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Making Federalism Work – The 18th Constitutional Amendment

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Abstract

The almost unanimous passage of a landmark consensus constitutional amendment—the 18th Constitutional Amendment—restored Pakistan’s constitution to its original intent of a decentralized federation of four provinces as envisaged in the 1956 and 1973 constitutions. This amendment was hailed by policy makers and academics alike as a major step forward in reforming the multi-order governance in Pakistan. This paper takes a closer look at the provisions of this amendment and highlights both the potentials and pitfalls of the new constitutional order for good governance in Pakistan. The paper concludes that the amendment must be seen as a first yet small and incomplete step in reforming multi-order governance in Pakistan. A large unfinished reform agenda remains to be charted.

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Making Federalism Work for the People of Pakistan: Reflections on the Role of the 18th Constitutional Amendment

Anwar Shah

This paper presents the findings of the World Bank mission comprising Hanid Mukhtar and Anwar Shah that visited provincial capitals in June 2010. The paper was prepared by Anwar Shah drawing upon valuable inputs by Hanid Mukhtar. It further benefited from comments and guidance by Jose Lopez Calix. The author is grateful to Alvaro Manoel, Abdu Muwonge and Kai Kaiser for helpful comments. The World Bank is grateful to Federal and Provincial Policy makers and government officials, Dr. Hafiz Pasha and Dr. Aisha Ghaus Pasha for their assistance to the mission.

Executive Summary

The Significance of 18th Amendment for Multi-order Governance in Pakistan

1. The 18th Amendment has introduced profound changes in multi-order governance. These include strengthening institutions of intergovernmental coordination and conflict resolution through the revival of the Council of Common Interest (CCI) and making the National Economic Council (NEC) more responsive to the provincial interests. It also eliminated federal/provincial shared functions and reassigned selective functions to the federation (not the federal government) to be guided by the Council of Common Interests and devolved others to the provinces. It has stripped the federal government of responsibilities for planning, industry, agriculture and rural development, social services and welfare including social protection. It has reasserted provincial control of local government functions and institutions. This has resulted in abolition of 17 ministries including the ministries of food and agriculture, education and health. It has also expanded the taxing powers of the provinces including a dynamic and buoyant tax base—sales tax on services. The Amendment also opened door for greater access to capital finance by permitting both internal and external borrowing by the provinces subject to limitations imposed by the National Economic Council.

2. The Amendment provided for a short transition period for transfer of responsibilities to provinces to be completed by June 2011. This has already been accomplished but full transition to the new constitutional order is expected to be completed by Fiscal Year 2015. This includes having new institutions of federation fully operational, restructuring of federal and provincial governments consistent with new constitutional order, and federal guarantees for transition expiring for redundant institutions e.g. the Planning Commission, Higher Education Commission and National Centre for Human Development etc., and employees. Once the system matures in Fiscal Year 2015, the structure of government in Pakistan would have undergone a profound transformation from centralized federal power to the centralization at the provincial level. For all economic and social services, provinces will assume a dominant role in policy making and service delivery. For an average citizen—*Allah Rakha*—then the government that would matter is his provincial government. Will it be a change for better or worse? Much depends upon how provincial governments react to the newly assumed powers.

The 18th Amendment—for better?

3. At least in theory the amendment may represent welcome move towards good governance in several respects. First it could reduce the threat of military dictatorship and thereby hopes to usher in a democratic and stable political order. Such a transformation in Brazil banished the military from the political scene (see Shah 1990), but in Pakistan it may well turn out to be a false hope if past political history of Pakistan is any guide. Second, by limiting arbitrary federal action, it has attempted to limit provincial discontent with federal policies. This has the potential of building trust and harmony in federal-provincial relations and thwart succession movements garnered by federal unilateralism or high handedness and brutality of military regimes. Third, the Amendment, by eliminating overlapping responsibilities has brought greater clarity for citizens in terms of which order of government to hold accountable for dysfunctional service delivery as their buck now clearly stops at the

provincial chief minister's doorsteps. Finally and most importantly, the Amendment has also moved government decision making a few small steps closer to the people. It has the potential of making governments responsive and accountable to people and tailoring public services to their aspirations and needs.

The 18th Amendment—A Missed Opportunity to Address Unfinished Agenda in Federalism Reforms?

4. For reforming multi-order governance in Pakistan, the 18th Amendment represented a golden opportunity that was missed in addressing some difficult issues in governance reform in Pakistan. These included realigning roles and responsibilities of federal, provincial and local governments in interest of peace, order, good government and growth. The Amendment further stripped federal government of its core federal functions such as securing an internal common market, security of life and property, protection of minorities and disadvantaged groups dealing with natural disasters. Provincial ownership of natural resources also works against a common political and economic union. Provincial powers to tax agricultural income, capital gains and services present a significant roadblock to tax reform. Finance does not follow function and provinces have the luxury of spending taxpayer monies without any accountability. Federal organization structure is not in alignment with the new mandate and the federal government continues to retain redundant institutions and employees. The revenue sharing arrangements also strips the federal government access to relevant financing instruments to secure a common economic union and incentivize citizen- and results-based accountability for merit services. Provincial government ownership of financial institutions poses significant risks for fiscal discipline and macro stability.

5. By relegating most regulatory functions to provincial domain, the Amendment, has also created a potential for a jungle of confusing and contradictory regulatory standards with high transactions costs for business and citizens. Finally and most importantly, the 18th Amendment failed to institutionalize any constraints to barriers to factor and goods mobility across the nation and instead has opened up potential for such barriers by recognizing provincial authority to discriminate against non-residents. The unintended adverse consequences of this change may well constrain proper working of political and economic union in Pakistan.

Potential Risks of Post 18th Amendment Constitutional Order: Province Building At Odds with Nation Building

6. The 18th Amendment also poses significant challenges for multi-order governance in Pakistan. Foremost challenge arises in peace and order. As Pakistan has only a handful of unbalanced federating units, potential for federal-provincial and inter-provincial conflicts are significant and accentuated with empowered provinces and the CCI may not be in a position to deal with such hot button issues. The Amendment has also circumscribed federal role in the war on terror as law and order, including police protection, is now primarily provincial function. The Amendment has supported a model of multi-order governance that does not appear to be in tune with the development and security needs of Pakistan today. In the absence of fundamental reforms of political parties' governance, electoral finance, land reforms and devolution to local governments, empowered provinces may not lead to greater participation and accountability, and the incidence of corruption and abuse of power may continue unabated. Empowered provinces may accentuate already common practice of the

use of public sector hiring for political patronage. Pakistan has also a civil service culture of elitism and the 18th Amendment may make pursuit of such stalled reforms even more difficult. On the economic and service delivery front, potential risks are even greater with provinces following “beggar-thy-neighbor” policies and creating barriers to trade and factor mobility. *Manna* from heaven transfers through the National Finance Commission (NFC) awards leaving no incentives for provinces to set national minimum standards for merit services and to create a level playing field for poorer provinces to integrate with the national economy. The provincial ownership of financial institutions creates soft budget constraints and in the absence of a legal framework for fiscal responsibility pose significant risks for macro-stability.

