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RESEARCH & ADVOCACY FOR THE ADVANCEMENT OF ALLIED REFORMS

PAKISTAN'S PUBLIC EXPENDITURE

INSIGHTS & REFLECTIONS

FOREWORD

Pakistan is currently facing several developmental challenges. Concerns about security, weak governance and energy shortages adversely affect the investment sentiment. Water scarcity looms and social indicators are significantly worse than the South Asia average. Several of the challenges stem from decades of policy neglect and insufficient public expenditure. Fiscal resources are pre-empted by the large interest cost of public debt, high defence spending, the electricity subsidy and losses of state owned enterprises. Furthermore, due to weak expenditure and financial management systems, the Government does not get the full value from whatever expenditure, it can muster for the needed economic services. The public sector thus has not fostered the enabling environment for the private sector to flourish and be internationally competitive. This does not auger well for economic growth and prosperity.

To improve long term growth prospects, Pakistan needs to invest in physical infrastructure and human capital. Significant resources would also be required to improve security and strengthen public institutions. The Government is fully aware of what is needed and has planned large-scale investments in energy, transport, water, education, health, sanitation, and in expanding public social safety nets. The challenge is to tap into relatively inexpensive sources for financing the investments. Some of these investments could be financed from savings following improved efficiency of public expenditure, better management of public debt and tighter financial accounting systems. Bilateral and multi-lateral concessionary financial assistance would be another low cost source. Improved governance would also help attract private investment in these areas. However, a large portion of the investment would have to be self-financed by substantially increasing tax revenue. The Governments' track record in tax collection is not stellar primarily due to the lack of political will to broaden the tax base. Many powerful and affluent individuals and rapidly growing economic activities like retail, urban property and agriculture are out of the tax net. Given the expenditure needs for sustained economic growth, the Government has to be resolute in broadening the tax base and improving tax collection.

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EXECUTIVE SUMMARY

Many of Pakistan's challenges stem from insufficient investments by the government in critical areas of the economy, mainly because a very large portion of fiscal resources are consumed by the following expenditures: large interest cost of public debt, high administrative and defense spending, a large electricity subsidy and losses of state owned enterprises. In addition, the government does not get the full value for money from the expenditure it is able to make in key areas. As a consequence, Pakistan's long-term productivity is declining which does not bode well for future prosperity.

To reverse this decline, Pakistan needs to invest heavily in creating physical infrastructure and human capital, improving security situation strengthening governance-related institutions. It needs to find relatively inexpensive and sustainable modes of financing these investments. Some of these investments can be financed from savings that the government can generate by improving the efficiency of its expenditure, and debt and financial management systems. However, a large portion of these investments would have to be financed by substantially improving tax collection.

Structure of Public Expenditure and the Fiscal Crisis in Pakistan

Revenue inadequacy: With a very low tax-to-GDP ratio, Pakistan falls close to the bottom in ranking of countries on the basis of revenue collection. This low ranking is due to the following: inefficient tax administration, a narrow tax base with only 10% of those employed paying tax, skewed tax structure with 68% of the tax revenue being generated from indirect taxes, a complex and non-transparent tax system, corruption and tax evasion, and a non-supportive political environment.

The debt burden: Pakistan's public debt was 63 percent of GDP in 2014, of which a large majority is domestic debt. Contrary to popular belief, this domestic debt is substantially more expensive than foreign debt. In the 2000s, the country's economic managers successfully reduced the debt burden from 83 percent of GDP in 2001 to 55 percent in 2007. Since then, however, the debt has increased again.

High burden of subsidies: Federal government's expenditure on subsidies and grants (primarily including subsidies on electricity and oil) has increased rapidly in the past few years, from 1 percent of GDP in 2002 to more than 2.5 percent in 2014.

Fixed spending of federal government: More than 53 percent of federal government's expenditure is on interest payments on debt, defense spending and salaries and remuneration. Another 29 percent is allocated towards subsidies and grants (such as on electricity and oil). These expenses either cannot or are unlikely to be decreased in the short run. The remaining expenditure that is fully adjustable is only 18 percent. Consequently, development expenditure as a percent of GDP has fallen sharply in the past 30 years.

Adequacy and Effectiveness of Public Expenditure in Pakistan

A critical result of the above situation is that inadequate amount of funding is available to finance public goods and services for the rapidly growing population. Thus, the gap in delivery of public services has increased during the last two decades.

Inadequate infrastructure: It is estimated that improvement in quality of infrastructure alone will boost Pakistan's per capita GDP growth by 3.7 percent; with major contributions from each of electricity (1.9 percent), transportation (0.6 percent) and telecommunication (1.2 percent) sectors.[1]

We estimate that the Government's current plans for major infrastructure in the next 5 years will cost around 3.6 percent of GDP per annum. Increasing efforts to generate sufficient revenue to finance these investments is the only sustainable mode of financing.

1 World Bank, "Pakistan: Investment Climate Analysis" Washington DC. 2013

Inadequate Human capital: Pakistan not only lags substantially behind its comparators, but the gap has been increasing over time. Pakistan's key social indicators remain among the worst in South Asia; and some of these indicators put Pakistan in the company of sub-Saharan African countries.

Human capital spending by provincial governments: The 7th NFC Award sharply increased the share of provinces in federal revenue. This led to a sharp increase in spending on health and education (at 19% per annum between 2006 and 2014). However, most of this increase was consumed by high inflation and the increase in salaries of government employees.

Inefficiencies in public expenditure in Pakistan

On average in Pakistan it takes twice the originally projected time and almost twice the originally estimated cost to complete a development project. Another weakness is a strong bias in favor of development spending at the expense of recurrent expenditure. This results in a poor mix of public expenditure that results in insufficient funds being provided to maintain existing assets.

Role of foreign assistance: Over the last 8 years, foreign assistance has financed only 15 percent of the development budget (national and provincial combined), and less than 4 percent of total expenditures.

Estimated impact of selected reforms: We estimate that a significant portion of government's future financing needs could be met by reforms in the following four areas:

1. Tax reforms at federal and provincial level, focusing on tax policy as well as administration. Fiscal impact: 0.5 – 0.1 percent of GDP

2. Debt management reforms, to reduce the cost and term structure of government debt. Fiscal impact: 0.4 – 0.8 percent of GDP

3. Power Sector reforms: reducing the cost of electricity subsidies by adjusting the price and improved governance; and improving the efficiency of subsidies through better targeting to deserving groups. Fiscal impact: 0.5 percent of GDP

4. Reforms of State-Owned Enterprises. Fiscal impact: 0.5 percent of GDP

5. Total fiscal impact of these reforms: 1.9 – 2.8 percent of GDP

Fiscal Management under Devolution in Pakistan

Recent changes in fiscal decentralization framework: Pakistan has seen some fundamental changes in its decentralization framework that had a major impact on overall finances and functions of government. These include the 7th NFC Award in 2011 that substantially increased the share of provinces in national revenue; and devolution under the 18th Constitutional Amendment which strengthened institutions of inter-governmental coordination and devolved a large number of federal functions to the provinces.

Local governments need financial and administrative authority: In Pakistan, the government and delivery of services remain significantly centralized and distant from the people to whom these services are being provided. Local governments are an important component of the state and are critical for providing public services. Their success in delivering even just municipal services will depend on providing them with administrative and financial authority and autonomy. For example, provinces have done a poor job of collecting the urban property tax – a tax that is levied to finance urban infrastructure and services. Punjab collects less than Rs 5 billion in property tax. In comparison, just one city in India, Mumbai, collects over INR 45 billion (equivalent to over Pak Rs 64 billion) in property tax. Unlike here, property tax in Mumbai is collected by the city rather than the state (Maharashtra) government.

CHAPTER 1

PUBLIC EXPENDITURE MANAGEMENT IN PAKISTAN: ISSUES & REFORMS

At present, Pakistan is confronted with a number of difficult economic, social and security problems. The economy remains relatively unstable after the commodity market shocks of 2007/08. The inherent weaknesses of the economy remains largely unaddressed because political compulsions prohibited successive governments from taking bold reform actions required to stabilize the economy. Fiscal fragility, the core of present economic instability, is mainly an outcome of weak revenue efforts. Successive governments have continued to find other sources for financing their growing expenditure needs rather than collecting taxes from the more affluent segments of population. The revenue problem is exacerbated by the timing and magnitude of fiscal decentralisation and expenditure rigidities. The present Government is confronted with harsh challenges of establishing macroeconomic stability, accelerating growth, reducing unemployment and poverty, tackling militancy and security problems, improving governance, raising enough revenue to meet Government's urgent expenditure needs, and elevating the level of country's chronically low social indicators. Among these, establishing macro-economic stability and handling the security concerns has rightly been the top most and immediate priority of the Government and courageous steps are being taken for resolution of these problems. Nonetheless, equally bold actions are required to tackle other issues plaguing the economy. This would require a strong political commitment and significant financial resources.

1A. THE STRUCTURE OF PUBLIC EXPENDITURE & **THE FISCAL CRISIS**

Pakistan revenue collection has been virtually stagnant since 2003/05 (see Figure 1). On the other hand, expenditure needs have been increasing due to large and growing public debt; requirements of accelerating economic growth and social development; and the compulsions imposed by political considerations and inefficiencies of public corporate sector.

Figure 1, clearly demonstrates the genesis and causes for persistence of the fiscal crisis. The period between 1999/00 and 2002/03 (FY00 – FY03) was the period of fiscal prudence, where revenue increased sharply while debt concessions and improved debt management generated substantial savings on interest payments. This led to two positive developments, the fiscal deficit declined rapidly,[1] and expenditure on core government functions (including development) increased noticeably.

The period between FY03 and FY07 was the period of fiscal complacency. Prudent debt management continued, but efforts on revenue mobilization slackened significantly. While expenditure on core functions continued to increase, an increasing portion of that was financed by running higher fiscal deficits. The period between FY07 and FY10 was the period of heightened fiscal instability caused by an external commodity market shock. With Government opting to absorb a bulk of the cost associated with the shock into the budget (by extending fuel and power subsidies), Government expenditure soared. With revenue remaining stagnant, fiscal deficit sky-rocketed. The period between FY10 and FY14 is the time when fiscal instability was compounded by poor management of power sector finances and imbalanced fiscal decentralization[2]. Poor sector governance, coupled with Government's unwillingness to adjust power tariffs led to a build-up of "circular debt" which had to be paid off by the Government from its budget. At the same time, the large scale transfer of fiscal resources were mainly absorbed by the enlarged wage bill, as substantial increase were made in salaries of Government employees.

1 In Figure 1, the fiscal deficit could be ascertained by the difference in the height of the stacked expenditure bars and the revenue trend line.

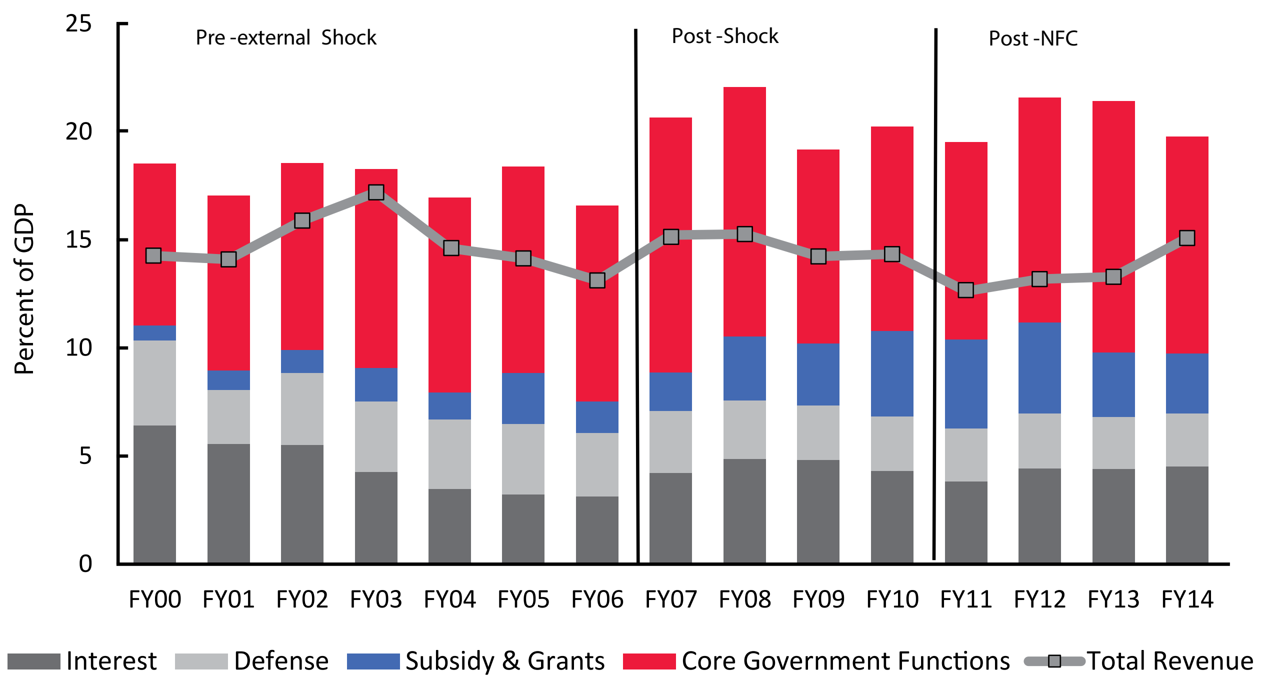

Figure 1: Making of a Fiscal Crisis

On June 30th, 2014, Pakistan public debt stood at Rs 16 trillion (63 percent of GDP), of which two-third was domestic debt. Carrying an average interest rate of 10.7 percent per annum, this domestic debt is substantially more expensive than the foreign debt, which carries an average interest of only 1.9 percent p.a.

Some of the key factors responsible for fiscal crisis are explained below:

Revenue Inadequacy

With a tax-to-GDP ratio of 10.4 percent Pakistan falls close to the bottom in ranking of countries on the basis of revenue collection. This low tax collection stems from a variety of inherent structural weaknesses in the taxation system including: (i) inefficient tax administration (poor management, weak human resources, lack of adequate IT supporting systems, excessive scope for discretion and rent seeking behaviour); (ii) a narrow tax base (of 39.4 million employed persons, less than 10 percent are registered and active taxpayers); (iii) skewed tax structure (68% of tax revenue is from indirect taxes); (iv) a complex and non-transparent tax system; (v) corruption and tax evasion (low compensation of tax officials, large informal sector in the economy); and (vi) a non-supportive political economy environment (tax policy and administration has catered to the interest of strong vested interest groups).

These problems are an offshoot of a marriage of convenience between the Government and the wealthier segments of the population. This has created an environment in which tax policy is designed, and tax administration is geared, to grant tax exemptions and concessions to the richer taxpayers mainly for political reasons. The increasing level of political polarization has further exacerbated the problem as every successive Government is forced to keep on upping the ante on tax concessions in order to win, or maintain, the support of the richer interest groups. On the other side, the rich and powerful use their political clout and resources to receive these concessions in lieu of providing support to the ruling party. As these segments preferred (and can afford) better quality services provided by the private sector, their interest in public services provided through tax revenue was only limited. As such, the whole system is focused on short-term and limited personal, or political benefits at the expense of long-term national interests. Nonetheless, the economy continued to move along with reasonable growth as key growth-supporting public expenditure could be financed through non-revenue sources, especially borrowing.

However, the stage is now reached that these non-revenue sources have either dried up or are available at a very high cost. At the same time, the trust in Government of the less affluent segments have waned sharply challenging the writ of the Government in many areas. This decline in economic growth and increasing level of law and order and security issues have started to threaten not only national but also personal interests. This, and other problems associated with low quantity and quality of public

2 The Seventh NFC Award increased the share of provinces in federal tax revenue from 46% to 57% (for details see Policy Note "Pakistan: Fiscal Decentralization and Expenditure Management". International Growth Centre, Lahore, 2015.

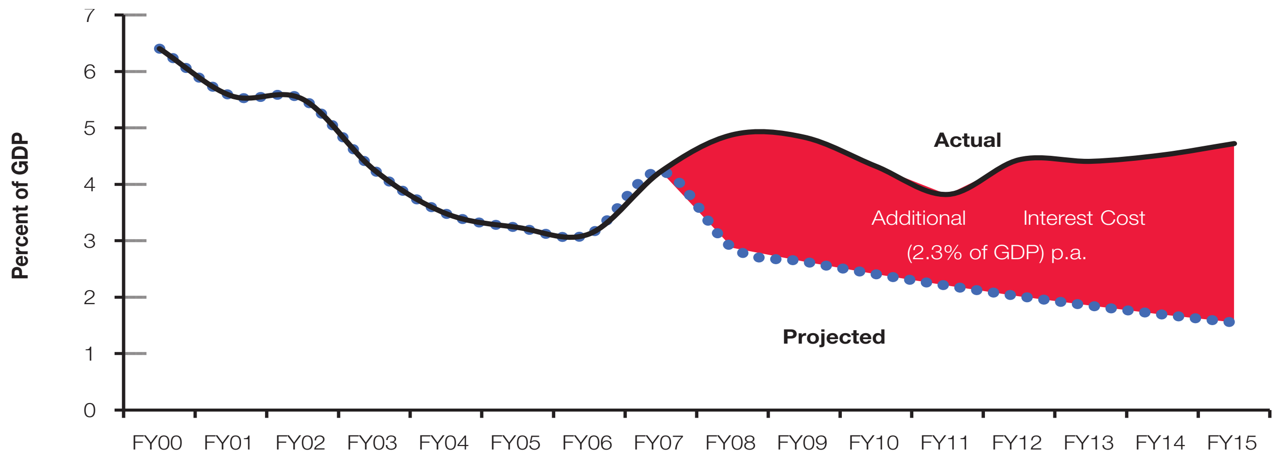

Figure 2: Trends in Overall Debt

infrastructure and service, has deterred private investment, further depressed economic growth. Accelerating and sustaining, a better shared, economic growth is the most potent remedy for most of problems plaguing Pakistan. This requires increasing the level and quality of public expenditure, which, in turn, require a quantum increase in revenue. Thus collecting, and paying, more taxes is in the interest on both the Government and private sector.

Poor revenue performance is only one, albeit the major, part of the problem. Weak expenditure and debt management too has had an adverse effect on the fiscal situation.

The Debt Burden

Pakistan's debt situation has been a source of concern for policy-maker for over two decades. On 30th June, 2014, Pakistan's public debt stood at Rs. 16 trillion (63 percent of GDP), of which two-third is domestic debt. Carrying an average interest rate of 10.7 percent per annum,[3] this domestic debt is substantially more expensive than the foreign debt, which carries an average interest of only 1.9 percent per annum. Yet, over the last fifteen years, resort to domestic borrowing has been much higher, mainly for three reasons: (i) because of its security and economic problems, Pakistan does not have a an easy access to financing with a low risk premium in international financial markets; (ii) budget support from international donors remained suspended for a considerable period of time due to of unfavourable fiscal situation; and (iii) for the Government, the fiscal cost of borrowing from the central bank is minimal,[4] although it imposes a huge cost on the economy.

