NFC). The NFC[6] is constitutionally obligated to help determine both the vertical and horizontal distribution of

[5] Conditional grant programs are practiced primarily for capital projects that are typically designed and determined at the federal level and local governments implement these projects on behalf of their provincial governments

[6] NFC unde Article 160 of the Constitution of Pakistan, interalia advices the President of Pakistan on the matter of 'dstribution' of tax revenues between the federation and the provinces and amongst provinces. The distribution formula is termed as an NFC award.

the net taxes between the federal and provincial governments by issuing a fresh award every 5 years. These transfers through the NFC award have become the lifeline of provincial governments. The federal divisible pool contains (shared with provinces) includes all revenues received by the federal government, all loans raised by the federal government and all monies received as repayment of loans. The constitution does not limit the NFC to address socio-economic disparities amongst the provinces only through grants-in-aid by the federal government and can settle on allocation of the federal divisible pool specific to the requirements of every province.

The NFC determines both the proportion of the constitutionally specified federal revenues that should go to the provinces and the criteria for the distribution of these revenues among provinces (Shah, 2003). The main charter of the NFC is to recommend on the following: a) The distribution of specified taxes and duties between federation and provinces b) The disbursement of grants to provincial governments c) The borrowing powers exercised by federal and provincial governments d) Any other financial matter referred to the Commission. Till date a total of 9 revenue sharing awards have been issued that include the Riesman Award of 1951, and the NFC awards of 1961-62, 1964, 1970, 1974, 1990, and 1996, the Presidential Order of 2006 and the 7th NFC award 2009.

3.2.2 Performance of the NFC

Reliance by sub-national entities on inter-governmental transfers through the NFC award has risen over the years. The share of both total transfers and its subset (divisible pool transfers and special grants) has increased. Tables 2 and 3 show that even though reliance on federal transfers

Figure 1: Distribution of Resources in Pakistan

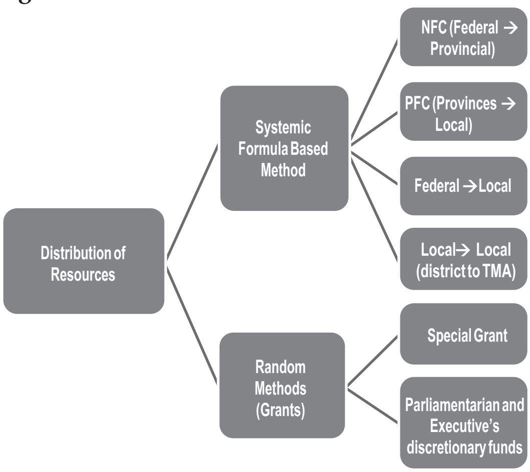

Table 2: Trend In Share Of Total Transfers In Federal Tax Revenues

	Total Transfers (in Rs billion)	Total Transfers[7] as %age of federal taxes	Divisible pool transfers & special grants as %age of federal taxes
1990-91 pre 1990 NFC	33.8	30.2	28.7
1991-92 post 1990 NFC	65.8	46.4	34.9
1996-97 pre 1996 NFC	139.4	46.4	43.0
1997-98 post 1996 NFC	131.7	44.9	37.9
2005-06 pre 2006 order	316.0	41.2	33.0
2007-08 post 2006 order	490.8	50.2	41.5
2008-09 post 2006 order	606.0	51.4	43.9

Source: Chapter 7: Fiscal Decentralization: Strengthening Provincial Finances (BNU Third Annual Report, 2010)

[7]Including hydro-electricity profits to Khyber-Pakhtunkhwa and other straight transfers.

has increased over time, there is less vertical inequity because more revenue is being transferred to the sub-national entities. Furthermore, horizontal inequity is also being addressed, albeit slowly.

Table 3: Share In Total Transfers By Provinces

	Total Federal Transfers in Rs billion	Punjab	Sindh	KP	Balochistan
1990-91 pre 1990 NFC	33.8	55.3	24.0	12.7	7.9
1991-92 post 1990 NFC	65.8	45.1	23.9	19.0	12.0
1996-97 pre 1996 NFC	139.4	51.3	24.9	15.9	7.9
1997-98 post 1996 NFC	131.7	47.0	23.8	17.8	11.4
2005-06 pre 2006 order	316.0	47.1	30.1	14.4	8.4
2007-08 post 2006 order	490.8	47.3	29.8	14.8	8.0
2008-09 post 2006 order	606.0	46.5	30.2	14.7	8.6

Source: Chapter 7: Fiscal Decentralization: Strengthening Provincial Finances (BNU Third Annual Report, 2010)

Despite some improvements in horizontal and vertical equity, the performance of the NFC has not been stellar. The award preceding the most recent one was an ad-hoc one that was announced by the president in the wake of failure to announce award by previous two NFCs constituted in 2000 and 2005. A failure to reach consensus has mostly revolved around several contentious issues that have included making decisions on a) which taxes to include in the divisible pool b) magnitude of the respective share of federal and combined provincial government in the pool c) distribution amongst the provinces d) criterion for distribution.

The distribution formula is based on multiple indicators that include population, poverty/backward index, IPD and tax effort/revenue generation yet it has historically failed to address the socio-economic disparities across provinces. Horizontal distribution is based primarily on population, limiting the financial capacity of the provincial governments to meet their assigned roles and responsibilities. In practice, disparities measured by IPD, backwardness or fiscal effort have been ignored. While population should get a greater weightage in Punjab, poverty/backward index must be an important indicator for KP, IPD and poverty/backward index for Balochistan and revenue generation/collection for Sindh. With the largest population, Punjab has remained the major beneficiary of all NFC awards. On the other hand, Balochistan has suffered the most for being the least populous province.

Addressing specifically the case of Balochistan, IPD is an essential economic parameter for equalization of provision of public services and development per capita in federating units (Figure 2). As the area increases, the per capita cost of development and providing public services also increase. As the population reduces or is dispersed, per capita cost of development and providing public services also increases. Low population density and vast area multiply the per capita cost of development and provision of public services in Balochistan.