The Way Forward

7. In order to forestall risks enumerated above, the 18th Amendment must be seen as an important first step in a series of reforms to create a responsive, responsible, fair and accountable multi-order governance in Pakistan. These reforms agenda could include:

8. Intermediate run at the federation level:

- To develop a coordinated response to ensure liberty and safety of life and property and ensuring the success of the war on terror.
- To institute a framework for ensuring that there are no barriers to trade and factor mobility.
- To develop a framework for transparency of all government operations and establishing compliance with the citizens right to information.
- To institute a legal framework for fiscal responsibility binding on all orders of government. This framework should introduce hard controls with objective escape clauses on borrowing, deficits and debt, and expenditures on wages and benefits as a share of public expenditure and prohibit government ownership of financial sector institutions for all orders of government as was done in Brazil in 2000.

9. Long run at the federation level:

- To develop a framework for tax base harmonization and income/sales attribution and allocation rules.
- To establish an autonomous tax collection agency for collection of taxes for a fee at all levels and supervised by a board of governors comprising all orders of government and the private sector.
- To harmonize federal and provincial regulatory regimes

10. Intermediate run at the Federal Government level:

- To conduct an overarching reform to realign structures with new responsibilities and work out a separation program for redundant employees and closing or restructuring of redundant institutions such as the Planning Commission, Higher Education Commission (HEC) and the National Center for Human Development (NCHD).

- To carry out fast track privatization and closing the Ministry of Privatization.
11. Long run at the Federal Government level:
- To consider contracting out tax collection to autonomous tax collection agency at the federation level.
 - To conduct a review of federal transfers with a view to setting national minimum standards for merit goods across the nation by introducing output-based finance in order to ensure monitoring of results and performance accountability.
12. Intermediate run at the Provincial Government level:
- To conduct a strategic overarching review of provincial government finances and operations to ensure that the provinces can meet challenges in service delivery associated with the new empowerment.
 - To introduce civil service reforms to reward task specialization and accountability for results.
 - To establish service standards, introduce incentives for competitive provisions and citizen-based accountability mechanisms.
13. Long run at the Provincial Government level:
- To rethink the role of local government as the primary agent for service delivery, local economic development and improving economic and social outcomes and introducing legislation to make that role possible.
 - To consider contracting out capital value taxation, agricultural income tax and services tax to the autonomous tax collection agency at the federation level.
14. Of course, this is an ambitious reform agenda and will take some time to materialize. Some would also argue that Pakistan may not have the capacity at subnational levels to successfully implement such reforms. While there may be some merit in this argument, technical capacity constraints, if binding are relevant for all orders of government as Pakistan has a civil service with rotating appointments and there may not be much significant difference in technical capacity in Islamabad versus Lahore or Karachi. Experience elsewhere especially in China and Colombia has shown that technical capacity assumes a secondary importance in local government performance. What matters most are the political commitment, bureaucratic incentives and results-based accountability. In Pakistan, political commitment to introduce fundamental reforms to improve service delivery has been consistently lacking and bureaucratic incentives remain misaligned to command and control rather than serving citizens. Therefore, an important first step is for all orders of government to subscribe to the objectives of such a reform agenda and developing strategies to accomplish these objectives through formal and informal means.
15. Pakistan during its more than sixty years of existence has moved from one crisis to another. An important reason for dysfunctional governance in Pakistan is lack of adherence to constitutional principles and disrespect for the rule of law by the ruling elite. The 18th Amendment is well intentioned to bring a greater clarity in the roles and responsibilities of various orders of government and to ensure greater provincial autonomy to possibly reduce

incentives for military interventions in the political system. This Amendment, must however be seen as only the first and an incomplete step toward reforming public governance in Pakistan. To complete this process further, fundamental reforms are needed to ensure that the public sector serves public interest and secures a common political and economic union. Important first steps in this direction would include devolution to local governments and a framework for fiscal responsibility and fiscal discipline for all orders of government. There is an enormous unfinished agenda for reform that needs to be undertaken over the coming years. A beginning must be made now by recognizing the need for reforms and developing a strategy to develop national consensus on the directions for reform. In the words of a Chinese philosopher, all long journeys start with small steps. The 18th Amendment must be seen as that first step in the long journey to restore Pakistan to its original glory. Indeed the reform process is eternal. We never fully succeed but we must keep trying.

Introduction

16. On April 20, 2010, Pakistan's parliament passed a landmark consensus constitutional amendment to restore Pakistan's constitution to its original intent of a decentralized federation of provinces as envisaged in the 1956 and 1973 Constitutions. This development came after several decades of military and autocratic rule which dismembered Pakistan's Constitution to serve the interests of the ruling elite and in the process centralized fiscal powers at the federal level. Table 1 shows that the division of powers in Pakistan has been in flux since late 1950s. The pendulum has swung in favor of centralization of powers at the federal level since 1956. This trend was reversed recently by the 18th Amendment in 2010. Taxing powers were centralized in 1956 at the federal level in the interest of tax harmonization and lower tax collection costs. That year, the provinces voluntarily gave up the powers to collect sales taxes in favor of federal collection and a formula based revenue sharing arrangements. The arrangements were formalized by the 1956 constitution. The military regime of General Ayub Khan sought legitimacy by introducing a system of "basic democracy" with indirect elections at the local levels and enhancing the powers of local council while keeping these under strict controls of federal bureaucrats. The regime also amalgamated the four provinces of the "West Pakistan" into one unit to counterbalance the dominance of "East Pakistan" in the federal system. The system of basic democracies was dismantled with the fall of the regime in 1968. During the period 1968-1971 there was a movement towards greater autonomy of the provinces. The 1971 elections returned Sheikh Mujibur Rahman of Pakistan Awami League to power at the federal level but the leader of the Pakistan Peoples Party, Zulfikar Ali Bhutto in collusion with Pakistan Army prevented Mujibur Rahman from assuming the position of the Prime Minister and instead ordered military action in East Pakistan which led to the formation of East Pakistan as an independent state in 1972. This was followed by dismantling of one unit in the truncated Pakistan. From 1973 to 1977 Pakistan was under a pseudo military-cum-democratic regime.