Nonetheless, country's economic managers have had made attempts to reduce the debt burden. In early 2000s, by implementing the recommendations of its Debt Committee,[5] the Government was able to reduce public debt from 83 percent of GDP in FY01 to 55 percent in FY07, causing interest payments to decline from 5.6 percent of GDP to 4.2 percent during this period. Subsequently, however, the external commodity market shock and poor fiscal and debt management eroded these early gains. Public debt and interest cost increased again, turning the virtuous cycle back to a vicious cycle. Today one can only ponder that if the debt and fiscal management of early 2000s had continued, Pakistan debt budget would (on the average) have been 24 percent of GDP less (Figure 2), implying a fiscal saving 2.4 percent of GDP per annum in interest cost (Figure 3).

3 This is the average of all Government domestic borrowings over a period of last 15 years.

4 For the Government, the State Bank of Pakistan (SBP) is a "lender of first resort", as interest paid by the Government on its T-Bills issued to SBP, circles back to the Government in the form of SBP profits.

5 Government of Pakistan, The Debt Committee Report:, Islamabad, 2001.

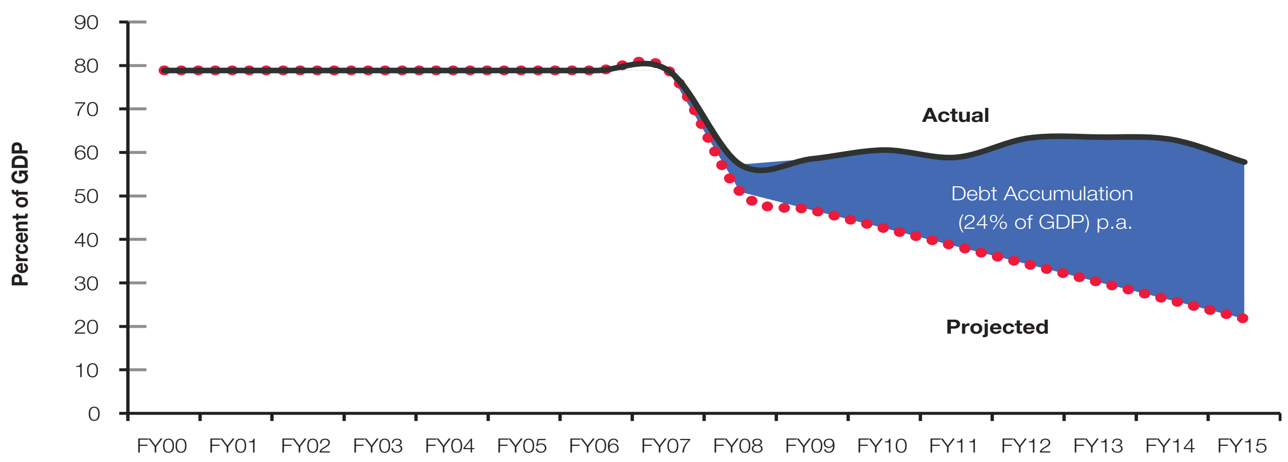

Figure 3: Trends in Expenditure on Interest Payment

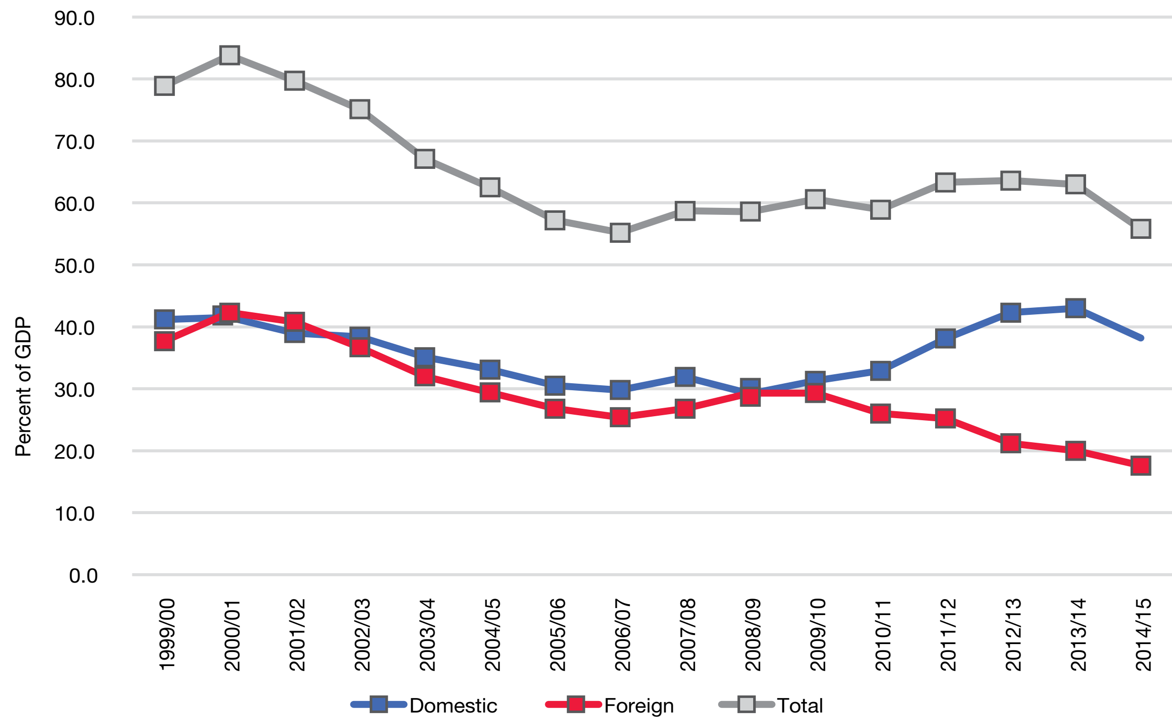

Figure 4: Pakistan-- Composition of Public Debt

It is essential here to point out that in Pakistan, it is critically important to have some discussion of the composition of public debt, not only because different components of debt have different fiscal impact, but also for the misperceptions about the external debt, and the political economy around them, that can adversely impact debt reforms.

Until 2009/10, domestic and foreign components of public debt were about equal in magnitude. However, over the last five years, they have diverged sharply as domestic debt increased rapidly whereas foreign debt declined (Figure 4. Presently, the share of domestic debt (at 69 percent of total debt) is more than twice of foreign debt (31 percent). This change in composition of debt has strong fiscal implications as, contrary to general belief, foreign debt has substantially lower fiscal cost. The average (implied) interest on foreign debt in 2014/15 was only 2 percent (including the cost imposed by depreciation of rupee), as compared to an interest rate of 10.6 percent on domestic debt. As such, of the total interest cost of debt of Rs. 1.3 trillion, domestic debt contributes 92 percent (of Rs. 1.2 trillion) while foreign debt adds only 8 percent (Rs. 100 billion)

As mentioned above lowering of public debt, by limiting fiscal deficit, is critical for creating additional fiscal space. The budgetary outcome for 2014/15 suggests that the Government may have turned a corner on that front and the domestic and total debt may have started to decline. In addition to continuing with this policy of fiscal prudence to lower the burden of debt, the above discussion implies that, at least in fiscal terms, the Government could be well served if it can mobilize additional foreign debt at the present terms and conditions to retire some of the domestic debt. Figure 5 shows the overall impact on interest cost of Government's debt reduction policy and a simulated impact of swapping 15 percent of domestic debt with foreign debt. Government's debt reduction policy will contribute an increasing level of savings (which will reach almost 1 percent of GDP by 2019/20), whereas a 15 percent per annum debt sway will provide an additional saving of 0.3 percent of GDP.

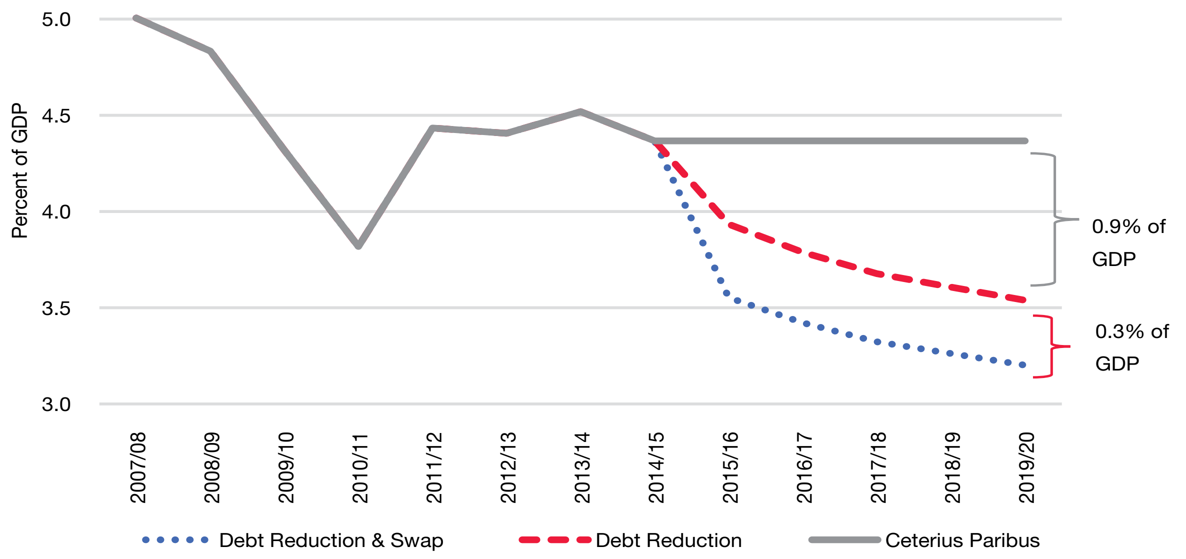

Figure 5: Interest Payments Under Different Debt Scenarios

The Subsidy and Grants Morass

In addition to significant fiscal resources devoted for security-related expenditure and on servicing of public debt, transfer payments (i.e. budgetary subsidies and grants) pre-empt another sizeable portion of these resources. As could be seen from Figure 6, these payments were relatively small (generally less than 2 percent of GDP) until FY07. However, the sharp increase international oil prices in FY08 caused budgetary subsidies on oil and electricity to increase rapidly. In addition, general deterioration in the financial health of State Owned Enterprises (SOEs) forced the Federal Government to pick a bulk of their losses by giving grants from the budget. The cost of these transfer payments increased from 1.8 percent of GDP in FY07 to 4.2 percent in FY12. However, with a subsequently moderation in power subsidy, declined to 2.8 percent of GDP in FY14.

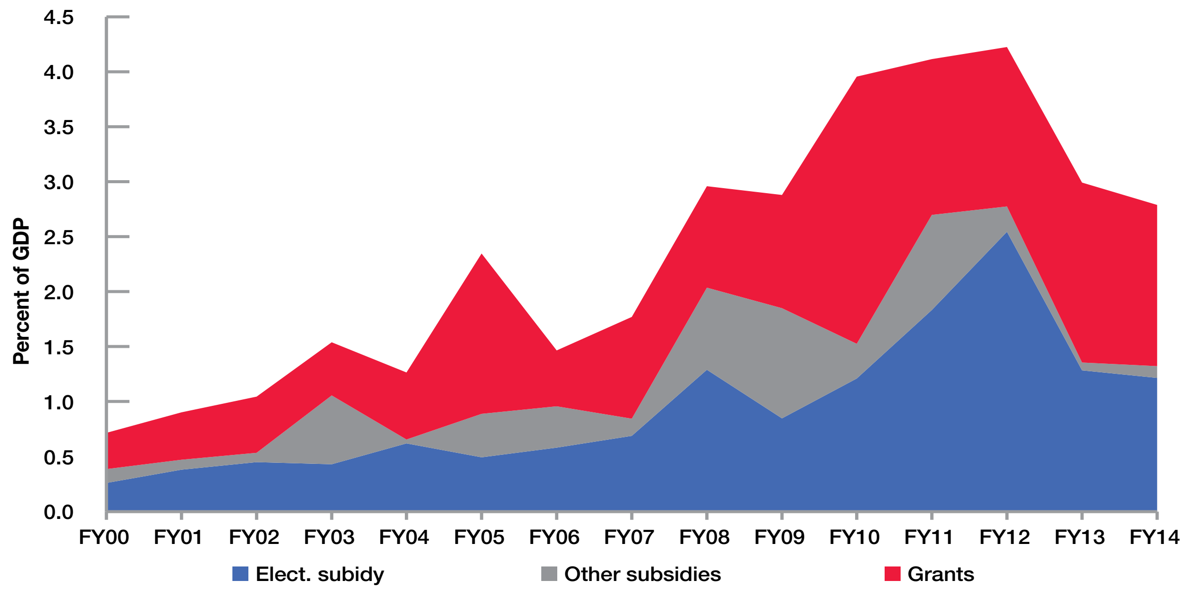

Figure 6: Trends in Subsidies & Grants

1B. OTHER ISSUES WITH **BUDGET & EXPENDITURE MANAGEMENT**

Over centralization of budget-making process is partly due to weak capacity of the line ministries/departments, and partly at outcome of a control (rather than management) orientation of the central ministries/ and departments. (Other Issues with Budget and Expenditure Management[6]) While on paper, every line ministry/department has full autonomy to spend its allocated budget as per its priorities. In practice, however, the central ministries exercise an excessive substantial control over the execution of budget. Although under present tight fiscal situation, some of these controls are justified, but micro-management of line ministries' finances by the Ministry of Finance through Financial Advisors (FAs),[7] badly compromises the financial autonomy of line ministries and dilutes incentives for improved expenditure management. As a result, an average development project twice as long to complete and twice the original cost to implement.[8]

Compartmentalisation of Budget Process

which allows a large portion of expenditure to get included in the budget without proper evaluation. Without much operational or logistical reasoning, expenditure management system is artificially fragmented into recurrent and development budgets with recurrent spending further divided into permanent i.e. the expenditure on on-going activities, and new[9] expenditures, with each category having its own set of rules and procedures for evaluation, processing and monitoring. For example, development spending has a completely different stream of evaluation, processing and monitoring than the recurrent budget, as Planning and Development Division (department at the provincial level) has a greater say in the process than the Finance Division. Partly for this reason, development projects, and consequently development spending, are more carefully evaluated than recurrent expenditure before including them into the budget.[10] In the recurrent budget, new budget is somewhat better evaluated than the permanent budget. The latter which constitutes major (about 80 percent of total expenditure) is hardly evaluated for its alignment with Government policies and priorities or even its need.

Structural Rigidities

severely constrain fiscal adjustment on the expenditure side. In broad terms, more than 53 percent of Federal Government's expenditure is incurred on interest payments, defence, and the wage bills. This part of expenditure cannot be reduced in the short to medium run. Another 29 percent of expenditure is allocated towards subsidies and grants. It is possible to reduce this expenditure in the short-run, but is unlikely due to political and poverty considerations, only 18 percent of the federal Government's expenditure is fully adjustable. This includes development spending and operational expenditure, which requires an increase rather than a cutback in order to meet infrastructural needs and enhancing increasing the efficiency and effectiveness of public expenditure.

Misplaced priorities

divert funds away from high-priority areas. As mentioned above, the fundamental problem is that high–priority social and physical infrastructure investments and pro-

6 World Bank, "Pakistan Public Expenditure Review: Reform Issues and Options", World Bank, Washington, DC. 1998; "Pakistan - Public Expenditure Management: Strategic Issues and Reform Agenda", Washington Dc. 2004; 2011, "Public Expenditure, Procurement and Financial Management Review" (Unpublished), 2011; Pasha, H.A. "Public Expenditure Reforms"; published in ***Sustainable Recovery in Asia**: **Mobilizing Revenue for Development***. 2000

7 The FAs are Ministry of Finance employees posted in every ministry with the mandate to "assist" the ministry on financial and budgetary issues. However, no budgetary release is made by Finance Ministry unless it is approved by the respective FA. On the other hand, FAs act on the directives of the Finance Ministry. This problem is exacerbated by weak technical and managerial capacity within the line ministries/departments.

8 World Bank, "Public Expenditure, Procurement and Financial Management Review", (Unpublished) 2011)

9 Expenditure on new activities, i.e. expenditure which is transferred from the development to the recurrent budget.

10 At the federal level, the development budget is carefully scrutinized by the Priorities Committee, which discuss the demand for development outlays of each ministry in a tripartite forum comprising, P&D, Finance and the Ministry in question.

poor expenditure have increasingly been crowded out by growing interest payments, subsidies, grants and military expenditure. To make matter worse, bailing out the poorly performing SOEs by absorbing their losses in the budget not only exacerbated the crowding out process, but also left little incentives for those SOEs to improve operational and financial management. On the other hand, power sector subsidies arise for two reasons. First, NEPRA makes determination of power tariffs separately for each distribution company (DISCO) on the basis of its company's minimum cost structure. However, the Government notifies a uniform tariff for the entire country. To adhere to provisions of NEPRA Ordinance, the notified has to be the minimum tariff determined by NEPRA for any DISCO (or less). This differential between determined and notified tariff is picked up by the Government in the budget, and is the biggest source of power subsidy. Second, the Government has shied away from using other instruments (e.g. imposing surcharges) to increase tariffs and lower subsidy, mainly on the pretext that poor consumers cannot afford to pay higher tariffs. However, an incidence analysis of benefits from power subsidy show that poor benefit the least and the rich benefit the most (Figure 7).

Despite significant progress, Pakistan's Public Financial Management (PFM) system remains in a state of flux. Pakistan has significantly modernized its PFM system under the Project for Improvement in Fiscal Reporting and Auditing (PIFRA) (see below). However, PIFRA faces some serious implementation problems, and the line ministries and line departments have not yet fully internalized it in their accounting systems, limiting its benefits. In addition, while external controls have improved, internal controls have remained weak due to lack of interest and capacity within line ministries and departments.