Figure 2: IPD Ratio – Province Wise

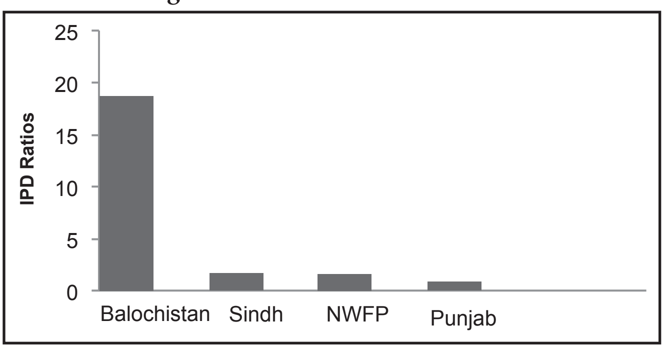

Table 4 represents indicators illustrating some of the regional disparities that have arisen as a result of the lack of a meaningful and equitable federal system (Ahmad, 2010).

A major weakness of the NFC award has been the inability to incorporate any mechanism to motivate resource mobilization in the provinces so that the financial dependence of the provinces on fiscal transfers can reduce. There is no incentive built in the transfer formula to reward provinces for increasing their tax effort or penalize them otherwise. Intergovernmental transfers, now further strengthened through the seventh NFC award and the 18th Amendment, also tend to create soft budget constraints, reducing incentive to raise effort. Sub national governments are tempted to over-spend on public goods provision and/or under-tax its own local tax base. This soft budget constraint faced by the provincial government does not encourage fiscal prudence regarding both expenditure and revenue When incentives are not properly aligned as in the case of Pakistan, sub-national governments tend to create situations where they commit to expenditures they do not have funds for, knowing that the federal government would come to the rescue, instead of allowing the expenditures to go unpaid because of externalities and/or of fear of accountability.

The bottom line is that the system of sharing development responsibilities and fiscal resources was not seen by the smaller provinces to be addressing adequately the three fundamental development outcomes i.e. regional disparities in income generation, social outcomes and own revenue generation.

Table 4: Population below the Poverty Line

Province	Overall	Provincial Capital	Large Cities	Small Cities	Rural Areas
Punjab	26	19	21	42	24
Sindh	31	11	29	38	38
KP	29	28	0	41	28
Balochistan	48	16	0	41	52

Source: (Ahmad, 2010)

4 Recent Changes

4.1 Eighteenth Amendment

The 18th Amendment has primarily sought to correct the anomaly in the parliamentary form of government by restoring the powers given to parliament under the 1973 Constitution (IPP, 2010). However, it does more than repeal the Seventeenth Amendment that had given enormous authority to the President. This reform marks a defining moment by ensuring a constitutional provision for one of the basic determinants of the rights of provinces and their capacity to govern effectively. The 18th amendment is set to become effective from 2011-12 and is likely to devolve some major functions and expenditure heads to the sub national governments in line with the provisions of the 1973 constitution. While devolution of power has transferred political authority, this amendment also has implications for transferring more economic power to the provinces. It is being put forward by many as a move towards a stronger federal system (Waseem, 2010). Let us look at how this is being set out to achieve.

Firstly, the size of federal government has been greatly reduced and the balance of power between centre and provinces has been altered[8]. The Amendment has several provisions to give more power to the smaller provinces and strengthen the senate. There has been widespread delegation of responsibilities to provincial governments and with this, the federation has made an attempt to shift the maximum burden to the provinces, which would have to take the responsibility and deliver their best. The number of fundamental rights have been increased to include the right to fair trial, the right to information and the right to education. With the abolition of the concurrent list, education has now become a provincial responsibility.

For our purpose, the most important changes in the Constitution relate to the assigning of responsibilities to governments at different levels. In this regard, a number of steps have been taken (IPP, 2010).

- Firstly, the Concurrent List in the original document that gave joint responsibilities to the federal as well as provincial governments has been removed. The concurrent list, containing subjects that were the joint responsibility of the federal and provincial governments, has continued to provide the federal government power, resources, and responsibility to manage the country under a centralized control. When the constitutional amendment comes into force, 44 of the 47 items on the concurrent list would automatically stand devolved to the provinces along with liabilities. Following the removal of the concurrent list, several items have been deleted from the federal list and are now taxable by provinces. These include state lotteries, duties in respect of succession to property, estate duty in respect of property and taxes on capital value of immovable property. It would substantially reduce the federal government's revenue as provincial legislative power would transfer substantial revenue collection from the federation to the provinces.

- Secondly, the role of the Council of Common Interest (CCI) has been strengthened. It shall now be chaired by the Prime Minister, shall meet at least once a quarter, and have a permanent secretariat while the list of subjects that will fall within the purview of the CCI has been substantially expanded including some of the subjects that were on the abolished concurrent list.

- Thirdly, devolution of power to local governments has also been expanded. The provision inserted by the 17th amendment by President Musharrraf relating to the devolution of power to local governments has been retained and expanded to provide that elections should be held to local councils by the Election Commission.

- Lastly, the finances of the provinces have been significantly strengthened. The provinces will have the right to raise domestic and foreign loans with the approval of the National Economic Council (NEC). They will be able to collect entire amount raised by excise duty on oil and natural gas. Future National Finance Commissions cannot issue awards that reduce the combined share of the provinces in the central divisible pool. In other words, the amount given to the provinces by the 7th Award has been frozen in time. The only discretion they have is to change the proportions allocated to the provinces. State lotteries, duties on succession to

[8] Usman Mustafa – Impacts and Implications of the 7th NFC Award (PIDE, 2010), BNU Annual Report (IPP, 2010)

property, estate duty in respect of property, sales tax on services, taxes on capital value of immovable property are now sub national taxes. Access and control over natural resources has also been enhanced and provinces have been assigned the right to levy taxes on services.

The 18th amendment has also been viewed as a means of upholding the promises of the Balochistan Package that had recommended repeal of the concurrent list, implementation of the operations of CCI as per the constitution, rationalization of the NFC Award, the need for special development package for the province, and payment of arrears in gas royalty (Rs 120 billion). This package of reforms was presented by the government in 2009.

While these changes are being viewed as positive steps towards correcting the highly skewed distribution of resources between the federal and provincial governments and amongst the provinces themselves, these have also transferred greater expenditure responsibilities onto provinces, bringing into question the capacity of the sub national governments to plan and deliver according to the mandate of the 18th amendment.

4.2 The Seventh NFC Award

The Seventh NFC Award was successfully concluded after a lapse of almost 19 years but has introduced some fundamental shifts in the basis for determining the vertical (i.e. from federal level to provinces), as well as horizontal (i.e. intra-provincial) distribution. For the purposes of this paper, we will focus on three aspects of changes made by the award.