17. A new constitution was enacted in 1973 but fundamental rights were suspended in the eve of promulgation of the new constitution. The emergency powers were used by Bhutto regime to wrest control of major industries, businesses and schools from the private sector. In 1977, Pakistan military used the pretext of economic decline and war in Afghanistan to stage a coup d'état. General Zia ul Haq ruled Pakistan with an iron fist from 1977 to 1987 and centralized powers at the federal level. Local governments were allowed to function under strict control of federal bureaucrats. As these bureaucrats assumed greater powers they made sure that most local governments remained dysfunctional and therefore under direct supervision of federal civil servants. With the demise of General Zia, Pakistan returned briefly to democratic control but the system was destabilized by the military. Again in October 1999 General Pervez Musharraf staged a military coup under the pretext that popularly elected prime minister did not follow the due process in removing the Chief of Army staff. In 2001, he sought to strengthen local governments while keeping control through indirectly elected Nazims as an antidote to return to power of the two major national political parties. General Musharraf was forced to resign in May 2008 and with his departure the local government system was set aside by the provinces. Table 1 shows that there has been consistent erosion of provincial taxing and spending powers over the period 1955-2010 and this trend was arrested by the 18th Amendment. However local government spending powers have typically increased during military regimes and diminished under democratic regimes while their taxing powers were eroded in late 1990s with the abolishment of octroi

tax in return for a static federal revenue guarantee—a poor bargain that significantly weakened local self-governance in Pakistan. Contrasting attitudes of military and democratic regimes towards local governments is explained by the military governments supporting a semblance of local autonomy to seek legitimacy and undercut political parties whereas democratic regimes at the center and provinces perceive local government as competitive providers reducing their relevance in people’s lives. Both types of regimes however perceive empowered and autonomous local governments undercutting their own dominance and control of political system and as a result local governments have remained as wards of the state in Pakistan.

Table 1 Shifting Sands of Power in Pakistan—Expenditure & Revenue Collection Share

%	1955	1965	1985	1995	2005	2010	2011
Expenditure Shares:							
Federal	60	60	65	67	70	66	67
Provincial	35	30	30	29	20	25	28
Local	5	10	5	4	10	9	5
All	100	100	100	100	100	100	100
Revenue shares:							
Federal	70	85	90	90	93	94	93
Provincial	25	10	5	5	6	5	6
Local	5	5	5	5	1	1	1
All	100		100	100	100	100	100

Source: World Bank Staff Estimates

18. This centralization of the fiscal system was accompanied by ever deteriorating law and order, and quality and quantity of public services. The dysfunction of public governance in Pakistan appeared to have reached a tipping point in the first decade of the 21st century that in popular western media Pakistan is now rightly or wrongly being labeled as a “failing state” and some Pakistani scholars have already labeled it as a “failed state” (see Nadeem ul Haq 2010). Will the new constitutional dispensation help Pakistan reverse this course? This paper examines the implications of the 18th Amendment for promoting peace, order, good government and growth. It reflects upon the state of fiscal federalism prior to the 18th Amendment. This is followed by a discussion of the 18th Amendment and its institutional, fiscal and service delivery implications. It discusses the 18th Amendment’s potential for improving public governance in Pakistan followed by discussion on overlooked issues. Moving on, the paper presents a conceptual perspective on multi-order governance in a globalized and interconnected world and compares and contrasts it with the governance system envisaged by the 18th Amendment. It also provides a synthesis of significant potential risks for political and economic union inadvertently introduced by the 18th Amendment. The paper also presents a forward looking view on the unfinished agenda for reform to avert potential risks and draws some conclusions.

19. The paper concludes that the 18th Amendment must be seen as a first step towards a broad agenda of reform in fundamental restructuring of multi-order public governance system in Pakistan. This is because the amendment offers some potential for improving public governance but also introduces major risks for political and economic union. These risks can be averted by further reforms. The unfinished reform agenda would include reasserting the home rule for local governments and treating them as the primary agent in

delivering public services, uplifting local economy and improving economic and social outcomes for its residents. It would also include ensuring liberty and right to life and property for all residents. In addition it would include a framework for fiscal responsibility binding for all orders of governments and creating common economic union through dismantling all barriers to goods and factor mobility. It would also include citizens' right to information and holding governments accountable for performance among others. Another important element would be reforming intergovernmental finance to introduce results-based accountability while preserving provincial autonomy and flexibility. The paper recognizes that it is an ambitious agenda and would take some time to materialize but an important first step would be for all orders of government to agree on the need for such reforms.

The State of Fiscal Federalism Prior to the 18th Amendment

20. The forefathers of the 1956 Constitution visualized Pakistan to be a decentralized federation with significant public spending responsibilities being carried out at lower levels of government. They also gave these governments significant revenue means to discharge their responsibilities. Federal government on the other hand was given greater access to own revenue bases than that needed for federal direct expenditures alone, so that it could ensure reasonably comparable level of services across the nation primarily through the exercise of its spending power (fiscal transfers to the provinces) to influence provincial-local priorities. The vision of decentralized federation was set aside in favor of a centralized quasi-federation under the military rule from 1958-1968. The military regime also tried to supplant a new form of local governance the so-called “basic democracy” which supported a system of indirect elections of local mayors. Most local functions were managed and delivered by elite civil and military bureaucrats with local councilors intended to provide limited popular participation in state affairs at the local level. With brief departure of military regime, the basic democracy system was dismantled and elections under the 1956 constitutional system were held in 1969 which returned Sheikh Mujibur Rahman’s Awami League to power. The Pakistan military leadership refused to respect the electoral outcome and instituted Zulfikar Ali Bhutto as the Prime Minister. This led to political strife resulting in the declaration by East Pakistan as an independent state of Bangladesh in 1971. Mr. Bhutto convened a constituent assembly in 1973 that adopted a new Constitution.

21. In the interest of administrative efficiency, the 1973 constitution chose to centralize revenue means by bringing sales taxation within the domain of the central government. This measure accentuated the centralization tendencies in public spending responsibilities. The 1973 also introduced as part of the Fourth Schedule a concurrent legislative list that enumerated shared responsibilities of federal and provincial governments. The intention of this list was to have an interim period of preparation prior to provinces taking over these responsibilities. Instead the federal government used this list to encroach upon provincial and even local government responsibilities. The provinces in turn made local governments dysfunctional and took over their responsibilities (see Table 2). The 1991 National Finance Commission Award sought to rectify this by giving the provinces unconditional access to a large pool of federal resources. The 1991 Award initiated a process of expenditure realignment which, over time, was expected to give provinces a greater say in areas of shared responsibilities such as education and health. The Award nevertheless delinked spending and taxing decisions in a major way and federal transfers to smaller provinces financed 99% of provincial operating expenditures. Military coup d’état in 1999 reversed the trend towards greater provincial autonomy and centralized power. This centralized power was used brutally to crush political discontent in Balochistan province nourishing a separation movement. The military regime also sought to debase major political parties by devolving responsibilities for service delivery from provinces to local governments. The military junta led by General Musharraf chose indirect form of elections for local mayors as a vehicle for central control. They also introduced complementary administrative and police reforms strongly resented by civil service elites. These reforms led to service delivery improvements at the local level but weakened provincial control over law and order. However, these reforms were incomplete as no rationalization of federal and provincial powers was attempted. The federal government continued to encroach upon provincial and local responsibilities in contravention of the division of powers enunciated by the 1973 Constitution (see Table 2 and Shah 1997). Major

political parties refused to acknowledge even some positive dimensions of these reforms and sought to dismantle these in toto upon returning to power. The democratic rule returned to Pakistan in 2008 and empowering provinces and dismantling military-led reforms became a rallying cry for all political parties. These efforts led first to a consensus—7th National Finance Commission (NFC) Award of 2009 effective July 1, 2010 to June 30, 2015 which served as a major step toward building provincial harmony and placating Balochistan and Khyber-Pakhtunkhwa provinces by including measures of poverty and inverse population density, and Sindh by including tax effort indicator in the formula (see Table 4) and subsequently forging a momentous political consensus that culminated in passing of the 18th Amendment on April 9, 2010. The 18th Amendment sought to strengthen the powers of the provinces and weaken the federal government authority. Federal Government, nevertheless, has continued to take some unilateral actions with adverse financial consequences for the provinces. One of the most egregious action has been the granting of 50% increase in wages of federal civil servants in face of major fiscal crisis and in the process adversely impacting provincial finances as provinces are forced by provincial unions to match such increases.