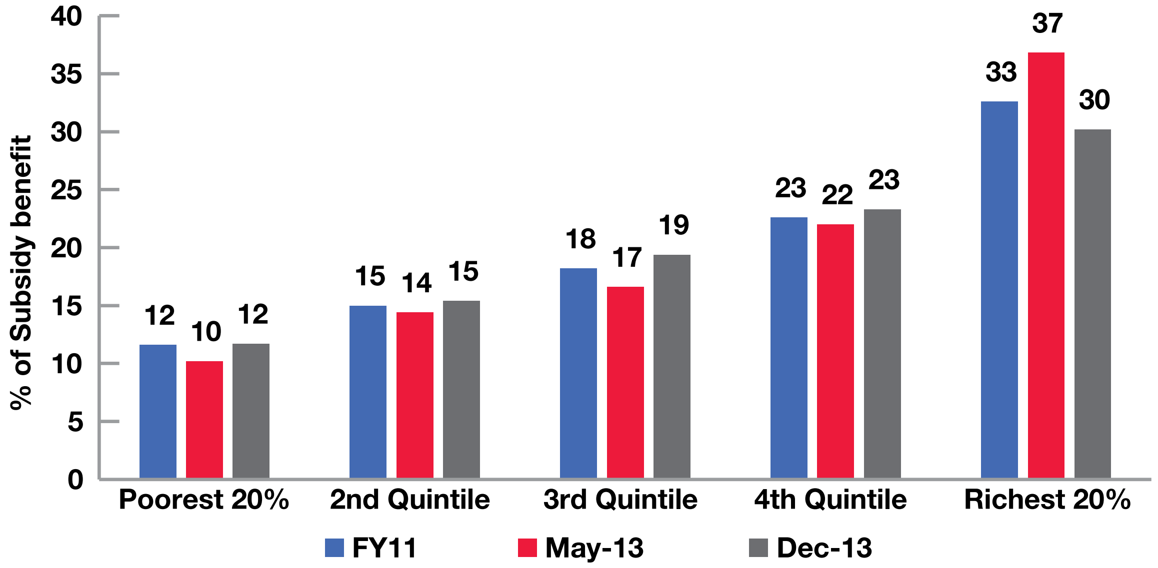

Figure 7: Benefit Incidence of Electricity Subsidy

1C. THE AFTERMATH – ECONOMIC AND SOCIAL DEVELOPMENT PUT ON HOLD

An inadequate response to the fiscal crisis has both short- and long-term consequences for the economy. The Government is faced with a dilemma of lowering fiscal deficit or continue its support for economic growth and development. The former, in view of a non-responsive revenue system and expenditure rigidities, imply cutback development expenditure and therefore slowing down economic growth, while the latter implies worsening the debt and therefore future fiscal situation. In short, under the conditions of revenue stagnation and rigid current expenditure, there is a positive correlation between development expenditure and (targeted) fiscal deficit. Good fiscal management requires creating enough fiscal space, by generating additional revenue and cutback on the non-priority expenditure, to minimize the impact of deficit-reducing efforts on development spending. In other words, prudent fiscal management will lower the association between (changes in) development spending and (changes in) fiscal deficit to the extent possible – ideally converting it into a negative correlation.[11] Figure 8 presents a 30-year trends in Government's development expenditure, overall investment and economic growth. As is apparent, development expenditure (as a percent of GDP) has fallen sharply. This has implication for overall investment. Public investment can decline if the Government vacates more and more areas for private sector to invest and operate.

In Pakistan, the footprint of the Government on the economy has remained significant. Hence, a substantial portion of Government's development spending should be considered as investment which should "crowd-in" private investment. Drop in the public investment, along with deteriorating law and order and level of overall governance (which too could be related, at least in part, to fall level and quality of public spending), caused total investment to decline. This in turn, led to a slowdown in economic growth.

Reversing the declining trend in development expenditure, is critical for improving the well-being of the population. This requires designing and implementing governance, fiscal and public sector management reforms.

11 During the period between 1999/00 and 2007/08, the correlation of the change between development expenditure and change fiscal deficit was -0.35, indicating that enough revenue was generated and/or recurrent expenditure is compressed to lower the fiscal deficit along with increasing development expenditure. However, during the last six years, this correlation has again turned positive (0.45).

Reversing the declining trend in development expenditure, therefore, is critical for improving the well-being of the population. This requires designing and implementing governance, fiscal and public sector management reforms. The foregoing discussion by no means imply that Government is oblivious of the problems and no attempt is made to improve expenditure and financial management in the country. Over the last ten years, the Government has developed and is implementing a comprehensive agenda of budgetary, expenditure and PFM reforms. These have changed (or are changing) the systems in which Government resources are allocated to policy objectives creating opportunities for improved efficiency and effectiveness of public expenditure.

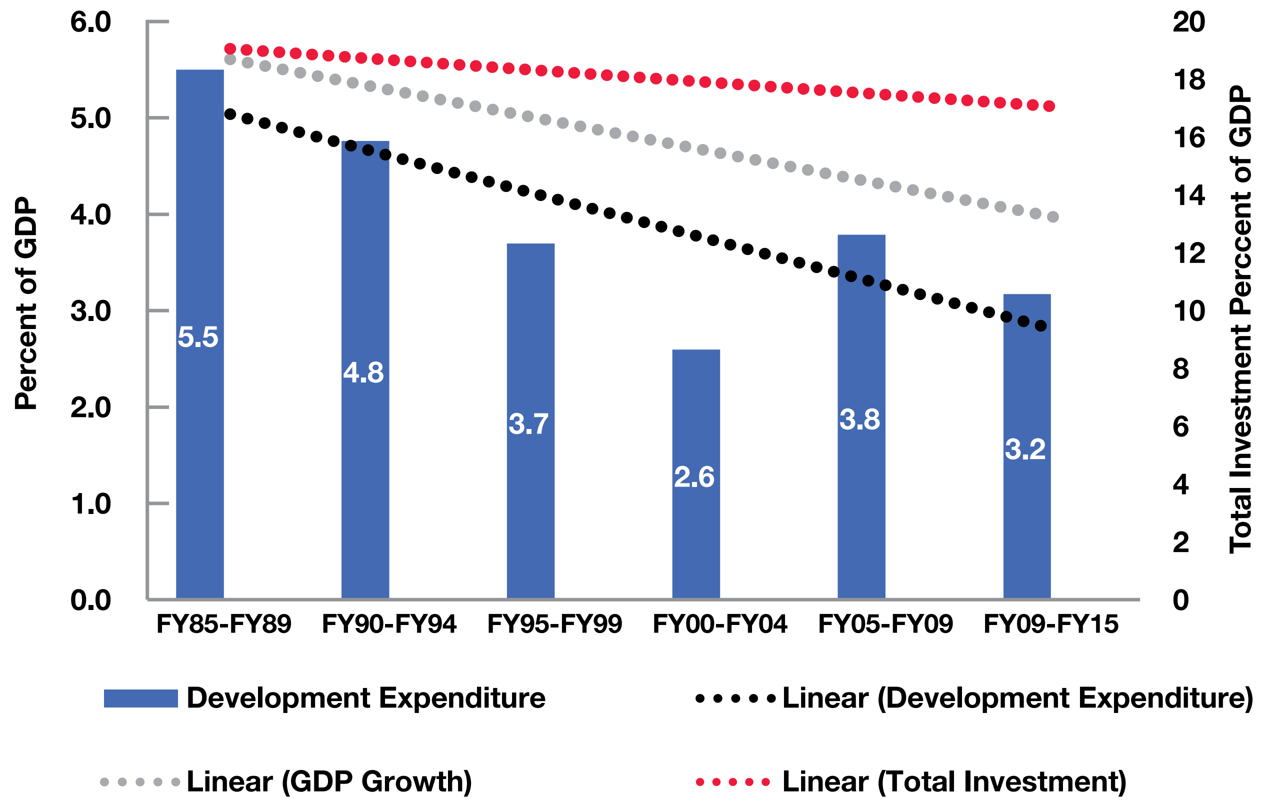

Figure 8: Trends in Development Spending, Public Investment & Growth

1D. BUDGETARY, EXPENDITURE MANAGEMENT & PFM REFORMS

Revenue Reforms
In order to re-establish fiscal stability and ensure availability of adequate resources for economic recovery, Pakistan needs to increase revenue collection significantly, partly because the option to finance expenditure from non-tax revenue would not be available in near future.[12] The need for more revenue has become even more urgent in view of Government's intent of a sharp escalation in public expenditure in the medium-run to meet the infrastructure and social development objectives. Meeting all these commitments would imply a significant gap between intended expenditure and resources which available to finance it.

Under a series of programmes, IMF and World Bank made attempts to improve tax policy. The most recent attempts[13] focus on of making some initial gains in tax policy and administration areas by focusing on "low-hanging fruits" of Government's intended fiscal reforms. This will enhance the fiscal space through generation of additional revenue by expanding the tax base and strengthening tax enforcement and compliance. Specifically, the programmes concentrate on: (a) reducing tax exemptions; (b) increasing the number of registered taxpayers; and (c) instituting an effective system of tax audit.

Budget and Expenditure Reforms

In 2003, the Federal Government initiated an important reform programme for adopting a Medium Term Budgetary Framework (MTBF) with aims to enhance fiscal discipline, improve linkages between Government's strategic policy priorities and budget, and enhance operational efficiency. The MTBF reform has resulted in change in budget preparation cycle of the Federal Government. Two new components are now embedded in the process; the Budget Strategy Paper (BSP) and the Output Based Budget (OBB). The former presents medium-term fiscal framework, a strategy for forthcoming year and three-year budget ceilings for each line ministry. Within these three-year ceilings, all Ministries present their OBBs. The OBB link policy priorities and current budget through outcomes, outputs and inputs. The OBB is being presented to, and approved by, the Parliament as part of the annual budget.
In addition to the above, the following important developments have been initiated as part of the reform programme:

- The Priorities Committee, which used to discuss only project funding prior to MTBF has been upgraded and is co-chaired by Secretary Finance, Secretary Planning and Secretary Economic Affairs Division. The upgraded Priorities Committee discusses policy priorities of the Ministry/Division along with medium-term recurrent and development budgets

- The BSP is discussed with Parliamentary Standing Committees on Finance and Revenue. This process improves parliamentary input into the budgeting process of the Government

- The Budget Strategy Paper is discussed with political parties, economic advisory council and chambers. This is allowing greater focus on strategic economic and budgeting agenda

- In order to improve public financial management, a Public Finance

12 One of the biggest source of non-tax revenue has been defense-related revenue. These are mainly the grants given by the USA Government from the Coalition Support Fund (CSF) for reimbursement of expenditure incurred by Pakistan's defense establishment on war or terror.
13 The IMF's "Extended Fund Facility", and World Bank's "Fiscally Sustainable and Inclusive Growth Development Policy Credit."

Pakistan has been able to attract private investment amounting to less than 2 percent of GDP. In comparison, India has attracted more private investment in infrastructure than any other developing country.

Administration Act (PFAA) has been drafted. The PFAA represents a deliberate effort to draft a law that addresses immediate weaknesses in PFM in Pakistan and introduces modern budgeting practices. Issues addressed in the PFAA include budget preparation, better expenditure control especially for excess spending; budgeting for contingencies, clearer responsibilities including those of 'public entities', movement towards a single treasury account and greater fiscal transparency

- The monitoring mechanism is being strengthened whereby the Finance Division and the Planning Commission are currently defining processes for output and outcome monitoring

Financial Management Reforms

As mentioned above, PIFRA was started with the main aims of establishing an effective accounting, reporting and auditing system that complies with accepted standards, strengthen financial management and tighten internal controls; improve decision support system by generating information for management decision making, and enhance organizational and staff capacity.

The main achievements of PIFRA include: (i) a separation of audit and accounts to remove the built-in conflict of interest in the old system; (ii) establishment of comprehensive Government Financial Management Information System (GFMIS), which provides on-line and live information on fiscal transactions to all line ministries and departments; preparation of budget execution information through monthly civil accounts (which are presented 10 days after the closure of the month) and Budget Execution Reports; (iii) presentation of timely information for revision of budgets and where necessary approval of supplementary budget to meet urgent or emergency requirement; (iv) preparation of Annual Financial Statements within six months of the close of the year; (v) submission by the Auditor General of Pakistan (AGP) of the audit reports to the President, within eight months from the end of the fiscal.

Nonetheless, the progress on improving the PFM indicators have been mixed both at the Federal and Provincial Government levels. The reason for this is that PIFRA reforms are not yet fully embedded in the system. This is mainly because: (i) the new system is still viewed as an "alien" within the mid-management cadres of the accounting, auditing and finance establishments. This has translated into a strong resistance in adopting to the new system; (ii) the line departments are uninterested and unwilling to use PIFRA apparatus for better monitoring their expenditure and for result-based planning and budgeting. This not only limits the achievement of PIFRA, but also makes its opposition more vocal (iii) the overall fiscal accounting system of the Government is fragmented, as FBR and SBP and CDNS continue to use there its own system of accounting revenue, public debt and fiscal transfers, with no, or little, link with PIFRA; and (iv) PIFRA has not yet in a position to keep accounts of SOEs and TMAs.

Fostering Partnerships with Private Sector

Pakistan can take lessons from other countries who have succeeded in "shedding" some of the fiscal responsibility of development by promoting Public-Private Partnerships (PPPs) in delivery of infrastructure and key services. Other than its fiscal benefits, PPPs are also important as they bring private sector efficiency in delivery of public infrastructure and services. Yet, since 2001, Pakistan has been able to attract private investment amounting to less than 2 percent of GDP. In comparison, India has attracted more private investment in infrastructure than any other developing country. While adverse law and order situation is one, albeit important, reason for this low level of private investment, Pakistan has managed sizeable foreign investment in power sector in the 1990s and telecommunication sector more recently. Successes both in India and Pakistan highlight the potential of attracting foreign investment to finance infrastructure with incremental policy reforms.

However, it also needs pointing out that PPP does not provide a 'miracle' solution or a quick-fix, and should only be used where appropriate and where it is able to deliver clear advantages and benefits. This is specifically important as promotion and management of PPPs require a completely different mindset and skill mix in the Government than are accustomed to. The public –private partnerships are defined and governed by a complex interaction of national, provincial and municipal legislations and regulations and project contractual documents. In Pakistan, where the business-related legal structure is still evolving, legal due diligence and careful contract design may be crucial for all parties. Similarly, an effective and sustainable institutional structure is essential for promoting successful PPPs.

CONCLUSION

The present fiscal crisis is not entirely because of Pakistan's own making; its perpetuation definitely is. While there is no dearth of analytical material which identifies the causes of this crisis nor of the recommendations on how to manage it, successive Governments have been found unwilling (or unable) to implement those recommendations. Almost all the Governments of recent past have formulated reform packages to stabilize the economy and nudge it towards economic recovery; yet implementation of these reforms was weak, as the political costs were deemed to be too high compared with the benefits of stabilization. As such, in terms of results on the ground, there is very little to show for these reform efforts. The present Government is in the process of implementing some fiscal, taxation and financial management reforms. A resolute implementation of these reforms Pakistan can show major progress in upgrading its fiscal and financial management systems, which can ensure financial stability by generating more revenue and maximum value for the money spent by each level of Government. All it needs, is the will of to put adhere to the reform and some investment in building national (and sub-national) budgetary institutions. Wavering from this reform path will have devastating effects on country's future growth and development.

CHAPTER 2

ADEQUACY & EFFECTIVENESS OF PUBLIC EXPENDITURE IN PAKISTAN

Pakistan's performance on delivery of basic public services has remained sub-par when compared with other countries with similar per capita incomes. The bigger concern is that the gap in delivery of public goods and services has been widening during the last two decades, especially in relation of delivery of services to the poor. Deteriorating levels of governance explains only a part of this decline in performance of the public sector. A more important factor is the inadequate amounts of funds made available to finance the public goods and services for the rapidly growing population (and demand). To make matters worse, the prolonged fiscal crisis necessitated sharp cutbacks in public spending taking a heavy toll on public investment and critical operation and maintenance (O&M) spending, further deteriorating the efficiency of overall public expenditure.

2A. LAGGING DEVELOPMENT

Since the commodity market shock of 2007/08, Pakistan has been struggling to regain macro-economic stability. Partly because of weak fiscal situation, which caused underfunding of key infrastructure and services, leading to widening gaps in physical infrastructure and human development causing a marked deceleration in the pace of economic growth and social development.

Infrastructure Gaps

One of the most binding constraints on Pakistan's economic growth and productivity has been its energy deficit. The energy sector of the country is in poor condition due to unreliable mix of power sources; generation and distribution losses due to large scale power thefts and aging infrastructure; inadequate finances available to the sector; and weak governance and management.[14] The resulting energy shortfall has rendered high losses to economy, with some estimates putting these losses at Rs. 1.5 trillion (or 7 percent of GDP) in 2011/12.[15]

Nonetheless, over last 5 decades, Pakistan has made significant progress in closing its infrastructure gap with its comparators. During this period, Pakistan has done much better on delivering physical infrastructure than many of its competitors (World Bank 2010). However, looking at the trend during the last four years, it is apparent that the overall quality of physical infrastructure in the country has deteriorated (Figure 9) and despite some narrowing of infrastructure gap, Pakistan remains significantly disadvantaged vis-à-vis its competitors, including Malaysia, Sri Lanka, Egypt and Turkey.

At present, Pakistan has lowest quality of electricity supply, dismal quality railroads and to a lesser extent airport infrastructure, low density of paved roads and networks, and barely acceptable quality seaports[16] (Figure 10). Access to safe drinking water and improved sanitation is well below the comparator countries. Pakistan compares favourably with its comparators in terms of its telecommunication and irrigation infrastructure, yet it needs large injections of investment to meet the rapidly growing demand for modern mobile phone services and rehabilitate and modernize its ageing irrigation sector infrastructure.[17]

14 Lopez- Calix, J. and Irum Touqeer, "Re-visiting Constraints to Pakistan's Economic Growth", World Bank, Washington, DC. 2013.

15 Pasha, Hafiz, A. et al "Economic Costs of Power Load shedding in Pakistan", Institute of Policy Studies, Beaconhouse National University, Lahore; 2013.

16 According to the World Bank's survey, the transport sector was found to be one of top three problems for about 6 percent of the firms. Although, the survey reveals large firms are generally unaffected by deficiencies of the transport sector, the economic activities, especially of small and medium firms, do get affected with increased travel time and cost (World Bank "Enterprise survey, Washington DC., 2009).