Firstly, it is seen as a measure towards strengthening fiscal decentralization or addressing the problem of vertical in equity in the federal fiscal system in a more substantial manner than in the past. Effective from July 1, 2010, the seventh NFC Award has more than doubled the amount of annual resource transfer to the provinces. The share of the provinces has increased from 47.5% to 56% for first year and 57.5% for the remaining years. According to one estimate total transfers from federal government to provinces would increase to Rs 1,033 billion from Rs 655 billion[9]. The federal government has also reduced collection charges from 5% to 1%, increasing the pool for distribution by an additional 4 percentage points. In addition, sales tax on services taxed under federal excise duties has also been devolved to provinces. The 7th NFC Award has fundamentally altered the public finance landscape of the country by this unprecedented increase in federal transfers to the provinces.

Secondly, the seventh NFC award has taken major steps to reduce the horizontal imbalance and encourage fiscal equalization within provinces. It marks a watershed by agreeing upon a set of multiple criteria that goes beyond the population, for determining horizontal distribution of resources. In principle, the NFC award is based on four key indicators that include HDI, backwardness, fiscal effort, inverse population density (IPD) and revenue generation. In this award, population gets a weight of 82%, poverty and backwardness 10.3%, revenue collection and generation 5% and inverse population density 2.7% (Table 5).

In addition to the changes in the distribution formula, special considerations have also been made to compensate provinces for their unusual condition, the combined impact of which is shown in Table 6. With the adoption of the new formula, the share of Balochistan in the divisible pool has increased from 7.17% to 9.09% with underwrite revenue transfers of Rs 83 billion. Grants-in-aid have been

Table 5: NFC Award 2009 Distribution Criteria

Indicators	Weight	Punjab	Sindh	KPK	Balochistan
Population share (1998 Census)	82.0	57.36	23.71	13.82	5.11
Poverty/Backwardness	10.3	23.16	23.41	27.82	25.61
Revenue Generation/ Collection	5.0	44.0	50.0	5.0	1.0
Inverse Population Density (Area/Population Ratio)	2.7	4.34	7.21	6.54	81.92
Total share	100	51.74	24.55	14.62	9.09

Source: http://www.pide.org.pk/pdf/seminar/seminar148.pdf assigned to Sindh while 1% of the net proceeds of divisible pool taxes is to be assigned to the government of KP to meet the expenses of the on-going security operations. Several pending issues have also been resolved. Each province is to be paid every financial year a share in the net proceeds of the total royalties on crude oil from the total net proceeds that are in the same proportion as the

Table 6: Share of 7th NFC

Province	% Share in Divisible Pool	% Reduction in Share	Additional Budget
Punjab	51.74	1.27	48
Sindh	24.55	0.39	61
KPK	14.62	0.26	79
Balochistan	9.09	(+) 1.82	175

Source: http://www.pide.org.pk/pdf/seminar/seminar148.pdf

production of crude oil in the province bears to the total production of crude oil for that year[10]. KP is all set to receive approximately Rs 110 billion from the hydel profit within the next 5 years and Balochistan Rs 120 billion as Gas Development Surcharge (GDS) of 1954 to 1991 of 12 years installment.

The federation's decision to increase fiscal transfers to the provinces (through the latest NFC award) reflects a realiza tion on its part of the fact that the provinces need more funds for providing quality public services such as health, education, drinking water, sanitation etc for the masses. Yet it brings into question two major issues the capacity of the provinces and local governments to deliver and the incentives for own source revenue generation by the provinces.

[9] The NFC Award: Punjab biggest gainer Muhammad Sabir FISCAL REVIEW 2010 Business Recorder July 30, 2010

[10] 2008-2010 Report - Promise, Policy, Performance, Ministry of Information and Broadcasting, section on 7th NFC award

5 Key Challenges Going Forward

5.1 Prudent Fiscal Management

Although the passing of the 18th amendment and the NFC award is being highlighted as a step towards provincial autonomy, it is not without significant financial and administrative implications, requiring serious adjustments in development and non-development expenditures, work force arrangements, and legal issues. The volume and nature of provincial expenditure has substantially changed, due to the abolition of the concurrent list and the fact that the federal government is now not able to allocate development budget to provinces.

The share of provincial governments in public expenditures is also bound to rise from 30% to almost 36%. While this is still lower than India (45%) and China (54%), it is much higher than observed in Indonesia (10%), Malaysia (19%), and the Philippines (9%). Furthermore, for the first time, the provinces will undertake 53% (Rs 373 out of Rs 633 billion) of the Public Sector Development Programme (PSDP) 2010-11, an amount which is larger than by the federal government (Rs 280 billion)[11]. The removal of the concurrent list is also likely to burden the provinces with a surplus of permanent, contract government employees, and resource requirements. For example, approximately 110,000 Lady Health Workers alone are working under a programme of the Federal Health Ministry and 40,000 people at core federal ministries and 1.5 million from autonomous bodies will now have to be accommodated by the provincial governments. This is bound to have severe implications on the provincial capacity to deliver. Furthermore, there appears to be more space in the provincial budgets for diversion to flood relief, rehabilitation, and reconstruction than in the federal budget, which actually envisages a fall in development spending, according to one report by the IMF.

Following the reforms, the expectation by the federal government has been that the provinces will generate a large revenue surplus and by limiting their development expenditure eventually build up cash balances[12]. However, the current provincial budgets for 2010-11 reveal that larger transfers have not introduced any visible profligacy in current expenditure by the provincial governments and there is already ample evidence of a potential lack of planning and waste in allocation of resources.

The provinces appear to be more ambitious on the development side having allocated Rs 443 billion for 2010-11, which is 50% more than what was envisaged by the National Economic Council. This implies no significant build up of cash balances and consequently, the consolidated fiscal deficit is likely to be substantially higher than the target 4% of the GDP[13]. If there is any evidence of lack of proper fiscal management, it is in the proposed PSDPs of the provinces. The Sindh government has also proposed a six-fold jump in the development allocations from Rs 10 to Rs 60 million to each Member of the Provincial Assembly (MPA). The Balochistan government has allocated a lump sum amount equivalent to over 50% of the PSDP for unidentified new projects. The Punjab government has enhanced the allocation for special programmes/packages, including exotic urban development projects in metropolitan cities. The KP government proposed big increases in allocations for regional development, without a statement of specific plans.