Table 2 Legislative Responsibility & Actual Provision of Services—Pre 18th Amendment

Legislative Responsibility	Services	Actual Allocation of Functions
Federal Government ¹	Defense, External Affairs, Posts and Telegraphs, Telephones, Radio and T.V., Currency, Foreign Exchange, Foreign Aid, Institutes for Research, Nuclear Energy, Ports and Aerodromes, Shipping, Air Service, Stock Exchange, National Highway, Geological Surveys, Meteorological Surveys, Censuses, Railways, Mineral Oil & Natural Gas Industries	Federal Government
Federal/ Provincial Governments ²	Population Planning, Curriculum Development, Syllabus Planning, Centers of Excellence, Tourism, Social Welfare, Vocational/Technical Training, Employment Exchange	Federal/Provincial Governments
Provincial Government	Historical Sites and Monuments, Law and Order, Justice, Tertiary Health Care and Hospitals, Highways, Urban Transport, Secondary and Higher Education, Agricultural Extension, Fertilizer and seed distribution, Irrigation, Land Reclamation	Provincial Governments
Local Governments ³	Primary Education, Curative Health Preventive Health, Water Supply Drainage and Sewage, Farm-to-Market Roads, Land Development, Rural Developments, Link Roads, Intra-Urban Roads, Street Lighting Garbage Collection, Fire Fighting, Parks and Playgrounds	Primarily Provincial with Minor Local Government Involvement Local Governments

1. According to Federal Legislative List

2. According to Concurrent Legislative List

3. According Provincial Legislation

Table 3 Tax Assignment for Various Levels of Government—Pre-18th Amendment

Tax/Fee/Surcharge	Determinati on of:		Tax Collection & Admin.	Shares in Revenue (%)		
	Base	Rate		Federal	Provincial	Local
Federal						
Income and Corporation Taxes (excl. on Agriculture income)	F	F	F	50*	50*	0
Wealth Tax (incl. Agricultural Wealth)	F	F	F	100	0	0
Custom Duties	F	F	F	100	0	0
Excise Duties (excl. opium, liquors, narcotics, sugar, tobacco & gas)	F	F	F	100	0	0
Excise Duties on Sugar and Tobacco	F	F	F	50*	50*	0
Excise Duty on Natural Gas	F	F	F	2	98	0
Sales Taxes On Goods	F	F	F	50*	50*	0
Capital Value Taxes	F	F	P	50*	50*	0
Zakat ¹	F	F	P	100	0	0
Usher ¹	F	F	P	100	0	0
Royalty on Crude Oil	F	F	F	2	98	0
Royalty on Natural Gas	F	F	F	2	98	0
Air Travel Tax	F	F	F	100	0	0
Surcharge on Natural Gas	F	F	P	0	100	0
Surcharge on Mineral Oil and Electricity	F	F	F	100	0	0

1. According to Federal Legislative List

* 5% of tax revenues is retained by the Federal Government as administrative charges and the rest is divided as specified above

Table 4 The 7th NFC Award (2009) for Federal Divisible Pool Transfers to Provinces

Total Pool	56%-57.5% of the following sources of federal revenues: Personal and corporate income taxes, wealth tax, sales tax, excise duties on tea, tobacco, sugar, betel nut and other excises. Amount FY 2010-11: Rupees 865.8 billion
Formula for provincial allocation	Population – 62% weight Poverty – 10.3% weight Provincial tax effort – 5% Inverse of Provincial Population density – 2.7% weight
Provincial shares In Population Punjab: 57.4% Sindh: 23.7% KPK: 13.8% Balochistan: 5.1%	Provincial shares in NFC allocation Punjab: 51.7% Sindh: 24.6% KPK: 14.6% Balochistan: 9.1%

Source: Institute of Public Policy (IPP), 2011

The Role of Regional Inequities in Creating A Disharmonious Federation

22. Federation disharmony in Pakistan primarily arises from its political instability, role of military in civil affairs and a stagnant economy and surprisingly less from traditional sources of discontent such as income and service inequalities. Table 5 provides several measures of inequalities of regional per capita Gross Domestic Product (GDP). These include from the simplest measure of ratio of max to minimum per capita regional GDP to more sophisticated measures such as Theil's Index which is a regional population weighted index

of inequality with higher weights to lower income regions and Atkinson's index which incorporates an explicit inequality aversion parameter (see Shankar and Shah 2003 for details). The table shows for MAX/MIN provincial GDP ratio is only about 2 in Pakistan. This compares well to a ratio of 3.4 in India and 11 in China (see Shankar and Shah 2003, 2008). Pakistan also has low values of Theil and Atkinson indexes of inequality. Comparative international studies have further confirmed that Pakistan was more successful than other countries in keeping these differentials within limits (see Figure 1). This was largely achieved by market responses through the mobility of both factors—capital and labor. Pakistan experienced profound inter-provincial migration of capital and labor although public sector environment continues to throw formidable obstacles to such migration responses through quotas and domicile requirements and lack of security for life and property. Regional inequalities in access to basic social services such as education and health have also been constrained. Table 6 shows that largest differentials are in net secondary school enrollment rate where Punjab has 2.6 times the enrollment per school age population than the province of Balochistan. In Thailand and China such differentials are much larger (see Shah 2010).