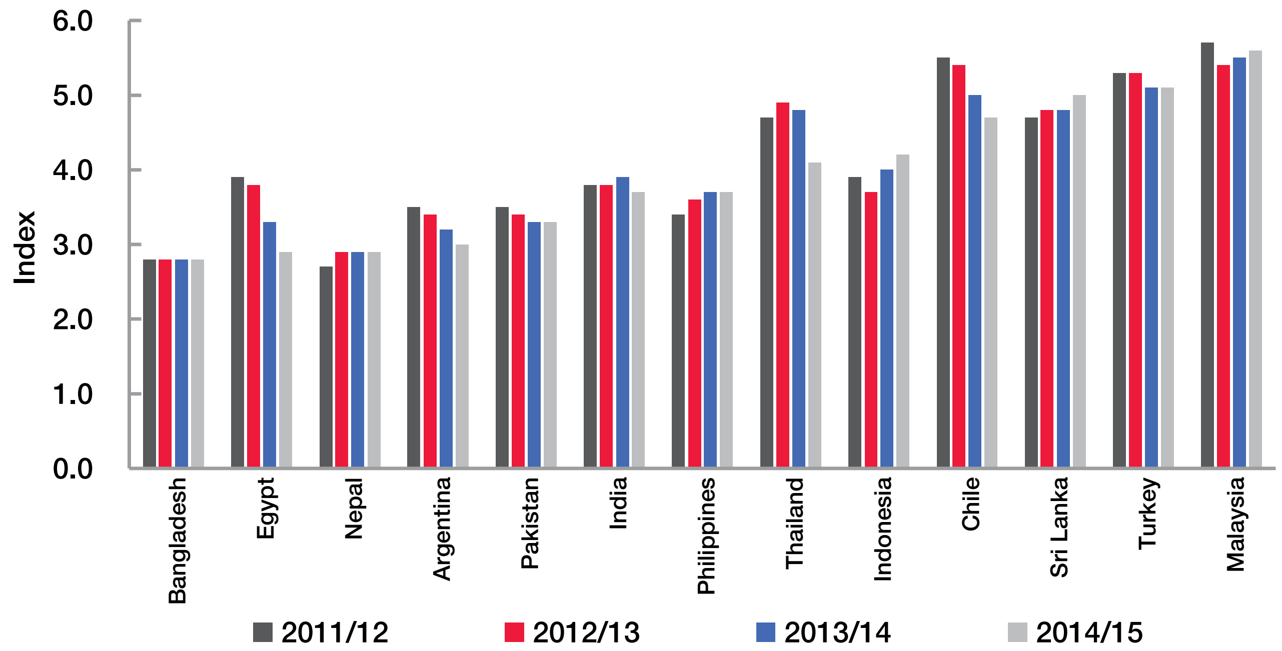

Figure 9: Quality of Infrastructure

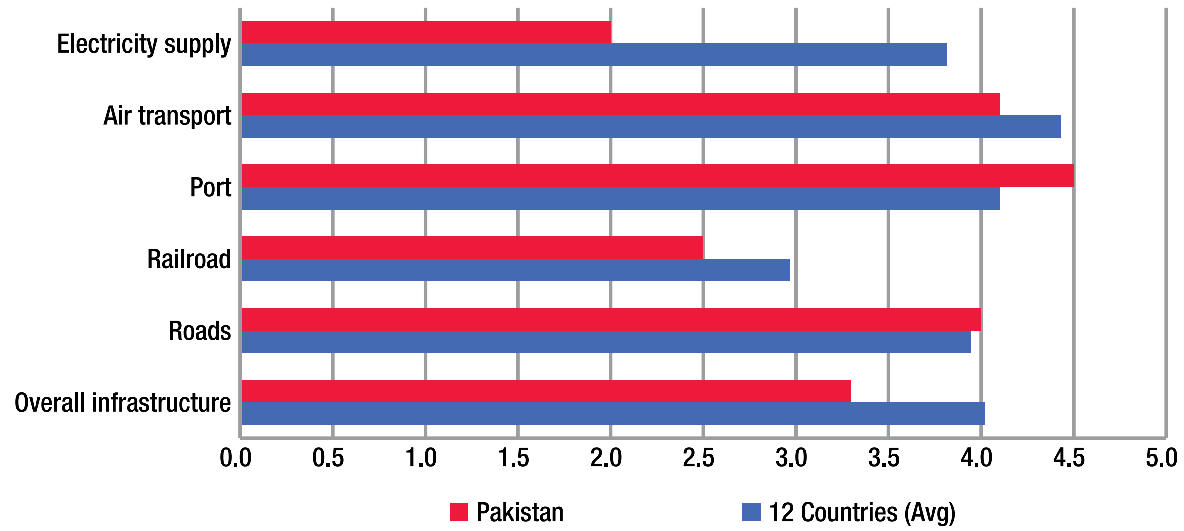

Figure 10: Sector- wise Quality of Physical Infrastructure

With electricity gap reaching 20 percent of the overall demand, Pakistan is currently ranked second in South Asia on the size of electricity deficit.

With electricity gap reaching 20 percent of the overall demand, Pakistan is currently ranked second in South Asia on the size of electricity deficit (Figure 11). Over the last seven years, electricity gap has widened at an alarming rate. Power outages resulting from load management of about, which were at 3 hours a day in 2007 have increased to 8-10 hours a day by mid-2012, causing an estimated loss of about 2 percent of GDP per annum.[18]

At the macroeconomic level, poor quality of infrastructure is costing Pakistan quite dearly in terms realizing its full growth potential.

17 World Bank, "Pakistan - Public Expenditure Management: Strategic Issues and Reform Agenda: Strategic Issues and Reform Agenda, World Bank, Washington DC. 2004.

18 Government of Pakistan, "Economic Survey 2011/12", Ministry of Finance, Islamabad, 2012.

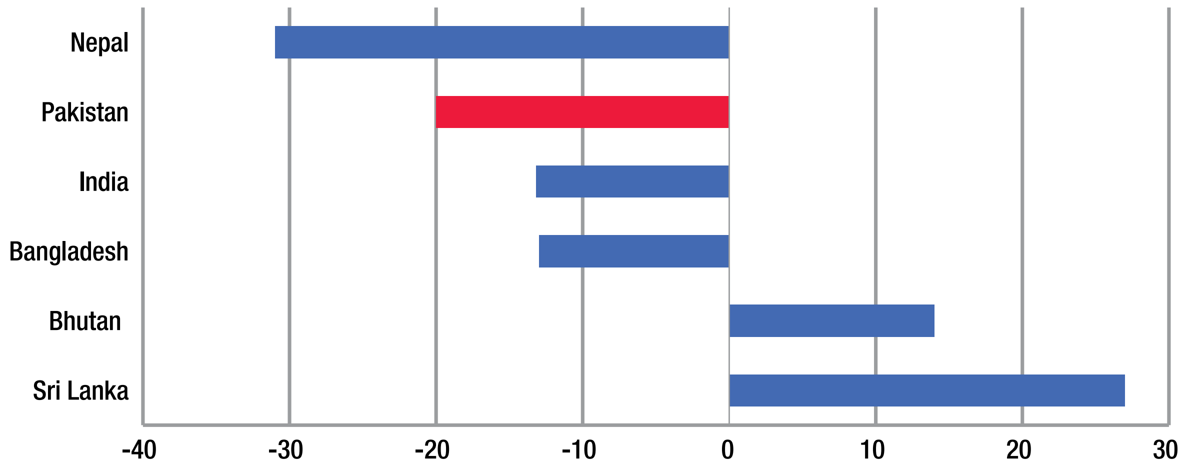

Figure 11: Electricity Deficit

It is estimated that improvement in quality of infrastructure alone will boost Pakistan's per capita GDP growth by 3.7 percent; with major contributions from each of electricity (1.9 percent), transportation (0.6 percent) and telecommunication (1.2 percent) sectors.[19]

Inadequate Human Capital

Over the last three decades, economic growth in Pakistan has not produced commensurate social improvements. As such, Pakistan human resources remained relatively undeveloped. In terms of Human Development Index (HDI), Pakistan not only lags substantially behind its comparators, the gap has been increasing over time (Figure 12). Pakistan's key social indicators remain among the worst in the region; and some of these indicators puts Pakistan in the company of sub-Saharan countries. Pakistan's primary school (net) enrolment rate is almost 21 bps below that of its comparators; life expectancy at birth lags 6 years behind; and infant mortality rate is more than 2.5 times that of comparators. Pakistan's poor human development not only indicates weak social development, but also points to low overall productivity of Pakistan's labour force.

19 World Bank, "Pakistan: Investment Climate Analysis" Washington DC. 2013.

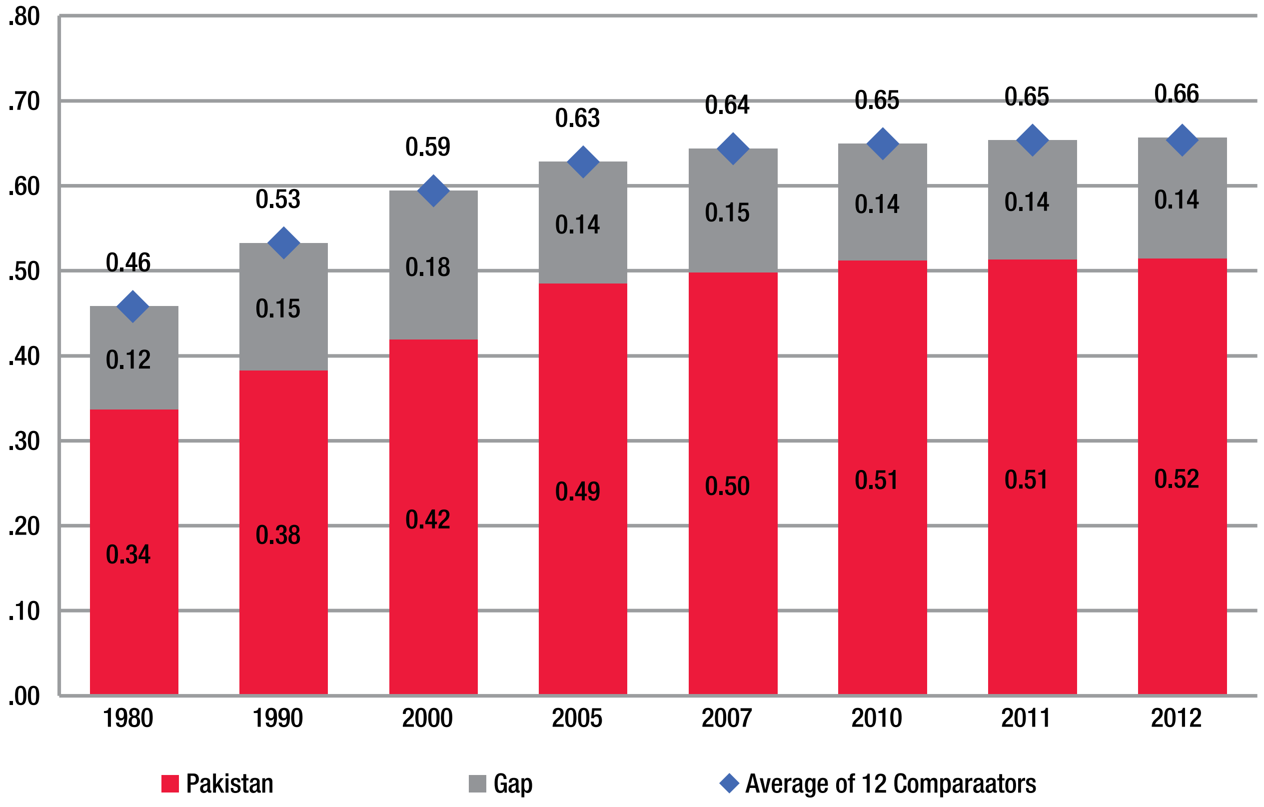

Figure 12: Human Development Index Pakistan Vs. Comparators Countries

2B. EXPENDITURE INADEQUACIES

The fundamental reason for these infrastructural and social gaps is inadequacy of finances made available to these sector. While, compared with other developing countries, social sectors in Pakistan have been perpetually underfinanced, indicating the low priority these sectors have held for the policy-makers of the country. On the other hand, the recent underfunding of infrastructure coincides with the fiscal shortcomings that emerged in the late 1980s and as a consequence of prolonged unaddressed structural weaknesses in public finances.

To assess the adequacy of social spending, it is important to note the Seventh NFC Award sharply increased the share of province in federal revenue.[20] This led to a marked increase in spending on health and education (at 19.4% p.a. between 2005/06 and 2013/14). However, most of this increase was

20 See Chapter 3 of this report.

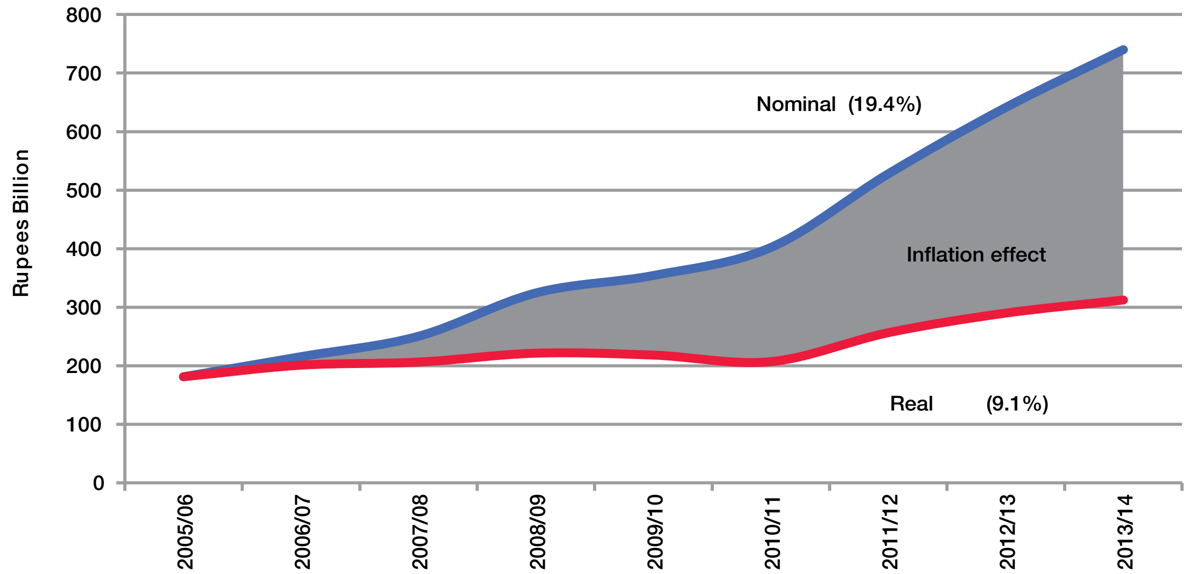

Figure 13: Trends in Public Expenditure on Education and Health

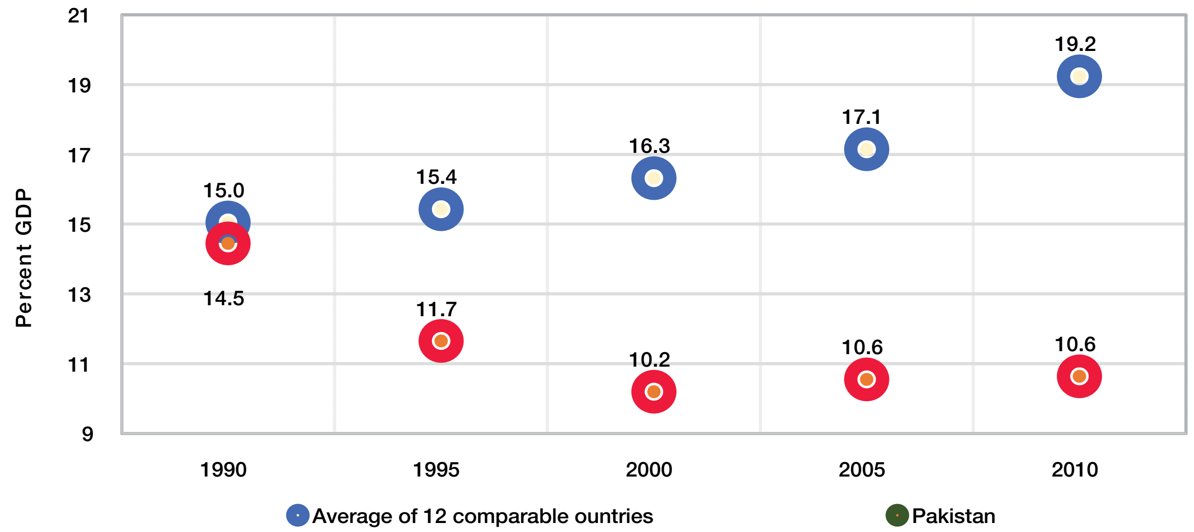

Figure 14: Expenditure on running the government

eaten away by the prevailing high inflation, implying that real inputs devoted towards these sectors increased at a much smaller rate (9.1 percent per annum.) (Figure 13). Even this increase may be overstated as salaries of Government employees increased at a rate faster than inflation, and social services being labour intensive, a bulk of the expenditure on these sectors goes for wages and salaries. As such, the increase in real budgetary resources for the social sector was not enough to bring about the desired improvement in social indicators. The problems in public service delivery can be linked to the fact that overall fiscal resources to finance core Government activities have been falling, and its gap with comparator countries on such expenditure has been increasing sharply (Figure 14). The major reason for the widening gap of expenditure on core activities is low levels of revenue that the federal and provincial Governments generate.[21] Moreover, in competition for scarce fiscal resources, these core activities continue to lose out to politically motivated projects and programmes.

Increasing the pace of economic growth and social development in Pakistan depends on effective bridging of the infrastructural and human development gaps. This, in turn, requires channeling much higher levels of financial resources into these areas. As the non-core activities of the Government (i.e. interest payments, subsidies, etc.) will continue to claim significant fiscal resources in the foreseeable future, the only way to meet the financial needs of the accelerated socio-economic development is by generating much higher level of revenue than the Government has sone so far. Both the Government and taxpayers have to understand the trade-offs between short-term political and personal gains from low revenue mobilization, and the long-term benefits of faster economic and social development which additional revenue can bring.

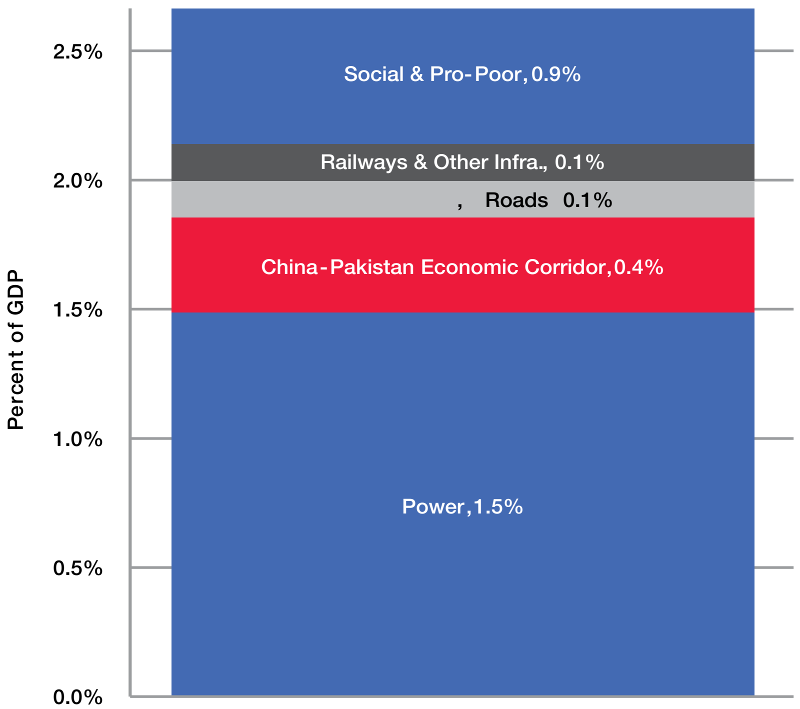

Figure 15: Next 5 Years' Funding Needs

Merely as an illustration, Annex I provides a list of selected projects which are impacting (or are expected to have a strong impact on) well being of local population and could be implemented solely through taxpayers money. Many more such projects could be have been implemented if the Government had more tax revenue. Even some of these projects suffered long delays due to paucity of funds, thus delaying people of their benefits.

The Government has revealed its intentions for a major upgrade of country's infrastructure and enhancing allocations for social sectors and social safety nets. On the basis of Government's present commitments, the additional cost of these projects and programmes is estimated to be around 3.6 percent of GDP per annum (Figure 15), with bulk going towards power sector projects. The efforts on the revenue front continue to lag behind, however. Financing these large intended expenditure through additional borrowing is neither possible, nor in light of Pakistan's already high debt levels should be considered as a viable option. Increasing efforts to generate sufficient revenue to finance a large portion of these investments is the only sustainable mode available to the Government.