The budgetary announcements made by the federal and provincial governments following the seventh NFC award are reflective of the uncertainties in the fiscal situation. Table 7 shows the difficulty in reconciling the federal and provincial announcements at the budget for 2010-11. Hence it is still not clear as to how the recent policy changes will affect fiscal deficit as various estimates continue to be put forth at different levels while none of these tend to corroborate the estimates by international organizations such as the IMF.

The seventh NFC award was announced in the backdrop of low and stagnant tax to GDP ratio. The high dependency on fiscal transfers to finance sub-national expenditures was seen to be a disincentive for tapping the sub-national tax base. Thus, an important question in the design of the new system of federal transfers is whether it will motivate

[11] http://tribune.com.pk/story/57334/revelations-by-the-imf/

[12] of Rs 167 billion

[13] As stipulated in the agreement with the IMF

sub-national entities to increase their revenue effort. Tow taxes the VAT on services and the urban property tax are reviewed to assess whether the new system of fiscal transfers enhances the motivation to raise taxes.

used as inputs and credited away, net becomes difficult to determine.

Table 7: Estimates of Fiscal Deficit

	Announced at the National Budget	Announced by the Provinces	Developed afresh	
National	- 4.0	-5.2	-4.0	**Post Flood?**
Federal	-5.0	-5.0	-4.4	
Provincial	1.0	0.2	4	

Source: Conference by Forum of Federations

Provincial VAT on Services

Under the common 1935 Government of India Act, sales taxes on goods were assigned to the states (provinces) while services to the center. Following the Pakistan General Sales Tax Act 1948 this was reversed for the case of Pakistan and services became a provincial assignment hence levying of taxes on 'Goods' by the federation and 'Services' by the provinces. More recently, and effective from July 1, 2010, VAT has become applicable on all economic activities, covering all 'Supply of Goods' and 'Rendering of Services', with very limited exceptions (Kasbati, 2010). The 18th amendment has reiterated the right of the provinces to levy and collect the GST on services, which was, also the principle agreed to in the 7th NFC award. However, fissures have clearly emerged in the tussle over administration of the GST on services.

But why is it difficult to implement the VAT in provinces? To start with, the process is bound to take long at least 3 to 5 years and requires serious consultation amongst provinces. Provinces also lack the capacity to firstly deal with cross-provincial taxation and GST on interprovincial transactions and secondly implement any kind of crediting or refunds mechanism. Further there also complexities in implementing 'place of supply' rules. For example in the case of Sindh, GST on services is Rs 63 billion of which almost 12% are from advertisements, travel related and clearing agents reflecting activities throughout the country. In the modern economy, it is also becoming harder to distinguish between goods and services. Examples include computer software and SIM cards. The 'Headquarters Problem' also complicates implementation of GST on services. National firms tend to pay tax for all branches at the headquarters location and that city receives revenue under an origin-based system. Further more, when gross collections are not correct a large part is

Provinces, particularly Sindh, have undergone a recent drive to set up a provincial tax administration. There estimation of the benefits of implementing this tax on services rested on faulty assumptions. This decision was based on an overestimated share of services in GST as many services are used by businesses that are subject to a refund. In addition, according to a very recent World Bank report the Federal Board of Revenue (FBR) has little incentive to collect this tax due to a small collection fee and the fact that revenues are to be returned to provinces. Ignoring the warning in by several authorities that provincial administration of the GST is likely to cause a loss in current revenue collections, Sindh was adamant on implementing VAT on services.

The Sindh Proposal is based on using a final point sales tax system which would result in allocating to provinces more revenue than the GST would actually collect and would also reintroduce cascading and distortions. This form of GST is most suitable for beauty parlors, haircuts and restaurants, where there is no difficulty in determining 'place of supply' (Ahmad, 2010). Imposition on mobile tax bases such as construction, architecture, and accounting will be self-defeating and will hurt business. Tax exporting to other provinces is quite likely for instance by imposing a non-refundable tax on importers and courier agencies that are mostly based in Karachi. Additionally competition between provinces on the same subject matter may result in a phenomenon, which is known as 'race to the bottom', which in the case of federalism could occur in the form of tax competition. In the case of GST on services, Balochistan could impose zero provincial sales tax to boost port of Gawadar. While each province would be compelled to lower tax rates in order to attract investors, the one with the lowest would benefit while overall tax revenue would reduce. It may also damage inter-provincial cooperation.

The case of the telecom industry in Pakistan deserves a special mention. It has generally fared well for contributing to GST on services. There is particular ease in implementing this tax as a relatively small number of sophisticated companies with good information are part of this industry (Ahmad, 2010). Through taxing this industry, the government is tapping into a growing revenue base through an integrated framework (split arrangement of sharing responsibilities of collection and implementation between the federal and provincial governments). The FBR administers the input credits, refunds, audits and claims while the taxes go to provincial accounts on a pre-determined basis. Within this arrangement it is also possible for provinces to make additional collection such as from hotels, restaurants and professionals based on the criterion that there is no cross-provincial crediting and taxation is restricted to non-tradeables, to limit creating impediments to common economic space. In the longer term, dual VATs such as in India may be considered. Work for the next NFC must be initiated now.

Table 8: Provincial Share in Consumption of Services by Households (2007-08)

Province	Annual Expenditure (Rs billion)	Provincial Share (%)	Population Share (%)
Punjab	618.9	60.39	57.36
Sindh	243.4	23.74	23.71
KP	133.8	13.05	13.82
Balochistan	28.8	2.82	6.11

Source: (Ahmad E., 2010)

Although gross tax paid approximates an origin basis, the crediting and refunds returns it to an effective destination base and there is relative ease in administration for telecommunications. In addition, there is no issue of base. Calls made, calls received, billing of customers and numbers of handsets can all be proxies for the base. Distribution across provinces roughly in line with aggregate consumption across provinces (Table 8). However, this should not be applied to any other service as it would become impossible to administer and flying invoices could multiply given the break in the administration chain.