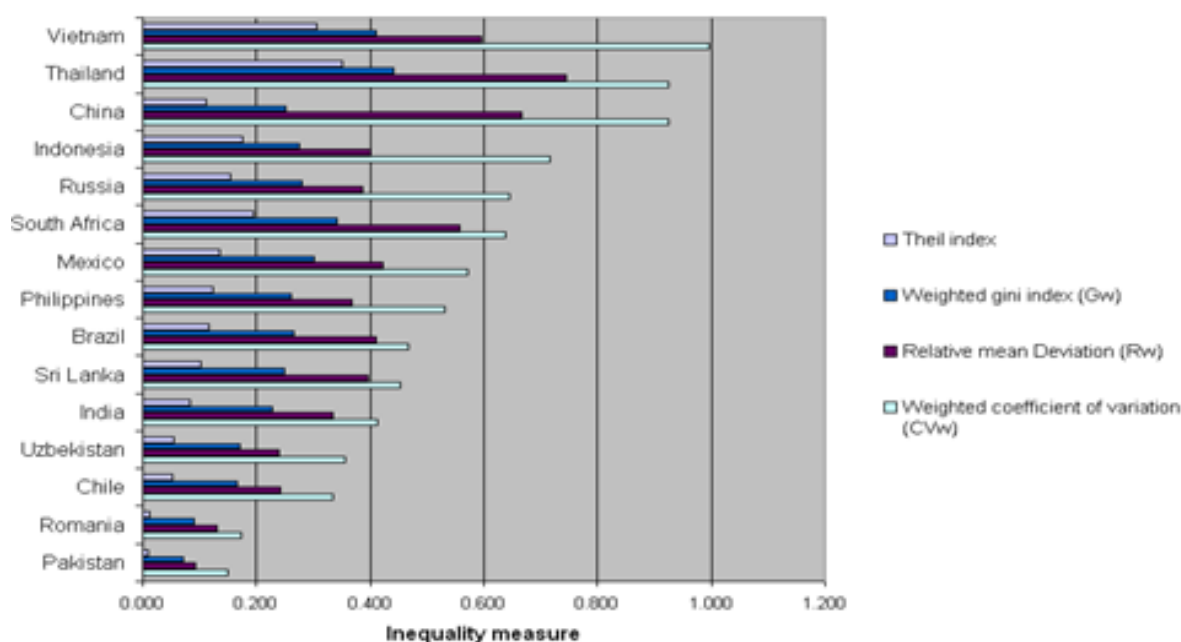
23. Trends in regional disparities during the past decade, however, are disconcerting. Table 5 shows that during General Musharraf's military regime over the period 1999 to 2008, provincial per capita GDP inequalities worsened and a divergence trend has taken hold and continues to progress unabated. The military regime largely alienated the province of Balochistan by its high handedness and may have contributed to its economic decline. This decline in turn contributed to uneven distribution of benefits from economic growth and strengthening of separatist movement in Balochistan.

Table 5 Trends in Regional Inequalities—Disparities in Provincial Per capita GDP

Year	MEASURES OF INEQUALITY		
	Theil Index	Atkinson Index	MAX/MIN
1990/91	0.01753	0.01237	1.84815
1991/92	0.04585	0.01389	1.93099
1992/93	0.05723	0.01645	2.02856
1993/94	0.07053	0.01557	1.99397
1994/95	0.08351	0.01298	1.87197
1995/96	0.12174	0.01198	1.82214
1996/97	0.12751	0.01138	1.76743
1997/98	0.11604	0.00977	1.69654
1998/99	0.12567	0.00714	1.55292
1999/00	0.24418	0.01645	2.01393
2000/01	0.25702	0.01796	2.08163
2001/02	0.26938	0.01708	2.03599
2002/03	0.31169	0.01992	2.16048
2003/04	0.38132	0.02103	2.21051
2004/05	0.41694	0.01621	2.00446
2006/07	0.51179	0.01362	1.88667
2007/08	0.55143	0.01520	1.96106

Source: Author's Calculations

Figure 1 Regional Disparities in Pakistan in Comparative International Perspective



Source: Shankar and Shah 2004

Table 6 Regional Inequity in Access to Education and Health Services

Service Indicator	Max/Min	Punjab	Sindh	PKK	Balochistan
Gross primary enrollment rate	1.293	97	84	87	75
Net Primary Enrollment rate	1.409	62	54	52	44
Gross Middle School Enrollment Rate	1.583	57	49	54	36
Net Middle school Enrollment rate	2.00	22	18	17	11
Gross Secondary School Enrollment	2.600	13	11	8	5
Literacy rate	1.311	59	59	50	45
Full immunization	1.977	85	69	73	43

Source: Institute of Public Policy (IPP) 2011

The State of Decentralization in Pakistan prior to the 18th Amendment—A Comparative Regional Perspective

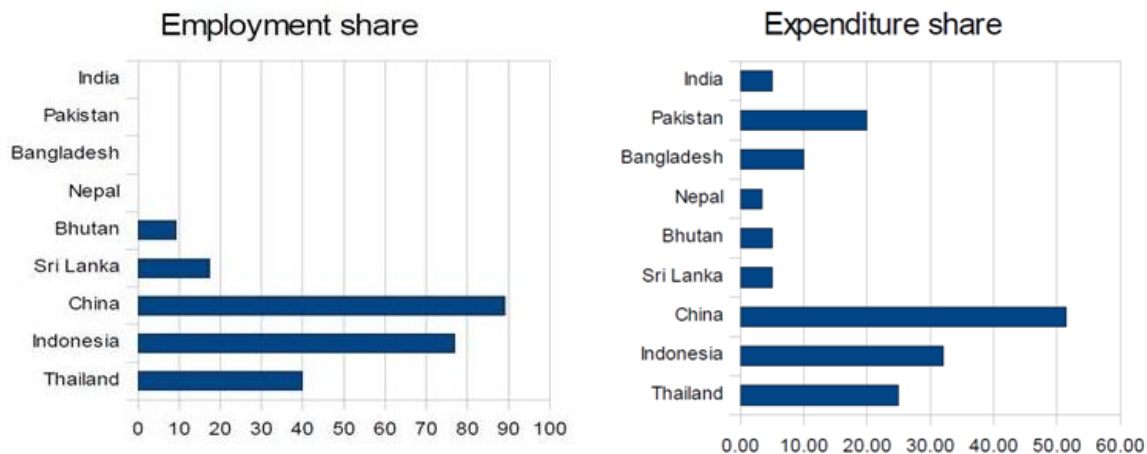
24. Decentralization attempts to move decision making closer to the people with a view to making governments responsive to local preferences, responsible in making best use of public monies to deliver services in the least cost manner, fair in ensuring access to basic public services by the poor, and accountable to citizens for their performance. It is instructive to see Pakistan's place among neighbors in moving governments closer to people. For this purpose, decentralization must be looked at from the perspective of people empowerment through strengthening local governance as opposed to sub-national governance. This is because the intermediate orders of governments in large federal

countries such as India and Pakistan may be far removed from people than central governments in smaller countries—federal and unitary alike. Therefore it would be inappropriate to compare provinces in Pakistan with municipalities say in Bangladesh. In view of this, local government serves as a better unit of comparative analysis of decentralization and this is the approach the paper adopts here. Decentralization to local government is examined on four dimensions, relative importance of local governments and political, fiscal and administrative decentralization.

Relative importance of local governments

25. If local governments do not have any significant taxing and spending powers then having full political, fiscal and administrative autonomy is not very meaningful as is the case in India, Nepal, Bhutan, Sri Lanka and in Pakistan prior to the 2000 devolution. Relative importance of local government is measured by two alternate indicators—expenditure and employment share of consolidated public sector. Figure 2 shows that China leads the way in strong local governance followed by Indonesia and Thailand. South Asian countries do worse although among this group Pakistan fares better than its South Asian neighbors on expenditure shares.