21 See Policy Note "Pakistan: Public Expenditure – Issues and Reforms" International Growth Centre", Lahore, 2015.

2C. EXPENDITURE INEFFICIENCIES

The other factor contributing to less than desired improvement in country's infrastructure and social indicators is the inherent inefficiency in the use of budgetary funds. As shown elsewhere, deficiencies of budgetary institutions and processes cause a significant erosion of the allocative and use efficiency of public spending.[22] First looking at the development expenditure, which, over the fifteen years, has grown at an average annual rate of 17 percent, with provincial outlays increasing faster (at 23 percent p.a.) faster than the federal development programme (13 percent p.a.). However, during the pre-NFC period (i.e. FY00 – FY10) the growth in development budget has been faster (at 19 percent p.a., 18 percent p.a. for federal and 26 percent per annum for provincial). After the changes in revenue distribution brought about by the Seventh NFC Award (i.e. FY10 – FY15), the development budget increased by only 12 percent p.a. with provincial budget increasing by 17 percent p.a., while the federal programme increased by only 3 percent p.a. As a result, the provincial programme which used to comprise only one-quarter of overall programme, now commands a share of 55 percent. Given that the federal Government still has the responsibility to developing national infrastructure; this implies slower development of trunk infrastructure over the last five years. Barring a major, although unlikely, breakthrough in the ongoing Eighth NFC deliberation, this trend is likely to continue for at least next five years.

The increase in development budget helped the provincial Governments to take a much better control of development in their respective provinces. A number of large infrastructure projects have been initiated, which better reflect the priorities of provincial Governments and likely to be in better sync with Governments' planning process. As such, these projects are expected to have much less implementation problems than federal projects implemented in the provinces.

However, the increase in development budget, both at the federal and provincial levels,

22 See Policy Note op cit.

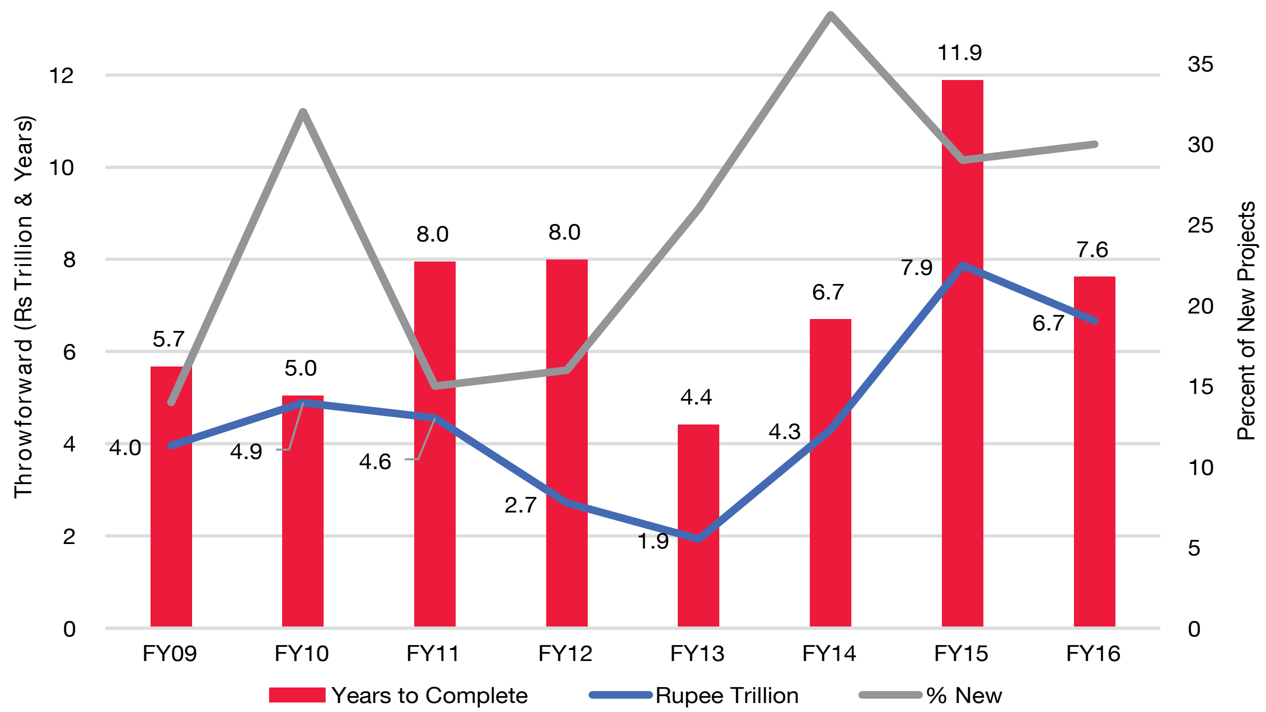

Figure 16: Structural Composition of PSDP

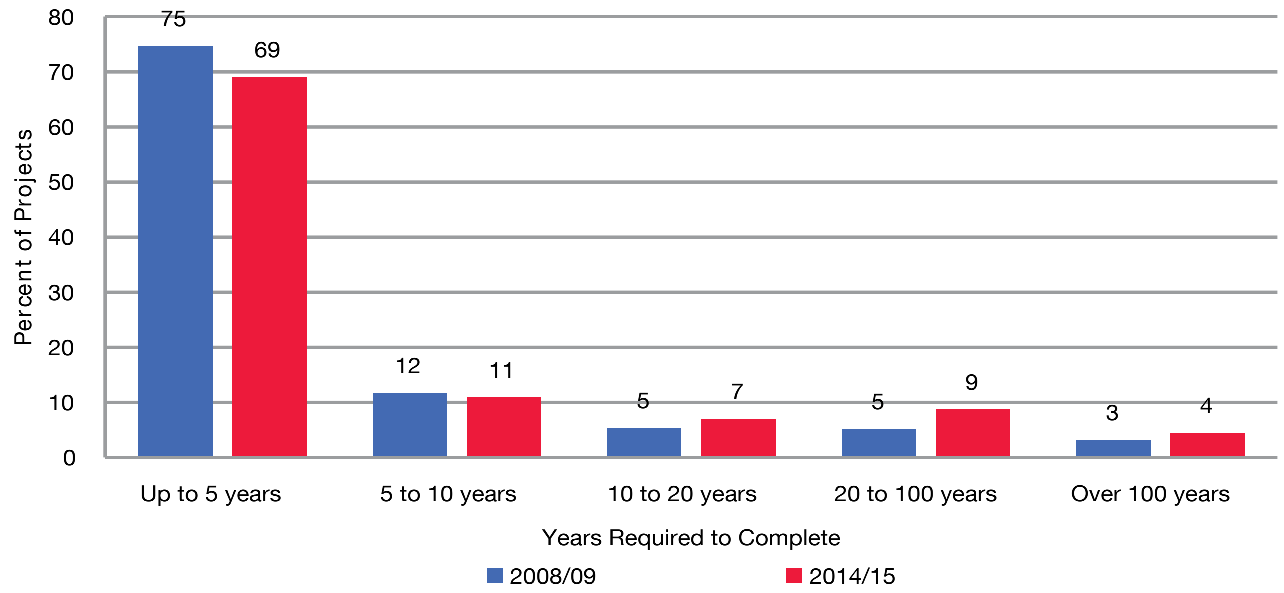

Figure 17: Inadequacy of PSDP Allocation, 2008/09 and 2014/15

Given the rigidities of the budget, development program remains the most potent tool for the line ministries to expand their claim on fiscal resources. This is achieved by concerted lobbying by each line ministry with the political government and the Planning Commission.

has also exposed some of the weaknesses of the planning and budgeting process, which can deprive the Government from achieving the optimal benefits from these investments. The increase in development budget was accompanied by a sharp increase in the number of projects included in the development programme, which lowered the flexibility of the development budget, which theoretically should have increased with the increase in the volume of development budget. The increase in the size of development portfolio, i.e. the number of projects, is mainly due to two factors: First, in order to implement its policies and priorities, every incoming Government made significant infusion of new projects in the development programme. This, however, was not

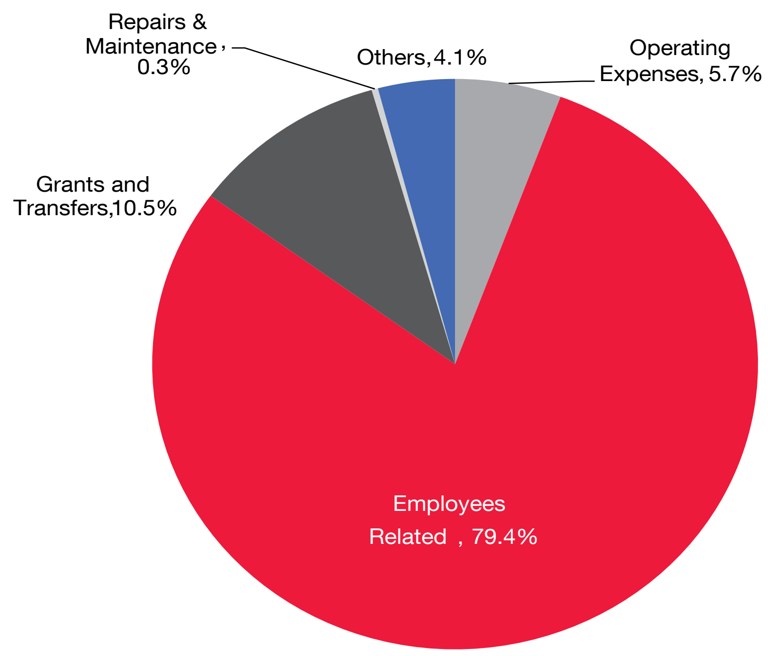

Figure 18: Economic Composition of Education Sector Spending

accompanied by a through clean-up of the past portfolio mainly for the reason that country's auditing system is exceedingly harsh on expulsion of projects from the development programme.[23]

Second, given the rigidities of the budget, development programme remains the most potent tool for the line ministries to expand their claim on fiscal resources. This is achieved by concerted lobbying by each line ministry with the political Government and the Planning Commission to get as many projects included into the ministry's development programme as possible. This lobbying process undermines the quality of development portfolio. With projects getting included in the development programme, at least partly, due to political clout of the line ministries, and not on the basis of their economic or social returns, they run into implementation difficulties at early stages of implementation, leading to long delays and cost overruns.24 Moreover, management and monitoring of a large number of development schemes increases the overhead cost generating additional inefficiencies in the system. ***A World Bank study has determined that on the average in Pakistan it takes twice the originally projected time and almost twice the originally estimated cost to complete a development project.***

The project approval process is fundamentally flawed. Projects are approved only on their "technical merits" with little, or no, consideration given to whether funding is available to finance them. At times approved projects have to wait years to be included in PSDP. However, no further evaluation is done to whether the felt need or even the economic and social returns estimated at the time of approving the project have remained unchanged or not. Moreover, there is a scramble to get projects included in the PSDP even with a "token allocation".[25] This adds to the rigidity of the development budget by increasing the "throwforward".[26]Figure 16 shows that the "throwforward" and the proportion of PSDP portfolio comprising of new projects has been growing significantly in recent years. This implies: (i) that the average time required to fully complete the present portfolio (even if no new project is added to it) at present level of allocations (shown in the figure by years to complete) has been increasing; and (ii) on-going projects are receiving relatively less attention and financing, which is likely to delay their completion.

Thin spreading of development resources cause further delays in completion of projects and programmes. For example, in the 2014/15 PSDP portfolio, at present

23 Under the auditing practices, dropping a project from the development programme initiates an automatic development observation (referred as "audit para" in official terminology), irrespective of whether the deletion was due to negative net returns of the projects; loss of rationale; not consistent with the current priorities of the Government; or for political reasons.

24 World Bank, "Public Expenditure, Procurement and Financial Management Review", World Bank (Unpublished), 2011.

25 A glaring example of this is a railway project. With an overall cost of Rs 55 billion, the project has been receiving a "token allocation" of Rs 1 million in each of the last three PSDPs.

26 "Throwforward" a term by the Government to define the claim of present portfolio of projects on future fiscal resources.

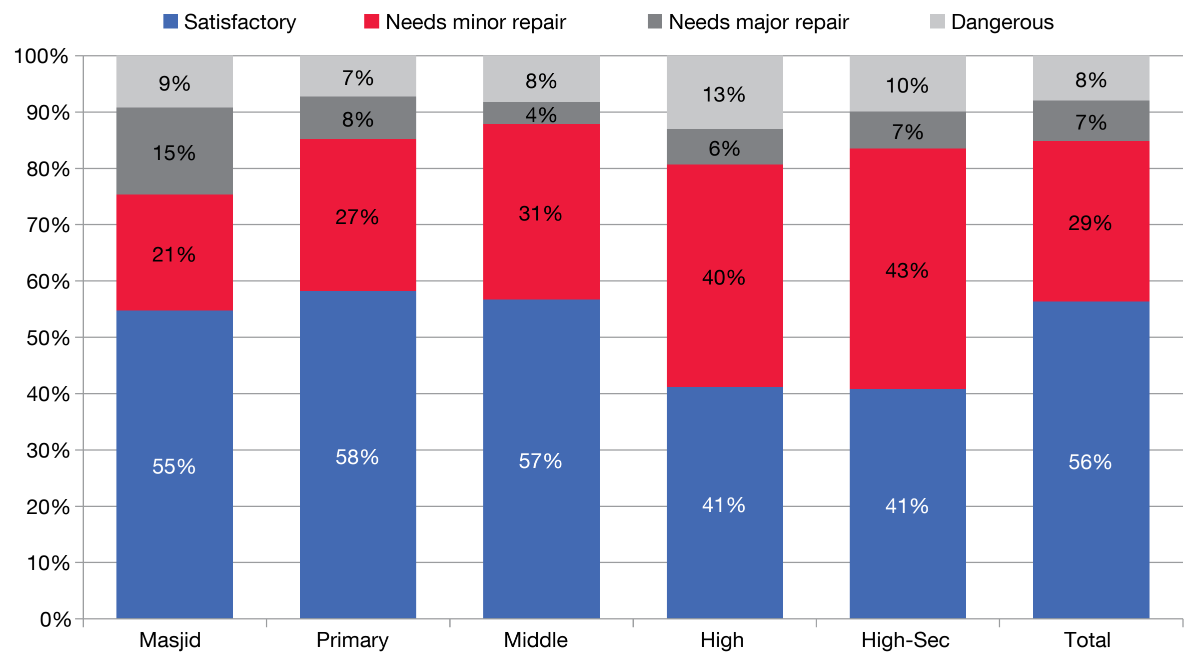

Figure 19: Condition of School Buildings, 2010/11

level of allocations, nine percent of portfolio consists of projects which will take between 20 and 100 years to complete, while another four percent of the portfolio will take over 100 years to complete. Rather than showing improvement, this thin spreading in fact has deteriorating since 2007/08 (Figure 17).

In addition, in Pakistan, there appears to be strong bias in favour of development spending at the expense of recurrent expenditure. The latter is generally perceived by the politicians and general public as a "waste". Given Pakistan's chronically low investment rates, there is nothing fundamentally wrong with this bias. However, when viewed together with Pakistan's budgetary rigidities, this bias leads to a sub-optimal mix of public expenditure, which results in higher allocations being made for creating new structures, but not enough funds provided to maintain the existing ones. In practice, this gives rise to a cycle of ***construct – neglect -erode – reconstruct***.

In Pakistan, the R&M budget, averaging to about 0.5 percent of total expenditure, has always been grossly inadequate. This inadequacy stems from insufficient fiscal resources to meet the all the development needs and a weak planning and budgeting system which assigns greater value to development spending visi-a-vis R&M expenditure. These two factors lead to a situation where new capital gets created through development expenditure, but due to inadequacy of R&M allocations, the existing stock of capital is not adequately maintained, reducing its productive life. As the existing stock of capital is eroded at a faster than optimal rate, the net addition to productive capacity through public investment is only fraction of the level of investment. The large share of rehabilitation schemes in the development programmes of the federal and provincial Governments stands witness to this phenomenon. For example, the 2014/15 federal PSDP contains a total of 1,144 projects, of which, 84 are rehabilitation projects claiming 7 percent of yearly PSDP allocation. Squeezing of R&M expenditure to make room for higher development outlays, at least in part, is a manifestation of the marked dichotomy in GOP's budget process, which almost completely separate preparation and execution development and recurrent budgets. As a result, the first step in budget-making is to apportion overall fiscal resources into development and a recurrent budgets, rather than catering for the sectoral priorities of the Government. The extra rigidities that this process imposes on the use of budgetary resources lead to further erosion in expenditure efficiency.

While inadequate allocation for R&M has a much stronger adverse impact on infrastructure projects, social sectors are not totally immune from shortage of R&M funds. Being labor intensive, social sectors do not require large allocations for operation and maintenance. Yet, it is this non-wage expenditure which is

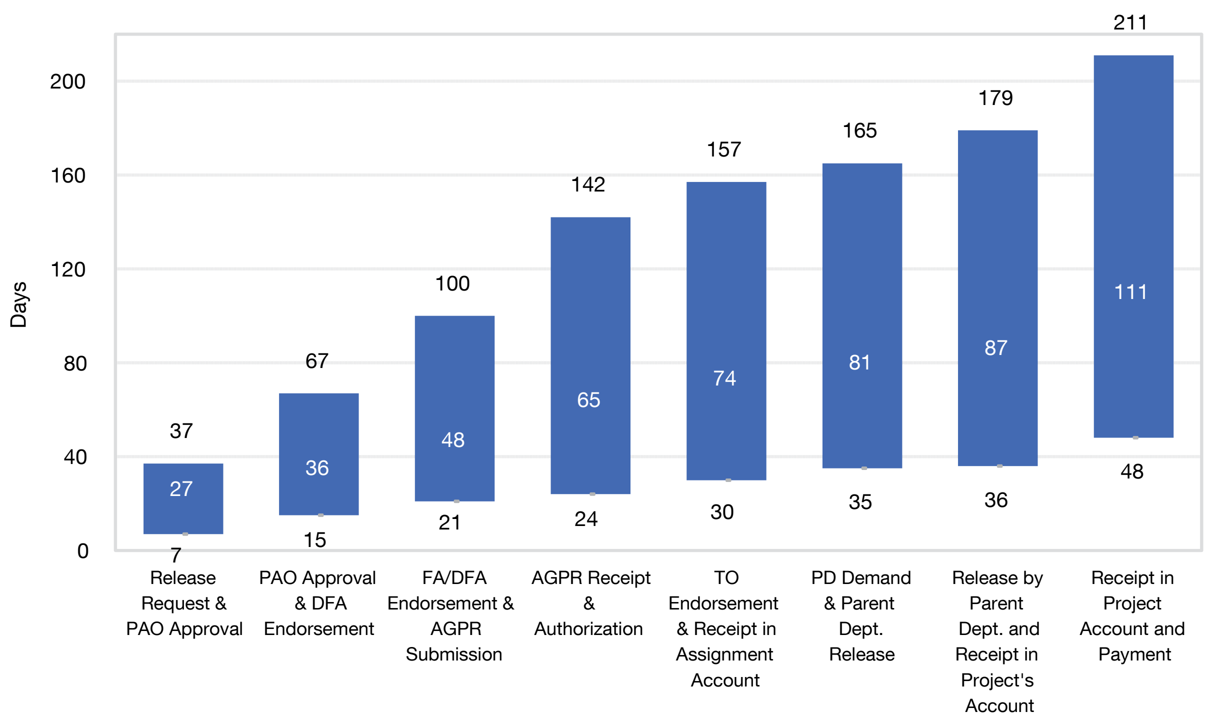

Figure 20: Cumulative time taken between the two stages of release of funds for development projects

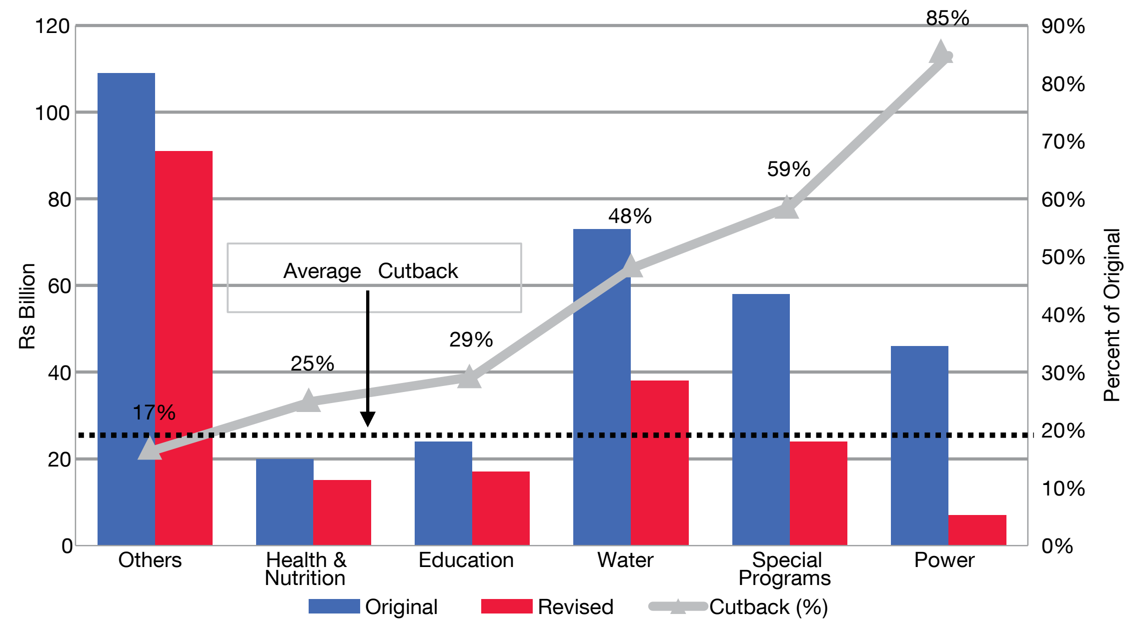

Figure 21: Distribution of Cutbacks in the 2012/13 PSDP

intrinsically related to the quality of social services. Inadequate allocations for non-wage inputs leaves health facilities without medicines and critical apparatus and schools without teaching material. In addition, data from Punjab shows that insufficient allocations for R&M (which is only 0.3 percent of school sector budget) (Figure 18) has left almost half the schools needing some repairs, with buildings of about 10 percent schools classified as dangerous (Figure 19). Situation in other provinces is not likely to be much different.