Alternative approach to implementing provincial VAT may be considered. Simple legal framework should be adopted that clearly defines goods and by exclusion all else are considered as services. A coordinated approach amongst the provinces will reduce the danger of race to the bottom. Employing a common administration will minimize the need to specify the place of supply rules for each service. An integrated framework such as for the telecom industry is a good practice where FBR is responsible for collection and services revenues go to provinces. There is a need to establish a mechanism for determining distribution such as through an NFC agreement or HIES estimates of consumption over the past three years (such as for telecom).

Urban Property Tax

Compared to most developing and transition economies, Pakistan has a relatively long experience in taxing urban property. The Punjab property tax system is comparable to international practices in design albeit challenges remain in implementation and the tax is levied under residuary powers of the province to raise funds for providing civic amenities in urban areas. However, both the yield of property tax and its importance among local revenues is low by international standards with recent measures (e.g. generous exemptions) further eroding revenues. International comparison show that the present level of property tax collection in Punjab is roughly a fifth of the level of comparable countries both in terms of proportion of total local revenues (less than 10% of revenues of municipalities compared to at least half in many countries) and as a share of the GDP (0.09% of GDP in Punjab compared to an average of 1.42% of GDP in industrialized countries, 0.42% in twenty developing countries, and 0.54% in transitional countries) (Property Taxes in the Punjab, Pakistan, 2006).

The revenue potential of property tax reform in Pakistan is substantial. Simple reforms could boost provincial tax collection by 110% (from Rs 41 billion to Rs 86 billion [2007-08]) and excluding gains from GST reform would contribute 11% to the overall revenue increase in Pakistan.

The key aspects of the property tax that need to be

Table 9: International Comparison (Property Tax as a %age of GDP)	
Country	**Percent of GDP**
Pakistan (Punjab)	0.026
Chile	0.7
Ethiopia	0.5
Croatia	0.2
Indonesia	0.1
Slovak Republic	0.6
Sri Lanka	0.7
Thailand	0.3
Hungry	0.3
Poland	1.1
Argentina	0.9
Mexico	0.3
South Africa	0.7
Canada	4
USA	3

addressed are:

Valuation: The Punjab UIPT Act, 1958 provides for an assessment of all type of properties, rented or owner-occupied, on the basis of actual rent. The rental market in the Punjab has registered an unusual increase during the period from 2002 to 2007 but the tax base remains static for both residential and commercial properties. The valuation tables are not updated frequently to reflect actual market value as a result of which the average rental value of the property in the Punjab might be understated by 45%. The period in between valuation of rating areas needs to be reduced. There is also no assessment-sales ratio study by the government. Further, the TMAs that are mandated to carry out valuation have neither capacity nor expertise. The overall valuation system also lacks buoyancy and has inherent inability to address peculiarities of properties and their rent-ability. The value based system is unable to capture the increase in the capital value of property through rental value. A capital valuation system might therefore be a better option for Punjab.

Coverage: It is important to determine whether ARV is appropriate as a base for taxation as most residential properties in Pakistan are owner-occupied and vacant properties are left out as they have no rental value. Secondly, the assessed tax base barely resembles the ARV due to exemptions and preferential reductions. Cities have expanded over the years whereas the tax base has remained stagnant. Failure to notify new rating areas and extension in existing rating areas along with the above mentioned have resulted in approximately 300,000 out of 750,000 properties untaxed in Lahore alone. According to a modest estimate, which is two years old, there are approximately 73 more rating areas in the Punjab. Proper assessment and collection of property tax with the help of GIS is also needed.

Exemptions: Due to exemptions and preferential treatment, there is low revenue yield and low coverage as it results in a reduced tax base while the assessed base barely resembles the ARV. It also leads to inefficient use of land. The estimated revenue loss due to these exemptions is approximately Rs 900 million per year. Owner-occupiers pay 10% of the normal tax liability. Ten percent reduction is allowed to provide for maintenance expenditures. Vacant properties are not taxed while owner-occupied residential properties with a lot area less than 125 square yards are also completely exempt. The result of this is that approximately 300,000 out of 750,000 properties in Lahore alone are not taxed (Bahl, Wallace, & Cyan, Pakistan: Provincial Government Taxation, 2008).

Tax Rate: The tax rate of 20% to 25% is considered too high and creates an incentive for tax evasion. Also the rate is levied against a base, which is well below the market rental value and needs to be re-adjusted. Secondly, the differential between owner-occupied and rented property of 1:10 is unjustifiably high (and a major source of corruption). It is much higher than in Karachi (1:2) and in Islamabad (1:1).

A few months before the announcement of the sevent NFC award, the Government of Punjab had set up a task force to examine the structural weaknesses of the property tax and recommend measures to improve the tax effort. This was motivated by the party in power's ambitious plans to increase expenditure on social protection and upgrade urban infrastructure. After exhaustive discussions over several months, the task force decided that for reasons of political feasibility, it was prudent to focus on two key weaknesses: updating the valuation tables and rationalizing the tax rate. Regarding the latter, after careful simulations to assess the incidence of the tax burden, it was decided to recommend a reduction in the tax rate from 25% to 10% and narrowing of the differential between owner – occupied and rented property to 1:2 instead of the current 1:10.

Table 10: Change in Tax Liability for Changes in Rate Structure by Property Category

Category-Wise Comparative Tax Liability @ 10% (Residential Self)- 10-Marla [250 Sq.Yd.+1800 Sq Ft.]

Category	Existing Tax Liability @ 20% +25% [1:10]	Projected Tax Liability @ 10% Based on Market Rentals of 2008 (New Valuation Table)			
		[1:5]	[1:4]	[1:3]	[1:2]
A	1,771	4,428	5,535	7,380	11,070
B	1,328	3,100	3,875	5,166	7,749
C	1,107	2,170	2,712	3,616	5,424
D	886	1,519	1,899	2,531	3,797
E	664	1,063	1,328	1,771	2,657
F	531	744	930	1,240	1,860
G	399	523	653	871	1,306

Table 11: Tax Demand Following Revaluation of Property, Reduced Differential and Lower Tax Rates (Million Rupees)

Description	Residential			Commercial			G. Total
Category	Self	Rented	Total	Self	Rented	Total	
1. Existing Demand	98.91	472.13	571.04	343.87	1915.83	2259.70	2830.74
2. Demand with New Valuation	247.27	1180.33	1427.60	1719.35	9579.15	11298.50	12726.10
3. Difference (2-1)	148.36	708.20	856.56	1375.48	7663.32	9038.80	9895.36
4. Demand with New Valuation & Reduced Differential	1236.35	1180.33	2416.68	4298.36	9579.15	13877.52	16294.20
5. Difference (4-1)	1137.44	708.20	1845.64	3954.49	7663.32	11617.82	13463.46
6. New Demand (4) with Reduced Tax Rate	494.55	472.13	966.68	1719.35	3831.66	5551.01	6517.69
7. Difference (6-1)	395.64	0.00	395.64	1375.48	1915.83	3291.31	3686.95

The incidence for each category of the proposed changes in the rate structure is given in Table 10. Given the political sensitivity of levying higher taxes (GDP growth rate was at a low 4%) the political leadership of the party in government in Punjab decided to levy the new tax demands (that would entail an increase in the tax incidence on owner occupied properties) only on the top three categories of properties (urban property in Punjab is organized in seven categories, A to G, by value).