Figure 2 Local Government Employment and Expenditure Share as % of Public Sector



Source: Ivanyina and Shah 2012

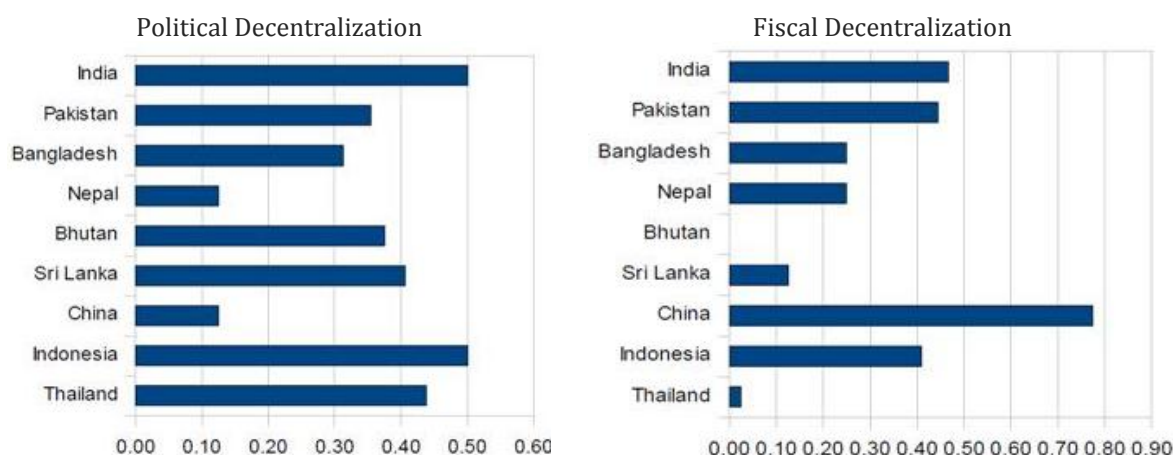
Political or Democratic Decentralization

26. Political or democratic decentralization implies directly elected local governments thereby making local officials accountable to citizens. A number of considerations go into its measurement. These include constitutional safeguards against arbitrarily dismissal of local government, popular elections of mayors, popular elections of local council members, degree of popular participation in local elections, provisions for popular recall of local officials, contestability of local elections, security of existence of local government—assured by law or constitution. India and Indonesia fare better than other countries (see Figure 3). In India, 73rd and 74th amendments to the constitution created local governments as the third tier of government. Pakistan does worse than India as it does not grant constitutional status to its local governments and mayors are indirectly elected.

Fiscal Decentralization

27. Fiscal decentralization refers to fiscal autonomy in taxing, spending and borrowing decisions. Basic rationale is that local governments that are self financed are expected to be more responsive and accountable to their residents. Fiscal decentralization ensures that all elected officials weigh carefully the joys of spending someone else's money as well as the pain associated with raising revenues from the electorate and facing the possibility of being voted out. Fiscal decentralization was assessed using multiple criteria: rate and base setting for local revenues, majority of transfers are formula based and unconditional, revenues more or less match responsibility, own revenues finance majority of expenditures, local government has responsibility and control over all municipal-local services. China is rated better than all countries in the region on these criteria. India and Pakistan do better than other countries in the region (see Figure 3).

Figure 3 Political and Fiscal Decentralization to Local Governments in Asia



Source: Ivanyina and Shah 2012

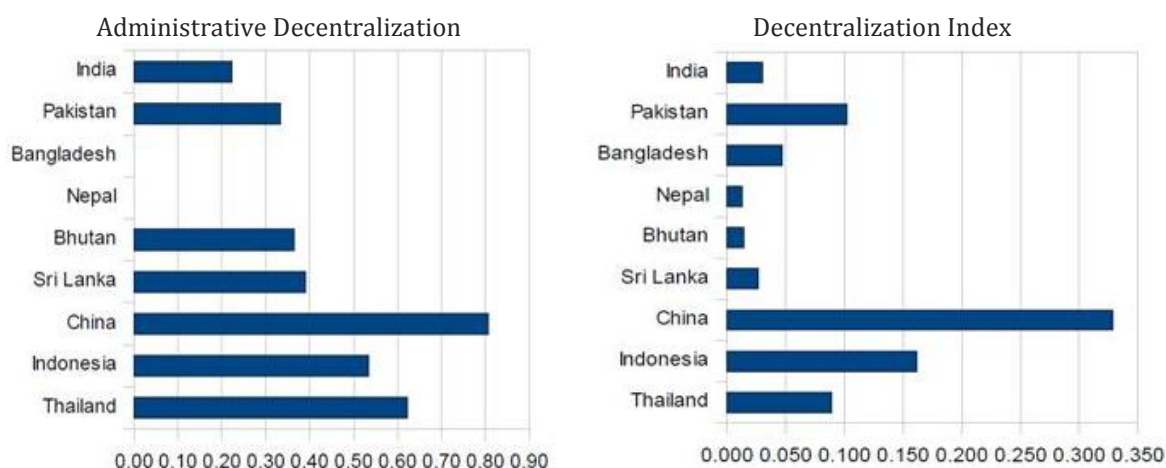
Administrative Decentralization

28. Administrative decentralization empowers local governments to hire and fire local staff and set their terms of employment without any reference to higher level government thereby making local officials accountable to elected officials. It is measured by multiple criteria that include freedom to hire and fire and set human resource management framework, freedom to contract out own responsibilities, and regulatory authority to pass bylaws. Both Pakistan and India fare poorly on administrative decentralization as elite national civil service officials working as chief executive at the local level are not accountable to local councils (see Figure 4). The 2000 devolution went half way to create accountability links at local levels but did not succeed due to dual accountability mechanisms with provincial control trumpeting local accountability. Subsequently the provinces of Punjab and Sindh have rolled back these reforms restoring the controlling role of provincial/national elite cadre of officials.

Overall Decentralization

29. The decentralization index captures the four aspects of local governance discussed above. As shown in Figure 4, Pakistan is ranked lower than China, Indonesia and Thailand but higher than its South Asian comparators.

Figure 4 Administrative and Overall Decentralization to Local Governments in Asia



Source: Ivanyna and Shah 2012

Implications of the 18th Constitutional Amendment–Institutional, Fiscal and Service Delivery

Institutional Implications

30. The 18th Constitutional Amendment is a landmark legislation as it introduces profound changes in the institutions of intergovernmental coordination. Most significant of these changes are restating the roles of two institutions of the federation—the revival of Council of Common Interest and strengthening of provincial representation at the National Economic Council.

The Council of Common Interest

31. The Council of Common Interests was initially created by the 1956 Constitution. It was chaired by the Prime Minister or by a federal minister on his behalf and had equal membership from the provinces and the federal government. It had jurisdiction over federal legislative list and electricity and was intended to serve as forum to seek provincial input in the conduct of federal responsibilities. There was no requirement for its periodic meetings and the federal government chose to make this institution dormant as it had little interest in provincial views. The 18th Amendment attempts to reinvigorate this institution to deal with all matters relating to the federation. The Council is to be chaired by the Prime Minister and will have four provincial chief ministers and three federal government nominees as members. The Council will have a permanent secretariat and must meet at least once every quarter. It has been entrusted with decision making, monitoring, supervision and control responsibilities over Federal Legislative List Part II which includes: railways, minerals, oil and natural gas, hazardous materials, industrial policy, electricity, major ports, federal regulatory authorities, national planning and economic coordination, supervision and management of public debt, census, provincial police powers beyond provincial boundaries, legal, regulation of legal, medical and other professions, standards in education and research, interprovincial coordination and conflict resolution.