Project implementation is also compromised by very cumbersome and generally unwarranted controls adopted by central ministries and the accounting system for release and use of development funds. For example a World Bank study[27] has determined that in 2007/08, it requires, on the average, 52 signatures and 111 days between the day a Project Director (PD) submits a request for funds and the day payment is made to a contractor/supplier (Figure 20).[28]

Some inefficiencies in expenditure, especially development, have been generated by the adverse fiscal situation. Repeated failures of the Government to generate adequate revenue resulted in expenditure compression in order to bring down the fiscal deficit. With development budget remaining the most flexible component of public expenditure, it has to bear a disproportionate burden of fiscal adjustment. The adjustment of development programme however had been completely discretionary and without any significant attempt to prioritize the cutbacks. This has often resulted in protection of political projects and programmes than those with greatest economic and social returns. Figure 21 illustrates this argument for the fiscal year 2012/13, when inability to generate the targeted level revenue forced the Government to make expenditure cutbacks in order to keep fiscal deficit within control. Other is scaling back some of the recurrent (generally O&M) expenditure, a cut of 20 percent was imposed on the PSDP. The distribution of this cutback was in stark contrast to the overall priorities of PSDP as maximum cut of 85 percent was imposed on the power sector. Wahter sector allocation was reduced by almost one-half, and those of health and education by more than one-quarter. The cutbacks on the remaining, presumably less priority sectors was only 17 percent.

The effectiveness of development programme is further eroded by: (i) Insufficient investment in many upstream activities involving a development project, e.g. — site identification, consultation with communities, basic design and costing of the project, appointment of key project personnel; (ii) shortage of qualified project management staff; (iii) Defective contract documents & corrupt contracting procedures; (iv) a complicated and time consuming

28 In this survey of select number of development projects, the minimum time taken for the funding cycle to complete was 48 days, while the maximum was 211 days.

27 World Bank. Op cit. 2011.

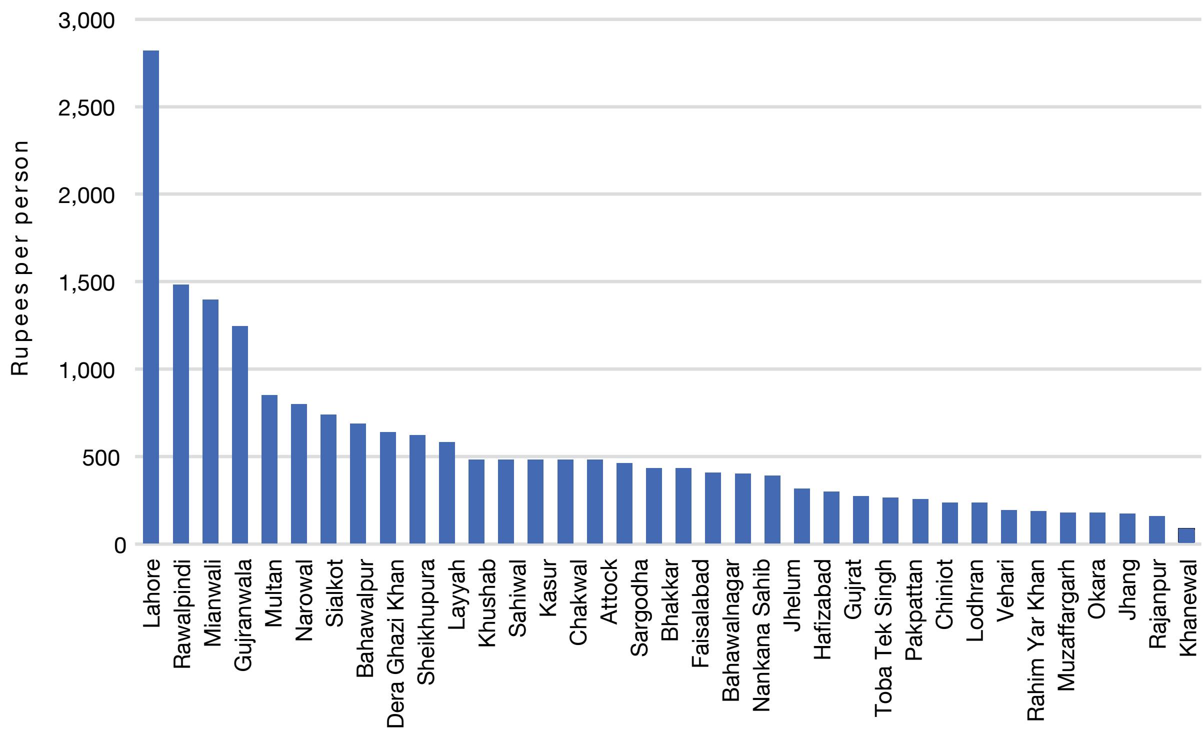

Figure 22. Punjab-- Per capita Development Expenditure by Districts, 2012-13

funds flow arrangement; and (v) diffused accountability and lack of ownership across Government agencies.

Other than containing all the problems of federal development programme, the provincial programmes all are iniquitous and most of development spending is channeled towards relatively more developed areas. An illustration of that is Punjab, were bulk of development spending (in per capita terms) is spent in Lahore and other urban areas, whereas smaller and less developed districts receive only national allocations (Figure 22).

In short, the effectiveness of Government spending is impacted by the quality of governance in the country. While South Asia in general does not stellar example of good governance, in comparison to the South Asian countries, Pakistan falls close to the bottom, rather than the top, in every indicator of governance (Figure 23). This is an outcome of absence or erosion of quality of many public sector institutions. Improving effectiveness of public spending requires political will and investment in rebuilding and strengthening these institutions.

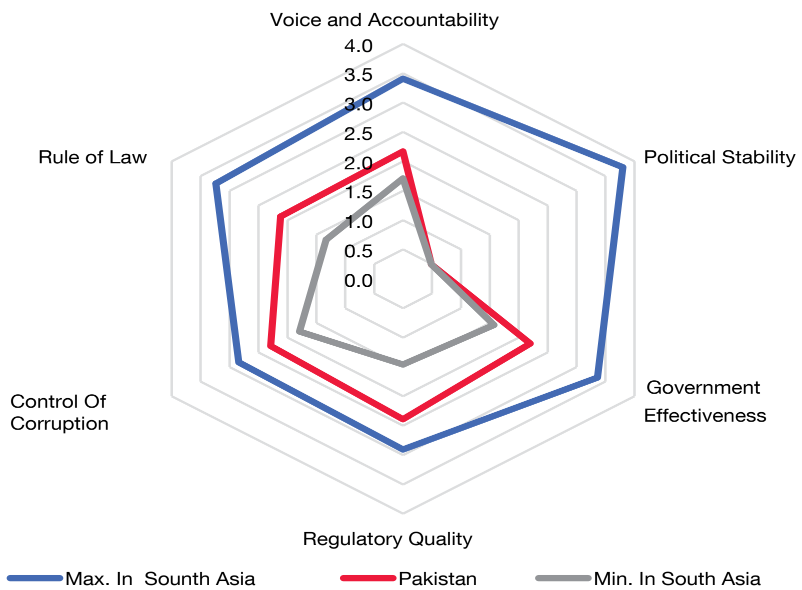

Figure 23. Governance Indicators-- Pakistan vs. South Asian Countries

2D. THE ROLE OF **FOREIGN ASSISTANCE**

Given the scarcity of budgetary resources, there is a wide spread perception that foreign assistance is financing a large portion of Pakistan's budget, especially the development programme. Also, that this assistance is mainly supply driven and by not catering to the needs and preferences of the country and Government is adding to expenditure inefficiencies and overall indebtedness. The factual situation is quite a bit different, however. Over the last 8 years, foreign project assistance has financed only 15 percent of development budget (17 percent of the federal programme and 12 percent of provincial development outlays),[29] whereas overall net external assistance funded less than 4 percent of Government's total expenditure (Figure 24). On the efficiency side, the evidence is mixed. On the average, foreign funded projects have performed only marginally better than development projects financed from Government's own resources. Yet, there is clear evidence that many of these foreign projects and programmes were responsible for establishing institutions, building Government's sectoral and overall capacity, and supporting reforms which otherwise may not have happened. For example, education sector reforms in Punjab and Sindh, which focuses on improving sector governance, management and financing, were initiated under World Bank projects/programs. Both the projects showed significant delays in implementation of some key components, especially provision of missing school facilities, yet they were instrumental in implementing some critical reforms in the sector, including: merit-based recruitment of teachers, distribution of free textbooks to all primary school students, providing stipend to girls students in classes 6-8, etc. Similarly, significant progress was made in establishing and strengthening of planning, budgeting and monitoring capacity of respective education departments. At the federal level, IMF and World Bank have been supporting economic reforms to establish economic stability and accelerate economic growth. The latter involves reforms to improve investment climate; strengthening and streamlining regulatory institutions, and instituting corporate governance in SOEs etc.

29 A bulk of foreign assistance to the Federal Government has been for infrastructure development, mainly in energy and transport sectors, whereas for provincial governments it is mainly for social sector development.

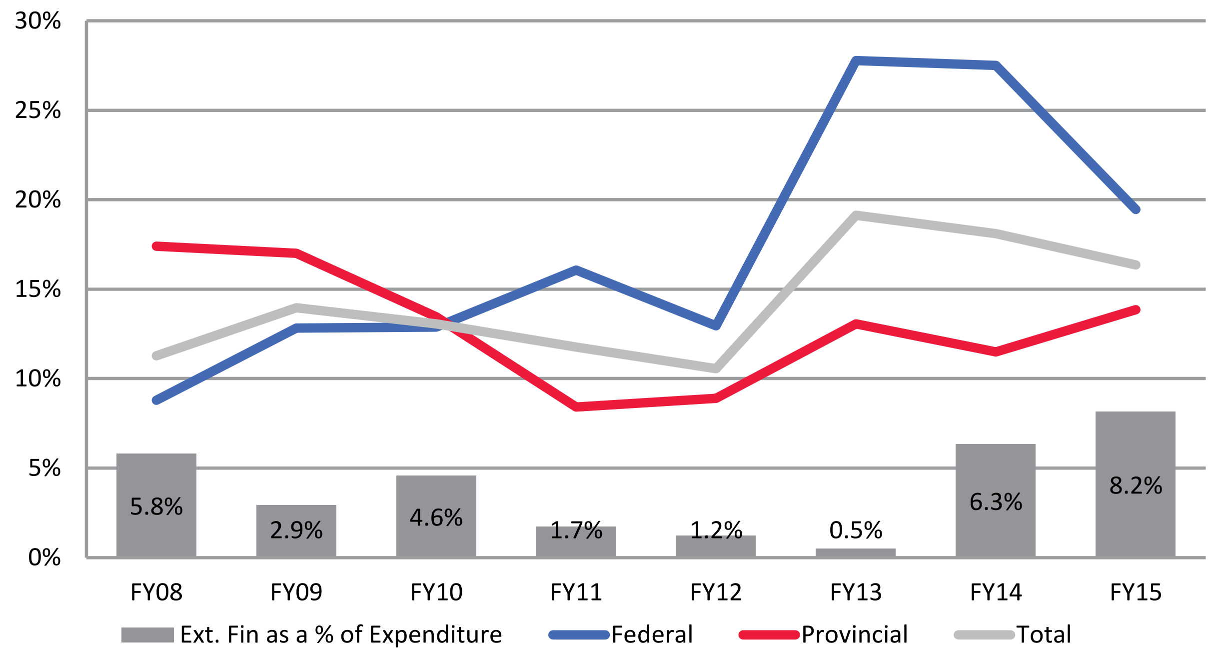

Figure 24: Share of Foreign Assistance in Development and Total Expenditures

2E. THE WAY FORWARD

The additional cost of Government's commitments for infrastructure projects and pro-poor and social spending could easily be financed by reforming public finances. The Government, both at the federal and provincial level, has taken a number of initiatives to improve fiscal management, enhance revenue and improve the efficiency of public expenditure. Some of these initiatives are in early stages of implementation, while others need a stronger will and capacity to be effective. Moreover, there is a need to supplement these initiatives with other reform actions and cast them all into an integrated reform package, which would include a roadmap for its implementation. The roadmap should clearly specify the timeline and the primary and secondary responsibility for undertaking every action with well-defined targets. The reform package has to be based on two pillars.

Pillar I: Expand the Fiscal Space

As shown above, Pakistan grossly underspends on all core functions of the Government. Despite operational inefficiencies, there is need to increase public spending on these functions. It may also be mentioned that even enhancing efficiency of public spending would require resources to establish, strengthen and modernize budgetary institutions; improve and re-engineer processes and procedures and enhance transparency and accountability of public transactions. Expanding the fiscal space would entail:

a. Enhancing revenue through integrated tax policy and administration reforms. To date, the Government has adopted a segregated approach to improve the taxation system, where tax policy and tax administration reforms are viewed and implemented in relative isolation.[30]

b. Efforts at federal level need to be supported by similar efforts at provincial level. For this, institutions like NFC, ECC and CCI need to be used to devise a system, acceptable to all provinces, to improve provincial resource mobilization.

c. Improving debt and cash management practices, at federal and provincial levels, to reduce the cost and term structure of Government debt and borrowing.

d. Reducing the cost of power sector subsidies by rate adjustment and improved governance; and improving their efficiency through better targeting.

e. Lowering the burden on the budget of inefficiencies of SOE through appropriately designed programme of privatization.

A tentative estimate of the fiscal impact of the above mentioned reforms is given in Table 1. This shows that a significant portion of Government's future financing needs could be met by designing and implementing economic and sectoral reforms.

30 Experience from other countries (World Bank, "Implementation Completion Report of the Tax Administration Reform Project" 2012) has shown that the chances of such a segregated approach are extremely limited.

Table 1. Estimated Impact of Government Reforms

Reform Area	Fiscal Impact (Percent of GDP)
Federal and Provincial Level Tax Reforms	0-5% - 1.0%
Debt Management Reforms	0.4% - 0.8%
Power Sector Reforms	0.5%
SOEs Reforms	0.5%
Total	1.9% - 2.8%

Pillar II: Enhancing Efficiency of Public Expenditure

Expansion of fiscal space, especially through better tax collection, needs to be supported by improved efficiency of public spending. The key to generating savings in federal and provincial budgets is to reduce low-priority. This exercise needs to be carried out on all three dimensions: (i) inter-functional, i.e., by shifting resources from less important functions to more important ones; (ii) inter-use, i.e., moving away from a 'build, neglect and rebuild' culture to a 'build and maintain' philosophy; and (iii) inter-Governmental, i.e., matching expenditure assignment with service delivery assignment across various layers of the Governments. The latter can be ensured by devolving local functions to local Government and decentralizing others to enhance their management, monitoring and accountability.

Although, the Federal Government has started preparing its annual budget under a Medium-Term Budget Framework (MTBF), yet budget separation issue has not yet been properly tackled, and to-date the MTBF has followed the existing dichotomy in budget-making. For improving effectiveness of MTBF, the ultimate aim should be to have a complete integration of development and recurrent budgets, so as to allocate fiscal resources to each ministry on the basis of available fiscal resources and the priority that each ministry holds in Government's overall policy framework. At the same time, the process should allow the line ministries to decide the activities, development or R&M, on which they would like to spend these resources. This would require giving line ministries a complete control on managing their budgets. The FA/DFA, who report only to the Ministry of Finance, in each ministry need to be replaced by Chief Financial Officers (CFOs) who would overlook the financial matters of the line ministry and report to the Principal Accounting Officer. Ministry of Finance, should retain the control and oversight role of finances by managing the macro-aggregates and focusing more on outputs and outcomes than the micro-management of line ministry's finances.

In the short-run the inadequacy of R&M budgets could be corrected by; (i) linking asset creation with asset management at each sector level by reclassifying the R&M spending as development expenditure, so that the asset management and asset creation decision are made in unison; (ii) ring-fencing R&M expenditure by amending the FRDL Act to define floor levels of R&M spending the FRDL Act in the same way as is done for pro-poor and social expenditures; and (iv) earmarking user charges for R&M activities (e.g., irrigation, roads, etc.).

The shortcomings of the development programme can be addressed by: (a) better use of instruments like "project readiness filter" to assess the implementation readiness of a project before it is approved; (ii) better training, improved incentives and enhanced accountability of project directors and project staff; (iii) undertaking a business process reengineering of flow of fund arrangements, e.g. a parallel, rather than in series, submission of release application, etc. (iv) introducing annual/periodic performance audits; and (v) strengthening the oversight and accountability of public expenditure by strengthening monitoring institutions. For the latter, the Federal Government and other province can benefit from the monitoring system put in place to monitoring the expenditure and output of the education sector.