The revenue impact of the proposed reform would be substantial and is shown in Table 11. Compared to the existing demand of Rs 2.8 billion, the new valuation would result in a demand of Rs 12.7 billion. Combined with reduced differential, the demand would rise to Rs 16.3 billion or a five-fold increase.

While the potential for substantially higher revenues following reform was attractive, the political party in power in Punjab had to balance this against the political cost of passing on the increased tax demand to constituents, even the rich ones. After a careful review of the costs and benefits, the party leadership decided to launch an elaborate campaign to educate the constituents on the need for higher tax demand and the benefits that would be ensue from the expenditures these would finance.

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

5.2 Natural Resource Management

Taxing and sharing of natural resources has always been a salient issue in public governance and its implementation in Pakistan has typically suffered from political difficulties. Disparity in distribution and reimbursement of natural resource rents has been a long-term source of intra-province dissonance. Difficulties in implementation have arisen in part from geographic and economic vagaries of the rents. Huge geographic concentration of production/tax base such as gas in Balochistan, which is sparsely populated, has complicated the distribution of natural resource rents. Some of the federating units have had serious reservations about the lack of equalization of surcharge, gas royalty and the use of well-head price.

Sindh, being the largest producer of oil and gas in Pakistan, with over 71% of gas and 56% of production of the country's total oil produce, over the last three decades,[14] has only received a small amount (approximately 12.5%) as royalty. Moreover, this amount is not even estimated according to international price of oil and gas produce but based on well-head pricing.

It is estimated[15] that 36-45% of Pakistan's gas is produced in Balochistan. Yet, there has considerable resentment in the province at what is perceived as exploitation of its natural resources by the federal government. 17% of the gas produced in Balochistan is used in the province and even today, a large number of Balochistan's 26 districts have no gas supply. The province has received only 12.4% of the royalties due to it from the federal government and the backlog dates back to 1953.

Much of Pakistan's hydro-electric power is generated in KP, site of the largest dam at Tarbela. Until 1991, when the CCI met to decide on the allocation, NWFP did not receive any royalties for the hydel power generated in the province. Successive provincial governments attempted to recover the arrears from Water and Power Development Authority and the federal government but little progress was made and frequent changes of government (and President) during the 1990s delayed the process further.

The NFC has historically failed to address the issue of royalties on the natural resources. Both gas and electricity have a certain degree of taxation associated with them, but the problem is complicated when the profits do not fall within the realm of the NFC. With no policy to ensure that

[14]http://www.rallypakistan.com/articles/politics/153-discrimination-over-right-to-natural-resources.html
[15]http://alaiwah.wordpress.com/2008/09/24/constitutional-distribution-of-natural-gas-hydro-electric-power/

oil and gas producing districts, get a certain part from that royalty, governmental oversight has been a major reason why oil and gas producing districts of Sindh and Balochistan are marked conspicuously by poor indicators of human development.

However, the 18th amendment and the seventh NFC award have taken major steps to address the grievances of the provinces in management of natural resource rents. The existing provinces have moved halfway in getting some control over their resources after a long struggle of 60-plus years. The seventh NFC successfully reached a consensus over distribution of gas development surcharge and gas royalty among provinces and agreed to the distribution of national resources on the basis of area, backwardness, poverty and contribution to the exchequer besides population. It further admitted to the right of provinces to net hydel profit. Under the 18th amendment, the ownership of oil and gas resources has been vested jointly and equally in the federal government and the relevant provinces. The 18th amendment has also met the expectations of the smaller provinces by providing more provincial autonomy to the provinces through diverting resources to the federating units, allowing them to explore natural resources, establish power generation units and get royalty on natural resources.

In specific, the amendment has ensured payment of net proceeds of royalty on crude oil to each of the provinces in proportion to the production of crude oil as a share of the total production of crude oil. It has also ensured payment of net proceeds of development surcharge on natural gas to the provinces. The development surcharge on natural gas would be distributed by making adjustments based on this average rate where the development surcharge on natural gas for Balochistan with effect from 1st July, 2002, would be reworked. Both KP and Balochistan are ready to receive significant payments as hydel profit and Gas Development Surcharge respectively over the next 5 years.

5.3 Decentralization from Provinces to Local Levels

The design that was incorporated in the Local Government Ordinance issued in 2001, drew inspiration from the system of 'basic democracies' implemented during the 1960s. The provinces were instructed to issue their own local government laws as long as the basic construction proposed by the center was not tempered with. The process of devolution since then has caused significant fiscal decentralization, by doubling of Local Government (LG) expenditure to 2.5% of the GDP (Ghaus, 2010).

But despite the transfer of a large number of functions to LGs, they have limited capacity to deliver. The LGs also have inadequate fiscal powers and hence make minimal fiscal effort to raise taxes. They also have restricted administrative and financial autonomy to make decisions and carry out reforms. Moreover, the performance of the Provincial Finance Commission (PFC) has also remained poor particularly in terms of fiscal equalization. Moreover, inadequate attention has been paid to capacity building and setting up of monitoring and supervision bodies.