National Economic Council

32. The National Economic Council is also a constitutional body with oversight responsibility on national economic policies and it has remained active in the past. It was chaired by the Prime Minister and its membership in the past was left at the discretion of the President provided at least one member from each province was represented. The 18th Amendment tilted the balance of power on this council in favor of provinces by mandating two members each, including the chief ministers from each province and having four federal members appointed by the Prime Minister. The Council now must meet at least once every six months.

33. In addition to strengthening the above institutions of the federation, the 18th Amendment introduced significant changes in the division of powers as discussed below.

Constitutional Rearrangements in Pakistan

34. The 18th Amendment deleted list of federal/provincial concurrent responsibilities and reassigned selective functions to the federation to be guided by the Council of Common

Interests and devolved others to the provinces. The former list primarily consists of natural resources, electricity and regulatory functions (see Table 7). The latter comprises most economic and social services. Table 8 shows that federal government has been completely stripped of its responsibilities in planning, industry, agriculture and rural development, social services and welfare including social protection. This has resulted in abolition of the seventeen ministries with FY 2010-11 budget of Rs. 49 billion, including the ministries of food and agriculture, education and health. Table 8 provides a listing of these ministries and their FY 2010-11 budgets. These functions have been absorbed on a selective basis by the provinces in existing departments. With the abolition of Ministry of Education, Pakistan joins Canada as the only two federal countries with no ministry of education at the federal level. With the abolition of Ministry of Health, Pakistan assumes a unique status among all federal countries.

35. The Federal Government has also been constrained in terms of its authority in banking, finance and insurance as its regulatory authority no longer extends to provincially owned entities or private entities operating in a single province. The Federal Government has been mandated to consult the provinces prior to initiating any hydroelectric projects. The provinces on the other hand have been given a free hand in all public services delivered within the provinces and control over all local government institutions. All the residual functions not enumerated in the constitution also fall in the domain of the provinces, a new article has been inserted to provide right to free education. Article 25 A states that “the state shall provide compulsory education to all children of the age of five to sixteen years in such manner as may be determined by law.” As education is a provincial responsibility, this article mandates provinces to provide free secondary school education to all citizens who seek such service.

36. There has also been limited reassignment of taxing powers (see Table 9). These include empowering the federal government to levy taxes on sale of goods and capital value of financial assets. In the past the federal government enjoyed these powers as the provinces had voluntarily surrendered their right to sales taxation in interest of efficiency of tax administration. The federal government has also been asked to vacate taxes on immovable property, estate and inheritance taxes, VAT (Value Added Tax) on services and Zakat and Usher (religious taxes) reverting these tax handles to the provinces. The resulting reassignment of taxes is detailed in Table 10. Provincial borrowing privileges have also been expanded to include domestic and foreign loans subject to limits and conditions imposed by the National Economic Council.

Outlook for Provincial Finances

37. The 18th Amendment has expanded the tax domain of provinces to include a dynamic and buoyant tax base—sales tax on services. This base alone if effectively taxed could yield revenues equivalent to 0.5%-1% of GDP. The IPP conservatively estimates it at 0.5 % of GDP for FY 2011-12. The provinces since FY 1996-97 have also levied agricultural income taxes but these taxes have extremely low yields. As noted by IPP, both the presumptive tax rates (Rs. 150-250 per acre) and penalties for non-compliance (maximum Rs. 1,000 in nominal terms) are extremely low. In fact the penalty for failing to file a return of Rs. 1000 is laughable and creates incentives for non-compliance. The IPP has recommended raising the presumptive tax rate to Rs. 750-1250 range and the non-compliance penalty to Rs 10,000. The proposed increases are fairly modest and still may not

be able to induce compliance. To raise significant revenues, effective tax rate should be at least 20% of income for large farms (25 plus acres). This would translate to a rate of Rs. 3000 per acre in real terms. The penalty for failure to file a return has to be punitive to ensure voluntary compliance and must be for large farms at least Rs. 1,000,000 plus assessed back taxes marked up by the rate of inflation plus 10%. Note that ideally agricultural income should be taxed as ordinary income in addition to having a local land tax on agricultural lands. But these options have been ruled by relevant constitutional provisions.

Table 7 Reassignment of Spending and Regulatory Functions by the 18th Amendment

Federation/CCI (Joint Federal-Provincial) Tasks—Federal Legislative List Part II	
Electricity	Provincial police operations beyond provincial boundaries
Minerals, oil and natural gas	Industrial policy
Railways	National Planning and National Economic Coordination
Major Ports	Coordination of Scientific and Technological Research
Census	All regulatory authorities under a federal law
Public Debt	Standards in higher education and Research, scientific and technical institutions
Federal corporate entities including Water and Power Development Authority and Pakistan Industrial Development Corporation	Interprovincial matters and coordination
Legal, medical and other professions	
Federal Functions—Federal Legislative List Part I	
Defense	International and inter-provincial trade
External Affairs and international treaties	Nuclear Energy
Immigration and citizenship	Airports, aircraft, air navigation, air and sea travel and shipment, lighthouses
Post and Telecommunications	Patents, trademarks, copyrights
Central banking, Currency, Foreign Exchange,	Stock exchanges and futures markets
Corporate regulation including banking and insurance	National highways and strategic roads
Fishing beyond territorial waters	Federal geological surveys and meteorological organizations
Standards of weights and measures	Local government in cantonment areas
Provincial Responsibilities	
All residual functions	
Local Government Responsibilities	
By provincial government determination	

Source: Constitution of Pakistan—4th Schedule

38. Provinces also have the potential of raising additional revenues from capital value taxes on property, estate and inheritance taxes and environmental taxes and charges. All these fields are currently either underexploited or unexploited. Overall, provinces have the

wherewithal to raise additional revenues from own sources but perhaps not the incentives as they have traditionally happily depended upon manna from heaven transfers (NFC awards) and have always clamored for increase of revenues from this source rather than raising revenues from own sources.

39. The 18th Amendment has also opened door for greater access to capital finance by permitting both internal and external borrowing subject to limitations imposed by the National Economic Council. Previously provinces were prevented from having such access as they required federal government approval for such actions so long they owed any debt to the federal government which they always did.