Improved efficiency of expenditure would imply that the results which were to be achieved over the next five years can be achieved 1 percent of GDP less expenditure.

CONCLUSION

Pakistan's ability to tap its growth potential is severely constrained by the inadequate quantity and poor quality of public goods and service. This is turn is an outcome of insufficient spending on core Government functions and activities due to scarcity of financial resources caused by weak revenue effort. Most of the scarce revenue resources generated are pre-empted by security needs, excessive spending on grants and subsidies, and high levels of interest payments. While Pakistan desperately needs to upgrade its physical infrastructure and provide better quality public services, financing them by additional borrowing is no more an option, as it would further exacerbate the debt problem. Higher levels of debt, through even higher interest payments, would further squeeze the fiscal space. The only way to covert the present vicious cycle into a virtuous cycle is to significantly increase Government. Revenue mobilization efforts need to be supported through a comprehensive programme for removing expenditure inefficiencies, which would require modernizing and making more effective the budget, expenditure and public financial management systems; and decentralizing expenditure decisions to the line ministries, departments and to the lower level of Government. In the recent past, Pakistan has managed to turn its fiscal situation around quite noticeably, with a strong political will and well-designed reforms there is no reason why it cannot do it again.

CHAPTER 3

FISCAL MANAGEMENT UNDER DEVOLUTION IN PAKISTAN

There is an increasing volume of evidence from across the world that proximity of the Government to the people is critical for promoting bottom-up accountability and therefore improving the quality of public services. In Pakistan, however, the Government and delivery of services remained significantly centralised and therefore distant from the people to whom these services are being provided.

Over the course of its history, Pakistan has experimented with a number of initiatives to decentralize governance. Most, if not all, of these initiatives, however, failed to improve the delivery of public services mainly because the primary objective of each of these initiatives was pre-dominantly political, and little attempt was made to balance that with service delivery aspects of decentralisation.

3A. THE HISTORY & POLITICAL ECONOMY OF **DECENTRALISATION IN PAKISTAN**

Pakistan's politics is dominated by Punjab, which has more than 50 percent of national population and therefore dominates the civil administration and military. Partly for this reason, and partly because Military Governments have ruled the country for about as many years as have the civilian Government, there have been strong centrist tendencies in Pakistan's federal system.

While the Constitution recognise Local Governments (LGs) as an important component of the state, it does not grant them a status of a separate tier of Government. Constitutionally, therefore, LGs are merely an extended arm of a provincial Government. As local and provincial politicians vie for the same political space creating strong and unwarranted frictions between the two levels, with constitutional ambiguity about their status putting local politicians at a considerable disadvantage. As such, local Governments have thrived solely under Military Governments, which have sought to strengthen this tier largely to achieve political legitimacy. Under democratic Governments, Local Governments have either ceased to exist or had their powers and functions greatly curtailed.

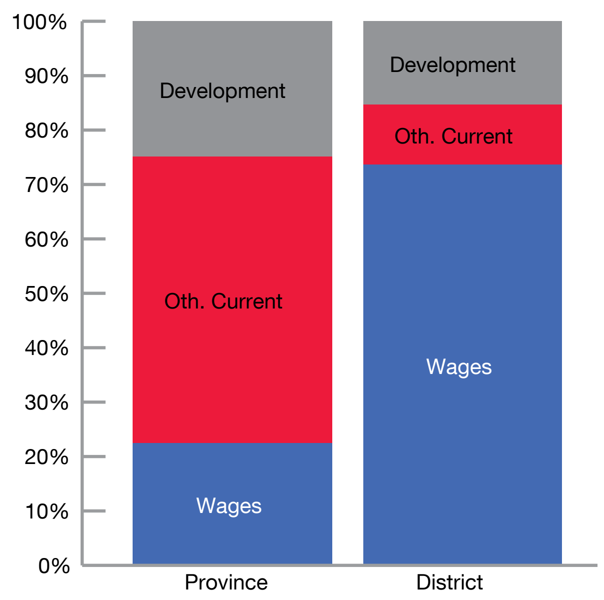

Figure 25: Composition of Expenditure

The strongest move towards devolution came in 2001 when the then military Government devolved a large number of provincial functions, including school education and health, to the local Governments, along with the customary municipal functions (i.e. water supply, sanitation, sewerage disposal, intra-city and local roads, etc.). However, as the devolution plan failed to provide a mechanism for integrating provincial and Local Governments, the provincial Governments tried to obstruct the functioning of the local Government at every step of the way. The most glaring example of that was that Government staff functioning in departments which were devolved to district Governments continued to remain employees of the provincial Government, thus giving no opportunity to improve service delivery through better human resource management. Similarly, in blatant disregard to the principles set by the devolution plan for providing fiscal resources to LGs as a single-line transfer, the actual transfers to the districts were compartmentalised into recurrent and development components, with LGs having no authority to re-appropriate funds from one component to meet of the other. Moreover, the share of districts in development budget was much smaller than in the recurrent budget (see Figure 25). Moreover, the recurrent transfers were barely enough to pay for wages of Government employees, with negligible funds provided for operational expenditures. In short, partly due to the above mentioned (and other) hurdles, and partly because of weak governance and managerial capacity, the districts Government could not achieve the results expected of them.

With return to power of elected Governments, the 2001 devolution was largely reversed as the democratically elected Governments showed no inclination to continue with the constitutional cover provided to local Governments, which lapsed in December 2009. Till recently there was no attempt made by any province to hold fresh local Government elections, thus giving officers of Provincial Government a control over local functions. In addition, through new LGOs, all four provincial Governments have moved to limit the legislative, administrative and financial powers of local Governments by assigning them mainly the municipal functions.

3B. RECENT CHANGES IN **FISCAL DECENTRALISAITION FRAMEWORK**

In 2010/11, the Government made some fundamental changes in the decentralization framework which had a major impact on overall finances of the Government and can potentially be a game-changers for fiscal management in the country.

The Seventh NFC Award

The Seventh NFC Award made some radical changes in the revenue sharing formula:

- The Award has raised the share of provinces in the divisible pool of federally collected taxes from 46.25 percent to 56 percent in 2010/11 and to further 57.5% for each of 2011/12 – 2014/15
- The size of divisible pool has been somewhat expanded by reducing the collection charges retained by the Federal Government from an average of 5.2 percent to only 1 percent
- For horizontal distribution of revenue among provinces, the Seventh NFC Award has moved away from the past practice of using population share as the sole criteria for revenue distribution and has included other factors, i.e. poverty/backwardness (10.3%), tax collection (5%) and inverse population density (2.7%), along with population shares (82%), into the formula
- The overall share of Balochistan has been increased from 7.17% to 9.09%; whereas shares of all other provinces, especially Punjab, have been reduced (Figure 26)
- To help NWFP cover the cost imposed by the "war on terror", 1 percent of gross revenue from the divisible pool will be provided to the province as direct transfer
- On the other hand, all federal grants were discontinued

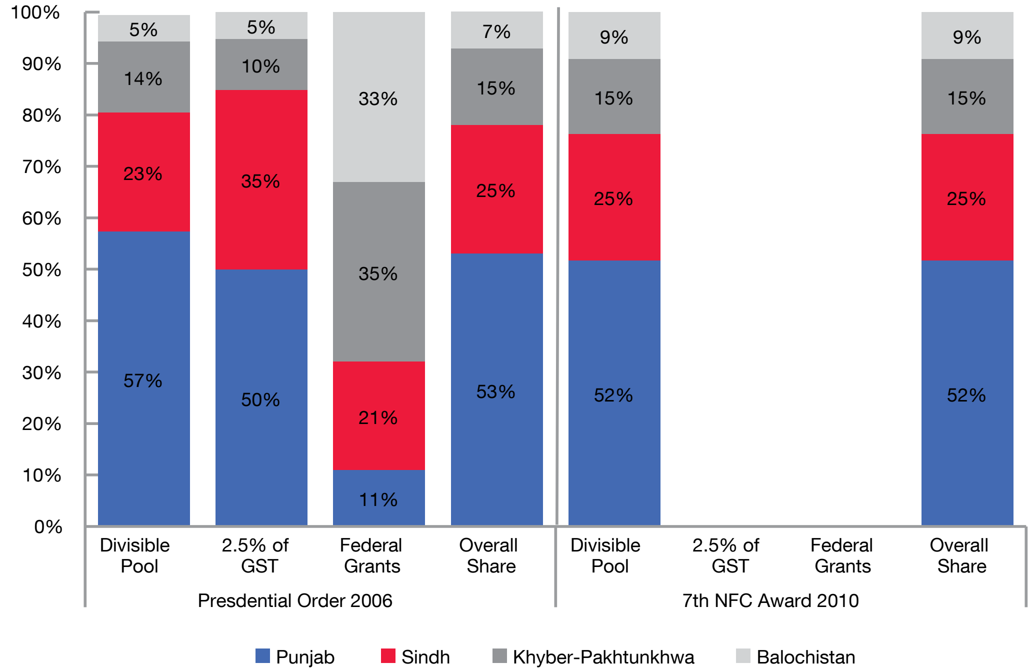

Figure 23. Governance Indicators-- Pakistan vs. South Asian Countries

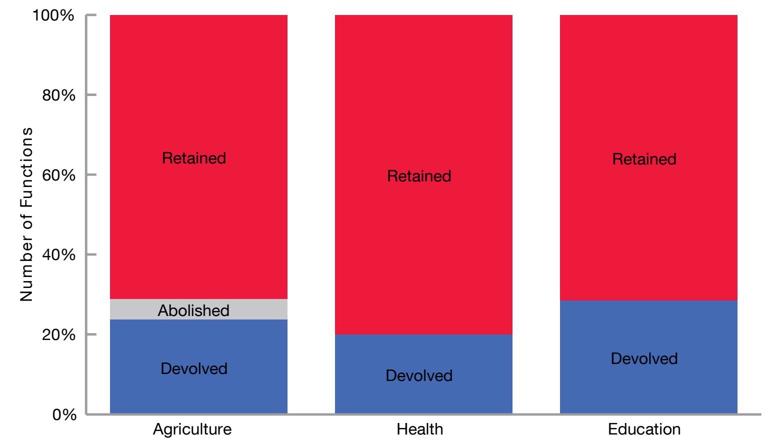

Figure 27: Extent of Devolution, as measured by Number of Functions

Despite this devolution of a large number of functions to the provincial governments, the fiscal implication of the 18th Amendment is likely to be small, as the expenditure responsibility shifted to the provincial governments constitutes only 0.25 percent of GDP

Transfer of a significantly higher portion of the divisible pool to the provinces, however, is not predicated on new monies. As the overall budgetary situation has remained very tight and over-committed; the implication of the NFC Award is that the Federal Government has to mobilise substantial additional resources to meet all its expenditure needs. Alternatively, the provisions of NFC Award can only be accommodated through the transfer of equally substantial expenditure responsibility from the federal to the provincial budgets.

By eliminating the Concurrent List of the Constitution, the Eighteenth Amendment has in fact removed a number of functions from the federal jurisdiction.

Devolution Under 18th Constitutional Amendment

The 18th amendment has introduced profound changes in the multi-tiered governance framework of the country. These include strengthening institutions of inter-governmental coordination and conflict resolution through the revival and strengthening of the Council of Common Interest and making the National Economic Council more responsive to the provincial interests. In addition, by eliminating the Concurrent List, Federal Government's role

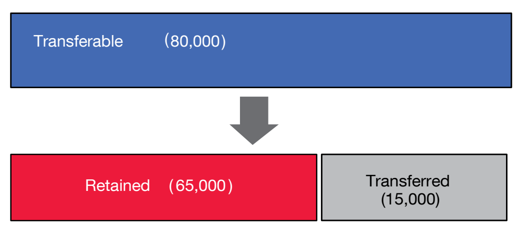

Figure 28: Transferable and Transferred Employees

in legislating and undertaking a large number of functions was eliminated leading to abolishing of 17 Federal ministries. Some of the functions, such as electricity; major ports; all regulatory authorities established under the federal law; national planning and national economic coordination; supervision and management of public debt; censuses; standards in institutions for higher education and research; and inter-provincial coordination were transferred to Part II of the Federal Legislative List, and thus would be governed not by any Government but by the "federation" through the Council of Common Interest (CCI).
As such, 17 federal ministries were abolished.

Despite this devolution of a large number of functions to the provincial Governments, the fiscal implication of the 18th Amendment is likely to be small, as the expenditure responsibility shifted to the provincial Governments constitutes only 0.25 percent of GDP (or 3.6 percent of the combined budget of the provinces).[31] This limited fiscal implications of 18th Amendment resulted from: (i) the provincial Governments were already performing some major components of the devolved functions (e.g. education, health, agriculture) and the federal role was very limited; (ii) even within the devolved ministries, the Federal Government opted to retain many functions and institutions (see Figure 27); (iii) the federal Government also opted to fully finance some of the devolved functions for at least five years;[32] and (iv) of the eighty thousand employees associated with the abolished federal ministries, only fifteen thousand were accepted by the provincial Governments (Figure 28) leaving the Federal Government to hold and pay for the remaining 65,000 "redundant" employees.

Notwithstanding the present low cost implications for the provinces, the future cost is likely to be significantly higher. This is mainly because after the term of the present NFC Award,[33] the federal Government is not obligated to continue financing some of the major devolved programmes.

31 See Pasha, A. (2013) "The Political Economy of Decentralization", World Bank, Islamabad, 2013.

32 These include all vertical programmes in the heath sector, population welfare programme, higher education, etc.

33 The present NFC Award was to end in 2014/15. However, the next NFC was constituted late and was unable to deliberate and agree on a new Award. The Government therefore has sought from the President a one year extension in the term of present NFC Award.

This probable transfer of these programmes from the federal to provincial budgets imply that provinces have to make fiscal space to adequately finance these programmes. Given the increasing claims on fiscal resources of the services presently financed by provinces, the best mode for the provinces to meet the additional cost transferred from the federal budget is by raising their own-source revenue.

The 18th Amendment has also made some major reassignment of taxation powers. The Federal Government has been asked to vacate taxes on immovable property, estate and inheritance; indirect taxation on services, capital value tax on immoveable property and Zakat and Usher (religious taxes) and have reassigned their collection to the provinces. It is up to the province how well they want to, or could, utilize these additional revenue basis.

In addition, the provinces have been given the right to borrow from domestic and international lenders subject to limits and conditions imposed by the National Economic Council.

3C. ISSUES ASSOCIATED WITH RECENT DECENTRALISATION

Fiscal adjustment made very difficult

Even prior to the Seventh NFC Award, Federal Government was having difficulties in managing its finances. With stagnant revenue and rapidly rising interest and subsidy bills, the consolidated fiscal deficit was hovering in the range of 5-6% of GDP – an unsustainable level, given Pakistan high levels of debt and its non-accessibility to concessional financing. By re-assigning greater share of revenue to the provinces, the NFC Award made fiscal adjustment even more difficult. Theoretically, this reassignment of revenue from the federal to provincial Government, would have created a larger deficit at the federal level, while the provinces would show fiscal surpluses, keeping the consolidated deficit more or less unchanged. However, large increases in wages of Government employees over the next four years ballooned public expenditure, especially at provincial level, increasing further the federal fiscal deficit and eroding drastically the fiscal surpluses of the provinces.

Large increases in wages of government employees over the next four years ballooned public expenditure, especially at provincial level, increasing further the federal fiscal deficit.

Tax Reforms Stymied

Income tax was already bifurcated on basis of source of income, with agricultural income being taxed by the provinces and the rest by the Federal Government. Although Services General Sales Tax (SGST) was always assigned to provinces, it was collected by the Federal Government (but with revenue transferred to provinces).

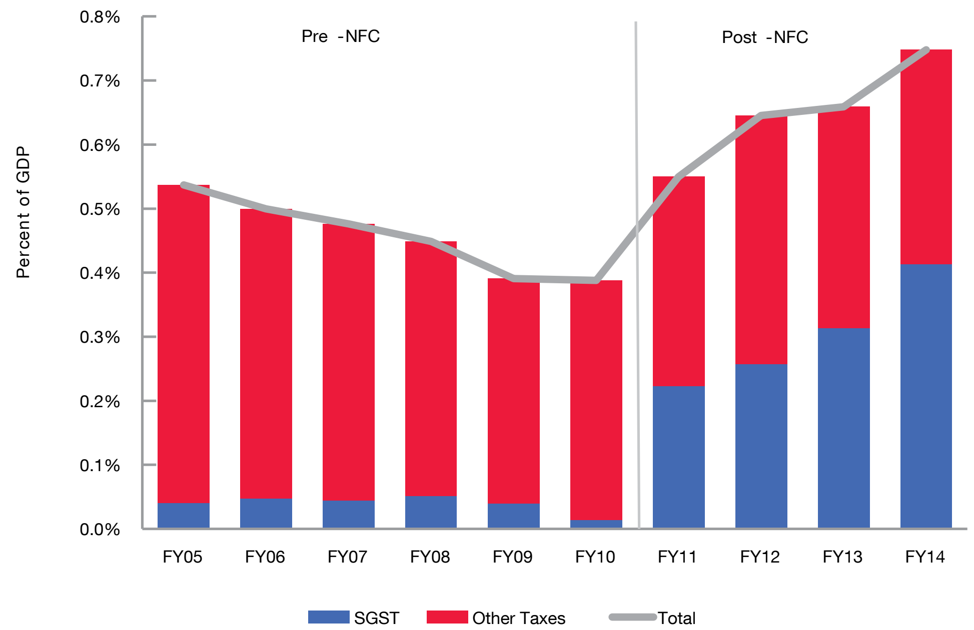

Figure 29: Trends in Provincial Tax Collection

With collection of SGST (and CVT) assigned to provinces, the NFC Award has effectively road-blocked any move for an integrated VAT type of sales tax in Pakistan.

Incentives for Tax Collection Diluted

Large revenue transfers from the Federal Government greatly diluted the incentives for, and the already weak political will in, the provinces to collect more taxes. At the federal level too, tax collection incentives have weakened, as for every tax effort worth Rs. 100, the federal Government gets to retain only Rs. 43 (the remainder Rs. 57 are given to provinces). Figure 29, shows the trend in provincial revenue collection. Overall revenue collection, which was increasing at an average annual rate of 9 percent in the Pre-NFC period (FY05 – FY10), accelerated to 35 percent after NFC (FY10 – FY14). This improved revenue collection by provinces seems to allay the concerns about weekend incentives for tax collection. It may however be noted that the comparison of the pre- and post-NFC collection of taxes by provinces is not strictly accurate as a bulk of the increase in the post-NFC period is due to revenue collected from services sales tax, the collection of which was assigned (from the federal) to provincial Governments under the 7th NFC Award. Revenue collection from other taxes continue to increase at an average rate of 10% per annum.

Some decline in expenditure efficiency

Efficiency of provincial Governments has never been admirable. Assignment of sizeable additional financial and administrative responsibility to the provinces created skill shortages and capacity gaps. The latter were exacerbated by provinces refusal to accept federal employees associated with devolved functions.[34] These inefficiencies are compounded by large increases in employees' salaries. For provinces, these salary increases badly eroded the financial gains from NFC award, and therefore undermining the opportunity to address the structural rigidities and inefficiencies which restrict the effectiveness of provincial expenditure.