On reviewing the revenue sharing under PFC award for Punjab one can observe that the system is fairly complex comprising of 4 types of grants where the share of development grants is relatively low (table 12). Moreover, there is no criterion reflecting local fiscal effort and no explicit consideration of fiscal equalization in current transfers. Transfer mechanisms must consider an enhancement the share of development grant, explicit provision in

Table 12:Types of Revenue Transfers to LGs in the Punjab[16]

Type of Grant	Purpose	Share in Total Transfer
General Purpose Grant	To meet current expenditures needs	71.2%
Equalization Grant	To remove any shortfall in benchmark expenditure	9.3%
Development Grant	To meet development needs	11.3%
Tied Grant	To provide additional finances to social sectors under protocols agreed with donors	8.2%

[16] (Ghaus, 2010)

for fiscal equalization between rural and urban areas, incentives for higher fiscal effort at the local level and conditional grants for some devolved functions in order to achieve a minimum standard of provision throughout the province.

On transfers, international experience has shown that large transfers can reduce fiscal effort and create dependency whereas performance-linked incentives in grants can lead to significant improvements. Use of gap filling approach to grants creates a tendency for LGs to raise expenditure and reduce fiscal effort while inter- jurisdictional fiscal equalization in grants needs more attention.

The performance of LGs can best be judged by analyzing the impact on social indicators. While there has been some improvement in literacy and coverage of water supply and sanitation, there has been little change in health, gender equality, and regional disparities. Within LG budgets, the largest share (over 60%) has been on education (primary, secondary) and on development side, on roads (Ghaus, 2010).

The system of local government is under review in the Punjab and various options for devolving functions to local governments are being assessed. Under Devolution Plan 2001 basis for allocation of functions is essentially the principle of subsidiarity where education (primary, secondary) and health (preventive, curative) were devolved to the LGs. Subsidiarity requires that spending and taxing responsibilities are allocated to the smallest geographical and/or population jurisdictions that can raise taxes most efficiently and in the process provide the desired level of service quality at the lowest cost per citizen (Inman & Rubinfield, 2009). As per the draft Punjab LGA 2010, reverting secondary education and hospitals to the provincial governments does not appear to be consistent with the principle of subsidiarity (Ghaus, 2010). However, some economic services like agricultural development and law and order (police) are better managed at the provincial level.

The principal source of revenue in LGA 2010 would be tax on annual value of buildings and land, which remains grossly underexploited. By giving flexibility to vary tax rate, the tax can become the budget-balancing device. Collection and rate-setting authority of property tax is not clear and there is a conflict of law in the division of powers between the provinces and LGs. Proposals for local resource mobilization have included development of urban immovable property tax and devolution of collection and rate setting to metropolitan governments along with reintroduction of local rate on agricultural land and a move towards full Operations and Maintenance cost recovery in water supply, sanitation, etc.

The 18th amendment however, has remained largely silent on the future of LGs. The amendment has removed the sixth schedule to the constitution that had given protection to 35 laws and ordinances promulgated during the Musharraf period, which could only be amended with the consent of the president. Included in these was the LG Ordinance of 2001. This leaves open the question of whether the provinces would continue the systems that were in place as a result of this ordinance.

5.4 Strengthening the Role of the CCI

Following the 18th amendment, and abolition of the concurrent list, national planning, and economic coordination has now become a joint responsibility of the federal and provincial governments. Supervision and management of public debt, federal regulatory authorities, and inter-provincial coordination are now new entries under the list of joint responsibilities. For this purpose, institutional strength and mechanisms are very important. Several institutions that are responsible for carrying out the various tasks in managing public finances and delegation of fiscal powers include the Council of Common Interests (CCI), the NEC, the Planning Commission, NFC, the Implementation Commission, Public Service Commission and Debt Management Office. The CCI has now an enhanced role as provinces have gained considerable fiscal space and autonomy following the recent reforms.

Article 153 of the 1973 constitution has provided for the CCI to take care of disputes between the center and a province or between provinces (Waseem, 2010). It is sometimes understood to be a quasi-executive body because it comprises the Prime Minister and chief ministers of provinces and their representatives. Although the CCI is powerful in theory, it is weak in practice. The meetings of CCI are rare, making it ineffective as an institu tional mechanism for conflict resolution. However, the 18th amendment has provided for periodical presentation of the CCI report to both houses of parliament. It has extended the membership of CCI by adding three federal cabinet members, made its quarterly meetings mandatory, provided for a permanent secretariat and expanded its mandate to include supervision and control over related institutions.

These steps have been designed to overcome its previously sporadic functioning and the proposed changes potentially increase its importance, but it remains to be seen how it will operate in practice, and whether it will become caught up in disputes between the centre and provinces. Specifically the role of the CCI must be enhanced to empower it as a monitoring body that not only monitors inputs such as budget allocations, revenue shares and intergovernmental transfers but also outcomes that include measuring impact such as through changes in interprovincial and regional distribution, rates of growth and unemployment and improvements in the delivery of key services such as education, health and water supply. The CCI should also play a role in promoting public private partnerships to take on additional expenditure responsibilities.

In addition, capacity building of provinces is also required to manage their new responsibilities. However, provincial capacity building should not just be in accounts keeping rather it should be to improve their development outcomes. The federal reform of transferring functions to sub national governments would bear fruit only if the provinces are able to improve the service delivery in the devolved functions. This marks a priority undertaking as the government grapples with the implementation of this reform.

6 Conclusion

As assessed above, the 18th Amendment and the seventh NFC award that supports it, carry immense potential for addressing Pakistan's crises of regional inequity, poor social outcomes and stagnant and low revenue generation blamed on an over centralized federal structure. Whether or not the new, far reaching arrangement of decentralized decision making will be effective in meeting these challenges depends crucially on how it is implemented. Key in this will be the ability of sub-national entities in prudent fiscal management that includes setting the right expenditure priorities and cost effective delivery of public goods and services. In turn, these objectives will be met only if sub-national entities are truly representative of the citizens and thus deliver better than the more centralized federal structure did. If, on the other hand, the substantially increased provincial resources are captured by sub-national elites at the apex of local social classes and/or through tribal custom, the new arrangement may well worsen regional inequity, service delivery and revenue generation. Whether this happens will depend crucially on the ability to build up the capacity at the sub-national level to deliver on these three outcomes and on an effective CCI that monitors performance of the sub-national entities including the mandate to take corrective action. Seen from this angle, the 18th amendment and the seventh NFC award are only the first, albeit important, steps towards improved governance in Pakistan.

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8 Annexure

Fiscal Federalism

The Way to Go

Federalism, overall, allows one to achieve a range of social goals, relating to redistribution, political participation, and various efficiencies, including the achievement of scale economies, the matching of benefits to costs, and the innovation flowing from competition among sub national governmental units. Furthermore, within a federal system sub national governments can check central government abuses and promote individual rights and liberties. While the boundaries of fiscal federalism are hard to draw, the core of the subject is clearly raising, borrowing and spending of public finances in federations (Anderson, 2010). Fiscal federalism can be referred to through several concepts that broadly include a) inter-governmental transfers b) governance structure and level of decentralization and c) assignment of taxes and expenditure.

The starting point of fiscal federalism, or the economic analysis of decentralized public governance, is that there are some economic functions that a central government should simply not be concerned with, essentially calling out to autonomous sub national governance. It is possible to find some basic fundamental rationale that tends to favor federalism. The first motivation is incentive-based, asserting how decentralized public governance is able to limit better than the alternative of centralized governance, the concentration of power in the hands of the few (Garzarelli, 2004). Hence, federalism aids the separation of powers by dividing a state into smaller, federated states as in the case of Pakistan, India, and USA. It is seen as enhancing accountability in public governance by limiting inefficient behavior of various kinds. The second motivation is knowledge-based, proposing that decentralized public governance performs a beneficial cognitive function as it becomes possible for citizens to more easily communicate their needs to government by setting up local government or jurisdictions (Garzarelli, 2004), also referred to as the decentralization theorem. Therefore, fiscal federalism, through decentralization, allows public consumption levels to be tailored to suit the preferences of a heterogeneous population (Bruekner, 2005).

The drawbacks of federalism, which have also been noted widely in the literature, include the sacrifice of scale economies due to smaller jurisdiction sizes (Oates, 1972), losses from inter-jurisdictional tax competition when government revenue comes from taxation of a mobile tax base (Brueckner, 2004), and failure to properly account for public-good spillovers across jurisdictions. In fact, the decentralization theorem clearly states that the level of government to which spending prerogative ought to be assigned is given by a tradeoff between realizing returns to scale in provision and internalizing externalities between jurisdictions on the other hand and the presumed greater responsiveness of local governments on the other.

Yet, despite this tradeoff and the additional requirement for a strong fiscal machinery at multiple tiers of governance, there is very little resistance to reforms that push for fiscal decentralization. Under the garb of fiscal federalism, it is usually the preferred arrangement for management of public finance and expenditures since local governments are assumed to be better aware of the needs of the citizens and taxpayers and therefore deemed more capable of formulating informed decisions. This argument is assumed to be compelling enough to neutralize the gains from economies of scale in the provision of pubic goods and services and generation of tax revenue under federally control fiscal management. Economists further argue that by placing sub national governments in competition with each other, fiscal decentralization also provides them incentives to foster local economic prosperity mitigating the risk of losing valuable tax revenue (Weingast).

As a notion, however, fiscal federalism is distinct from decentralization (Dafflon & Madies, 2009). Vertical fiscal relations are more limited in fiscal federalism, first out of respect for the autonomy of the sub national units, and because of their responsibility for assuming the fiscal consequences of spending decisions. But also because the target of redistribution is often different: whereas, in decentralized finance, redistribution aims to allow residents access to comparable services without a heavier financial burden, in fiscal federalism the aim is, rather, to bring disparities between local governments down to a politically acceptable level without reference to individual positions.

The Fundamental Design: International Experience & Best Practice

The division of fiscal powers has been occurring in a variety of countries that have included centralized nations such as such as the Kingdoms of Jordan and Morocco, Central and Eastern Europe states that are in the transition from a command to market economy, countries that view decentralization as a strategy for improving local service delivery in reaction to financial crises such as Thailand; nation-states that are trying to avoid the centrifugal forces of separatism such as Bosina & Herzegovina, Indonesia, Sudan, Pakistan and a host of other countries and regions in which bottom-up participatory budgeting is taking hold such as Latin America (Ebel, Subnational Tax Policy Design and Fiscal Decentralization, 2003).

Yet the predominant concern in implementing any regime of fiscal federalism[17] in any part of the world is primarily deciding which fiscal prerogatives to assign to which levels of government. In the original discourse on fiscal federalism, a popular view had been to leave taxation to the federal level while limiting local taxes to sub-national entities in the face of a mobile tax base (Shelton, 2010). This was based on the perception that most sources of revenue can be more efficiently raised by federal governments while spending can best be conducted by local governments. In practice, however, federal governments are also often reluctant to devolve tax powers to lower levels of government either because they feel sub national governments lack the capacity, and infrastructure to collect taxes or because they do not wish to let go of the control over taxation. Such practices have often led to severe discrepancies in the fiscal balance between governments, as we will see in the case of Pakistan.

The role of sub national governments is subsequently elevated in a decentralized regime as they become agents that provide services to identifiable recipients up to the point where the tax price for those services reflects the benefits received. They become the conduit for setting up a system of budgets that best approximates the efficient solution of equating benefits and costs. But to satisfy these conditions, sub-national (local) governments must be given the authority to exercise own source taxation at the margin and be in a financial position to do so. It has been successfully debated within the policy discourse, that effective fiscal decentralization requires meaningful revenue autonomy at the sub national level.

While the delegation of resources from the federal to sub national governments is one concern, the parallel transfer of authority and inherent capacity to manage the resources is another. Devising a solution for devolving key decisions on taxation and spending from central to provincial to local governments is hence considered a central objective of fiscal federalism. In fact, according to one definition, it is taken to mean a description of a system of taxes, on one side, and public expenditures, on the other, that divides responsibilities between different levels of government (Mosteanu & Iacob, 2005). In the fiscal decentralization literature, this is known as the 'tax assignment problem' (Bahl & Jorge, The Property Tax in Developing Countries: Current Practices and Prospects, 2006). Hence, the original tenets of fiscal federalism have focused both on the decentralization theorem and the tax assignment issue (Shelton, 2010).

[17]Fiscal federalism is a notion, which is distinct from decentralization (Dafflon & Madies, 2009). Constitutional law defines three distinct distributions of state sovereignty – unitary , confederation and federal government, where a federation is defined as 'a system of voluntary self-rule and shared rule' (Kincaid, 2002, p.7), in which the central government and the governments of the constituent territories decide by common accord how to divide powers and maintain their independence within their own spheres of authority, anchored in a federal constitution' (Dafflon & Madies, 2009). Unitary form of government is obviously more centralized, followed by a confederation and federal form of government respectively along the continuum of government systems.

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