Potential Risks to Macro-stability

The 18th Amendment has also empowered provinces to borrow from domestic and international sources subject to conditions imposed by the National Economic Council (NEC). Experiences from across the world suggests that such a provision can accelerate the pace of sub-national economic development. However, these experiences also highlight substantial risks, especially if such borrowings are not effectively regulated. NEC neither has the mandate nor capacity to be able to discipline such borrowings. The problem is further complicated by provincial ownership of financial institutions. As such, there is significant potential that huge unmet development needs or even political considerations can prompt provinces to go on a borrowing binge, with their borrowings from these self-owned financial institutions going practically unnoticed by NEC and even SBP.

Wavering on right-sizing the federal Government

Even in the implementation of the amendment, the Federal Government failed to seize the opportunity to re-align its organisational structure with the new mandate and instead retained all redundant employees and continue to finance vertical programmes as if it was financing its line agencies rather than instituting grant programme with specific objectives and accountability mechanisms. It has also allowed the Higher Education Commission and the National Centre for Human Development to continue without re-thinking their roles and the appropriate new institutional structures to perform those roles.

34 Additional concerns are documented in Shah et al "Fiscal Federalism in Pakistan: Challenges and Opportunities", World Bank, Islamabad, 1996; Shah, A., "Making Fiscal Federalism Work in Pakistan", World Bank, Islamabad, 2013.

3D. LOCAL GOVERNMENTS- FUTURE ROLE,CAPACITY & FINANCING

Despite a long list of issues it has created, 18th Amendment has made two important changes with far reaching implications for the multi-tiered governance in Pakistan. First, by removing the role of Federal Government from a large number of functions, it has unequivocally accepted the need for decentralising Government, which could be critical for future devolution/decentralisation in the country. Second, although the amendment stopped short of establishing local Governments (LGs) as a separate constitutional tier of Government, by inserting article 140(A) into the Constitution, it has made it mandatory for the Provincial Government to establish and support a system of elected LGs.[35] Thus making LGs an unquestionable reality.

However 18th Amendment failed to address two important aspects of devolved governance, which can have strong impact on the life and functioning of LGs. These are: (i) defining the roles and responsibilities for LGs, which was left for the Provincial Governments to decide on the basis of their own conditions and circumstances; and (ii) providing protection to LGs from political victimisation by provincial Government.

The results of the 18th amendment is that all Provincial Governments have promulgated Local Government Acts (LGAs) and have committed to holding LG elections in 2015. There is a great deal of commonality in these LGAs, LG Acts of all four provinces tend to subordinate the local Governments to the provincial Governments. They allow the Chief Ministers to dismiss a local Government or head of council and appoint officeholders after the dismissal of council heads. All four LG Acts provide for the establishment of Provincial Finance Commissions (PFC), headed by the provincial Finance Ministers. The local councils would receive allocations through the respective Provincial Finance Commission Awards, and would have limited powers to impose taxes or exercise regulatory functions. All four LG Acts require audits of the local councils by the Office of the Auditor General.

However, these LGAs contain some striking difference as well. Particularly, the Khyber Pakhtunkhwa LGA strives for a deeper devolution of state authority than other provinces, Punjab LGA provide for a five-year term for LGs, whereas, Sindh and Balochistan LGAs specify a four-year, and Khyber Pakhtunkhwa a three year term. The Punjab and Balochistan LG Acts allow District Councils to function under the directives of the provincial Government, giving the provincial Government leverage over LGs. The Khyber Pakhtunkhwa and Sindh LGAs give greater autonomy to the provincial Governments to supervise and inspect local Governments.

While all the LG Acts devolve the key service delivery functions to local Governments, provinces have made exceptions to retain large entities such as the Karachi Water and Sewerage Board, Sindh Building Control Authority, Lahore Development Authority (LDA), and Solid Waste Management (SWM), etc.

Most important deviation from the 2001 Local Government Ordinance is that local Governments have mainly assigned municipal functions. Major actions like agriculture, education, health etc. have been retained by the provinces. However, The LG Act of Punjab provides for the creation of education and health authorities, comprising members from the Provincial Government, local

35 Article 140(A) of the Constitution explicitly states, "Each Province shall, by law, establish a local Government system and devolve political, administrative, and financial responsibility and authority to the elected representatives of the local Governments." Moreover, sub-clause 2 of the same article stipulates that "Election to the local Governments shall be held by the Election Commission of Pakistan."

Provinces in Pakistan have done a very poor job of collecting the property tax – a tax which was levied to finance urban infrastructure and services.

Governments, technocrats and the private sector. The Chief Minister will be the appointing authority and can dismiss the heads of the authority or dissolve the authorities.

Notwithstanding the commonalities and difference in LGAs, the success of LGs in delivering even the municipal services will depend on providing them with adequate administrative and financial authority and autonomy. Pakistan at present is the most urbanized country in South Asia. Provision of urban municipal services has become increasingly important for urban development as well as for defining the relationship between the Government and urban population. Barring the largest cities, urban infrastructure in other urban centres require major upgrading, and thus large scale investment. This could be ensured by providing these LGs with adequate financial resources. Provinces in Pakistan have done a very poor job of collecting the property tax – a tax which was levied to finance urban infrastructure and services. For example, Punjab with at least 6 major cities and scores of medium and small sized urban centres collect less than Rs. 5 billion in property tax. In comparison, just one city in India, Mumbai, collects over ₹ 45 billion (equivalent to over Rs 64 billion) in property tax. The difference is that unlike Punjab, property tax is collected by Mumbai Municipal Corporation rather than the state (Maharashtra) Government.

3E. AGENDA FOR THE FUTURE

The fiscal decentralisation under the Seventh NFC Award and the 18th Amendment has created as many problems for fiscal and expenditure management as it has solved. Many of the problems created originate from Government's inability to collect sufficient revenue. To sharply increase the revenue, the Government has to:

- Prepare and implement a compressive reform package involving both tax policy and tax administration
- Most importantly, the reform package has to include a comprehensive plan to correct the incentives of additional revenue mobilization. This may involve a thorough review of NFC transfers, and if possible, some transfers made contingent on revenue efforts. The overall share of provinces cannot, and need not, be reduced but the province making serious efforts for revenue mobilization would gain at the expense of other provinces
- For implementing such an incentive package, the constitutional institutions, i.e. NFC, CCI and NEC, can play an important role by making a neutral assessment of the revenue needs of each Government, assigning revenue collection targets to each Government, and effectively monitoring the progress in achievement of these targets, with punitive actions taken against the Government(s) unable to meet the targets without ample justification. For this the CCI and NEC have to build appropriate capacities, starting with having their own secretariats. In order to avoid "tax wars" between provinces, these institutions also need to develop a framework for tax base harmonization and income/ sales attribution and allocation rules
- These institutions also need to play an important role in establishing overall fiscal discipline by agreeing to an overall macro-economic framework and establishing borrowing ceilings for each Government and ensuring that these ceilings are not breached
- The devolution agenda needs to be completed by establishing local Governments and providing them with enough, financial and human resources to carry out their functions in a most efficient way. For larger LGs, especially in urban areas, which have adequate administrative capacity, it would be appropriate to devolve taxes, like property tax, sanitation fee etc, to the LGs, rather than fiscal transfers through PFC
- The key local Government-related institutions like Local Government Commission and Provincial Finance Commission should be re-established and strengthened by giving them powers to make local Governments adhere to fiscal discipline and national standards.

ANNEX. PROFILES OF SELECTED GOVERNMENT FINANCED **DEVELOPMENT PROJECTS**

1. LYARI EXPRESSWAY (Total Cost Rs. 8 billion)

Start Date: May, 2002
Completion Date: December 2007

Lyari Expressway is constructed as an 8 lane 32 km long express-way connecting Mauripur Road and the Super Highway, with two inter-changes, five over-passes and five underpasses. It alleviates the burden of traffic plying between Karachi Port and the Super Highway heading upcountry. Presently, traffic flow on the road is estimated at traffic flow is estimated at 34,000 vehicles per day. The project suffered significant delays as Karachi City Government could not mobilize adequate funds. It was only with a Federal Government grant of Rs. 6 billion that this project could be completed.

One of the most important aspect of this project was its re-settlement plan, which is considered as most effective and world best practice. The construction of Lyari Express-way required demolition of 15,000 housing units and the displacement of 24,400 families] living along the Lyari River. This is considered as the largest urban demolition project for the purpose of road-making in the world. To re-settle the displaced people, the Government launched the Lyari Express-way Resettlement Project. As part of this project, the people were given a compensation package that included an 80 square yard plot of land on the outskirts of Karachi and Rs. 50,000 for construction. The lands were allotted in newly developed suburbs in Hawke's Bay, Taiser Town and Baldia Town. In addition, the new settlements were planned as integrated communities, with schools, markets, worship places and hospitals. These new settlements were significantly better the previous irregular housing of displaced people.

2. MAKRAN COASTAL HIGHWAY (N10) (Total Cost Rs. 17 billion)

Start Date: June, 2002
Completion Date: December, 2004

In term of its geographical size, Balochistan is the largest province of Pakistan. However, it is least populated and the most backward province of the country. Its poor connectivity within, with other provinces and rest of the world contributes to its backward. Construction of Makran Coastal Highway, is an attempt to connect the newly established port at Gwadar with Karachi.

This 529 km highway is considered as a masterpiece of engineering prowess of Pakistani experts not only because it contains 63 bridges, 1,433 culverts and 4 causeways, but also due to difficult environment in which they have to implement the project as area lacked building material, especially water.

Makran Coastal Highway provides numerous economic, social and strategic benefits. It also provides an all-weather route to serve the population in entire coastal region, besides facilitating communication, trade, fish produce and export by linking Karachi with ports and fish harbours of Ormara, Pasni, Gwadar and Jivani.

3. FAISALABAD – MULTAN MOTORWAY (M-4) (Total Cost Rs. 42 billion)

Start Date: August, 2009
Completion Date: Ongoing

Motorway network of Pakistan is a key component of the National Trade Corridor Improvement Programme (NTCIP). In furtherance to the existing network of Motorways (M-1, M-2 & M-3), National Highway Authority (NHA) has undertaken the challenge of building Faisalabad - Khanewal - Multan Motorway (M-4, 243 km) in shortest time possible. In order to squeeze construction time, construction work has commenced from both Faisalabad & Multan ends and important segments of the road, i.e. Faisalabad – Gojra (68 km) and Multan-Khanewal (57 km) are already operational.

M-4 will ease traffic on N-5 & reduce distance between Khanewal - Pindi Bhattian by about 150 km. It will result in huge savings in vehicle operating costs besides reduction in time and enhancing efficiency. It will further open new avenues for economic development and provide better access to modern education, health and other facilities. M-4 will also create job opportunities for skilled & non-skilled people of the area during construction phase.

4. BENAZIR BHUTTO SHAHEED BRIDGE (Total Cost Rs. 5.4 billion)

Start Date: March, 2012
Completion Date: December, 2014

Project includes building of a 1200 meter bridge on river Indus, 31 km of approach roads, river training works and guide banks.

Existing upstream crossing of Indus is at Ghazi Ghat Bridge, and downstream at Sukkur Bypass. Guddu Barrage also exists between these two bridges close to Sukkur Bypass Bridge. Distance between Ghazi Ghat Bridge and Sukkur Bypass Bridge is 377 km. Within this reach, a crossing through Guddu Barrage and 10 ferry crossing points also exist. This is the longest among the bridge-to-bridge breakup of length along River Indus; which reflected the genuine need of an additional bridge. New bridge is located 130 km downstream of Ghazi Ghat near Zahir Pir on N-5 and 90 km from Guddu Barrage. Distance between Nishtar Ghat & Sukkur Bypass is 200 km. New bridge will reduce distance/travel time for commuters and also ensure safe passage (as use of ferry service is prone to accidents) besides increased socioeconomic activity on both sides of the river.

5. LOWARI TUNNEL PROJECT (Total Cost 10 billion)

Start Date: April, 2004
Completion Date: Ongoing

Connectivity of Chitral district, including Chitral city, with rest of Khyber Pakhtunkhwa province and other parts of the country is only through Lowari Top. This is not only difficult and dangerous route, but also it closes down during winter months as heavy snowfall makes the route impossible to travel. This leaves the travelers between Peshawar the only option to cross into Afghanistan and then back into Pakistan to reach Chitral. Even this route does not certain, as it also closes down during bad weather or events of militancy in the vicinity. During the winter months connectivity of Chitral with rest of the country is extremely limited. The limited connectivity adversely impact economic activity and other aspects of lives of population of the area.

The 9 km tunnel not only provides an all-weather access route between Peshawar and Chitral but also reduces the current 14-hour drive time from Peshawar to Chitral by 50%. The importance of the project for the local population could be gauged from the fact the All Pakistan Muslim League (APML) won its only National Assembly in the 2008 elections seat from Chitral. The win is attributed to starting of the project by General (Retired) Pervez Musharrraf (who heads APML).

Despite many implementation problems, the project was 85 percent completed by January 2009, and provided limited access to vehicles to travel from and to Chitral during the construction work is not underway. However, the work stopped due to another change in government and has since commenced intermittently. In 2015, the government approved additional funds for the tunnel, which is now expected to be completed by October 2017 (more than 10 years after its original conceived completion date).

6. PESHAWAR NORTHERN BYPASS PROJECT (Total Cost Rs. 9 billion)

Start Date: June, 2003
Completion Date: September, 2014

There is serve through traffic of N-5, M-1 & Peshawar-Torkham road. This bypass will divert traffic from Peshawar-Charsadda, Peshawar-Bara, Jamrud-Warsak & Peshawar - Dalazak Roads. To reduce this congestion in Peshawar City by passage of N-5, NHA has built this 32 km bypass road at a cost of Rs 9 billion. The road bypasses Hayatabad, Bara Markets & future urban developments, further easing the present and projected traffic pressure within Peshawar city, reducing commute time and promote ancillary economic activity.

7. LAHORE METROBUS PROJECT (Total Cost Rs 30 billion)

Start Date: March, 2012
Completion Date: February, 2013

Over the last few decades, Lahore has experienced a phenomenal growth in population and vehicular traffic, which has immensely added to road congestion and pollution in the city, imposing a huge economic cost on commuters in e the need for an efficient and inexpensive transport system. The Lahore Metrobus Project required constriction of a road system, dedicated for plying a rapid bus service in some of the most populated areas of the city. The road has elevated construction in most congested areas of the city, including two elevated rotaries. Lahore Metrobus Service (LMBS) currently operates a fleet of 86 buses. The hours of service are 16, from 6am to 10pm. The frequency of buses changes from 20 buses per hour during off-peak hours to 27 buses per hour in peak hours. The buses run on a single 28.7 km long Ferozepur Road corridor with two other corridors being planned. Buses on the current route have an average speed of 26km/h. The daily ridership of the Metrobus exceeds 180,000 with the peak hourly ridership being 10,000 passengers per hour in per direction. This figure is projected to double by 2021. To keep the travel cost affordable for all segments of population, the fare is fixed at Rs. 20 per person per ride (irrespective of distance). However, this involves a 200% subsidy on every ticket paid by the Government of Punjab.

Other than its main objective of providing the citizens of Lahore with a safe, reliable and efficient mode of transportation and reduce traffic congestion on main intra-city roads, Metrobus will reduce air and noise pollution and promote economic activities, boost domestic commerce and save aggregate fuel cost.

8. MANGLA DAM RAISING PROJECT (Total Cost Rs 92 billion)

Start Date: June, 2004
Completion Date: Sept. 2011

Pakistan desperately need additional water storage capacity to: (i) ensure availability of irrigation water for agriculture during critical sowing periods; (ii) provide protection against devastation of floods; and (iii) generate additional and inexpensive electricity. Situation is made worse by the rapid rate of siltation of the existing dams. Raising the height of Mangla Dam by thirty feet meets all of these objectives as it adds 2.88 MAF to existing water storage capacity and 120 MW (i.e. 12%) to overall electricity generation capacity. By trimming the peak water inflows, it contributes to mitigate risks of heavy floods. Monetary benefits of the project are estimated to be about Rs. 111 billion in terms of enhanced agriculture produce, additional electricity generation and flood mitigation.

9. RAINEE CANAL PROJECT (Phase-I) (Total Cost Rs 20 billion)

Start Date: October, 2002
Completion Date: June, 2014

The project aimed at constructing a 175 km non-perennial canal in Sindh for protection against floods. The main canal and its 609 kms of distributaries will channel 5,155 cusecs of flood water for productive uses.
The project is a multi-purpose project for flood mitigation to protect against flood damage to cultivated area, properties and lives; better utilization of flood water to ensure enhanced supply of irrigation water to the province and irrigate 412,400 of additional agricultural areas which can enhance cropping intensity during Kharif season by 80 percent over a period of five years. In addition, the project provides a substantial potential for improved forestry & fruit production, dairy and fish farming; provide drinking water to population in the arid area of the province; promote ancillary economic activities and recharge local lakes.

10. KACHHI CANAL PROJECT (Phase-I) (Total Cost Rs 58 billion)

Start Date: October, 2001
Completion Date: Ongoing

The counterpart of Rainee Canal, Kachhi Canal has the same purpose as Rainee, only it is much bigger (500 kms carrying 6.000 cusecs with 1,500 distributaries and minors and a command area of 713,000 acres) and serves provinces of Punjab and Balochistan. Mainly because of inclusion of arid areas of Balochistan, the estimated economic rate of return of Kacchhi Canal (19.4 percent) is significantly higher than that of Rainee (12 percent).

The project was to be completed in 2007, however, due to funding and other implementation problems it is now expected to be completed in the second half of 2015. Because of the delayed implantation, the cost of project has increased from the original estimate of Rs. 32 billion to Rs. 58 billion (by 81 percent), as such its economic returns have been eroded significantly.

ABOUT CDPR:

The Consortium for Development Policy Research **(CDPR)** is an association of independent researchers and policy advisors based in Pakistan. It aims to consolidate resources and promote cutting-edge research to stimulate evidence-based debate on key policy issues. Its participating organisations include the International Growth Centre **(IGC)**, Center for Economic Research Pakistan **(CERP)** and the Institute of Development and Economic Alternatives **(IDEAS)**. The Consortium's policy advocacy is carried out via engagement with policymakers, media and other stakeholders using multiple avenues such as workshops, dialogues, seminars, web-based materials and regularly published high-quality policy briefs. CDPR is also building capacity as a reservoir of research materials (reports, papers, books, data) on key policy areas relevant to Pakistan.

CDPR'S ROLE IN THIS REPORT:

This report on public expenditure in Pakistan has been produced by conducting analysis on publicly available data and information at the federal, provincial and district levels. The analytical work and preparation of this study was led by Dr. Hanid Mukhtar, who is a Fellow at the Consortium for Development Policy Research (CDPR). Dr. Hanid recently retired from the World Bank as Senior Economist, where he worked primarily on macroeconomic and fiscal issues. Beside publishing articles on various issues in economics in some leading Pakistani journals, he has authored and contributed to a large number of World Bank economic reports on Pakistan. He has a Ph.D. in economics from Boston University.

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