Table 8 Federal Ministries Abolished (effective July 01, 2011)

Rank order	Federal Ministry	FY2010/11 Budget (Rs. M)	Rank Order	Federal Ministry	FY2010-11 Budget (Rs. m)
1	Food and Agriculture	19,800	10	Livestock and Dairy	486
2	Health	15,711	11	Labour and Manpower	434
3	Education	3,093	12	Minorities	220
4	Social Welfare and Special Education	2,130	13	Tourism	218
5	Population Welfare	1,969	14	Women Development	173
6	Youth Affairs	1,569	15	Special Initiatives	138
7	Environment	820	16	Local Government and Rural Development	78
8	Sports	654	17	Zakat and Usher	26
9	Culture	579		Total (17)	49,099

Source: Federal Budget FY 2010-11

Table 9 Reassignment of Taxing Powers among Different Orders by 18th Amendment

Federal Taxing Powers	
Added	Deleted
Taxes on sales and purchases of goods	Estate and inheritance taxes (Wealth tax including agricultural wealth)
Taxes on capital value of assets excluding immovable property	VAT on services
	Zakat and Usher
Provincial Taxing and Financing Powers	
Added:	Deleted
VAT on services	
Taxes on immovable property	
Zakat and Usher	
International and domestic borrowing subject to limits and conditions imposed by the National Economic Council	
Local Government Taxing Powers	
No changes	

Source: Constitution of Pakistan—4th Schedule

Table 10 Reassignment of Taxes to Various Orders (effective July 01, 2010)

	Determination of:		Tax Collection & Administration	Shares in Revenues (%)		
Tax/Fee/Surcharge	Base	Rate		Federal	Provincial	Local
Federal						
Personal Income and Corporation Taxes (excl. on Agriculture income)	F	F	F	42.5*	57.5*	0
Custom Duties including export duties on cotton and Jute	F	F	F	100	0	0
Excise Duties (excl. opium, liquors, narcotics, sugar, tobacco & gas)	F	F	F	42.5*	57.5*	0
Excise Duties on Sugar , Tea, Tobacco and Betel nuts	F	F	F	42.5*	57.5*	0
Excise Duty on Natural Gas	F	F	F	2	98	0
Sales Taxes On Goods	F	F	F	42.5*	57.5*	0
Capital Value tax on non-immovable assets	F	F	P	100	0	0
Royalty on Crude Oil	F	F	F	2	98	0
Royalty on Natural Gas	F	F	P	2	98	0
Air Travel Tax	F	F	F	100	0	0
Surcharge on Natural Gas	F	F	P	0	100	0
Surcharges on Mineral Oil and Electricity	F	F	F	100	0	0
Provincial						
Tax on Property Transfers	P	P	P	0	15	85
Property Tax ⁴	P	P, L	P, L	0	15	85
VAT on services	P	P	F,P	0	100	0
Zakat ¹	P	P	F	0	100	0
Usher ¹	P	P	F	0	100	0
Taxes on Professions, Callings & Trades ⁶	P, L	P, L	P, L	0	100**	100**
Agricultural Income Tax ²	P	P	P	0	100	0
Capital Gains tax ³	P	P	P	0	100	0
Excise Duties on Opium, Liquors & Narcotics	P	P	P	0	100	0
Stamp Duties	P	P	P	0	100	0
Cotton Fee	P	P	P	0	100	0
Betterment Tax	P	P	P	0	100	0
Electricity Duty	P	P	P	0	100	0
Court Fee	P	P	P	0	100	0
Education Cess	P	P	P	0	100	0
Motor Vehicle Taxes ⁵	P	P	P	0	100	0
Tolls on Roads and Bridges	P	P	P,N	0	0	100
Taxes on Cinemas and Hotels	P	P, L	P, L	0	100**	100**
Arms License Fees	P	P	P	0	100	0
Entertainment Taxes	P	P, L	P, L	0	100**	100**
Rates on Services like Water Supply, Drainage and Lighting	P, L	P, L	P, L	0	100**	100**
Local						
Export Tax	P, L	L	L,N	0	0	100
Market Fees	L	L	L	0	0	100
Fees at Fairs, Agricultural Shows etc.	L	L	L	0	0	100
Fees for Specific Services	L	L	L	0	0	100
Tax for Construction and Maintenance of Public Utility	L	L	L	0	0	100
Taxes on Other-Than-Motor Vehicles	L	L	L	0	0	100
Tax on Advertisements	L	L	L	0	0	100
School Fees	L	L	L	0	0	100
Fees on Sale of Cattle at Fairs	L	L	L	0	0	100
Tax on Lands not Subject to Local Rate	L	L	L	0	0	100
Tax on Hearths	L	L	L	0	0	100
Tax on Births, Marriages and Feasts	L	L	L	0	0	100
Conservancy Rate	L	L	L	0	0	100
Fees for Erection of Buildings	L	L	L	0	0	100
Fees for Slaughtering of Animals	L	L	L	0	0	100
Surcharge on any tax levied by the Provincial Government	L	L	L	0	0	100

F = Federal; P = Provincial; L = Local; N = Private;

1. Islamic Welfare tax which is not deposited into the Consolidated Fund and does not form part of the budget.

2. So far legislated by the Governments of Punjab, Sindh and NWFP.

3. Was abolished in 1986 by all provincial governments except Balochistan.

4. In Lahore Metropolitan Area, the provincial government retains 57.5% of revenues, as one-half of the 85% share of MCL is provided to WASA, a provincial agency of MCL. In Balochistan, it is shared on a 5:95 basis.

5. In Balochistan, 50% of the revenues are shared with local governments.

6. Each government (i.e. provincial and local) retain 100% of their portion of collected tax.

* 5% of tax revenues is retained by the Federal Government as administrative charges and the rest is divided up as specified.

** 100:100 sharing indicates that the tax base is co-occupied, each level of government retains its own full share of the tax.

Fiscal Implications of the 18th Amendment

40. With the 18th constitutional amendment almost all of direct services to people become the responsibility of provinces. As a consequence 17 central government ministries have been devolved to the provinces. Some of the retained functions of the abolished ministries have been reassigned to remaining ministries. For example, People's Works Program has been assigned to the Cabinet Division. A newly created Capital Administration and Development division at the federal level has been entrusted to handle all functions of abolished ministries retained by the federal government but not assigned to remaining ministries. Expenditure decentralization has also been accompanied by much more limited decentralization of taxing powers most notably for VAT on services. This is potentially a buoyant source of revenue. Revenue and expenditure implications of these changes have been moderated by the federal government in the transition period of three years. The federal government has agreed to provide financing for vertical programs in health, such as National Program for Family Planning and Primary Health Care, Expanded Program for Immunization, and the National TB Program for the next three years. It has also assured continued financing of the current and development expenditures of universities, and the NCHD. Incidentally NCHD has about 16,000 employees but the provinces have refused to take over NCHD functions and absorb its employees as they contend that the institution has mostly "ghost" employees. The federal government will also continue to finance, during the transition period, the Planning Commission and the Higher Education Commission—the two institutions with unclear mandates. The federal government will also retain indefinitely about 65,000 employees whose positions have been rendered redundant as a consequence of the 18th Amendment and the provinces have shown reluctance to accept them. So far provinces have accepted only 15,000 federal employees which were working in provincial field offices. With the transition arrangements in place, the federal deficit is expected to increase by about 3% and the provinces collectively will be in surplus by the same amount (see Table 11). While Pakistan's federal finances are already in precarious state with operating deficit at about 100% of operating revenues, this development will push the federal government further to the brink unless it takes corrective actions through privatization, restructuring of federal departments and tax reform. Its past record in dealing with these issues is not very admirable. This situation can be overcome in a fully mature system by FY 2015 provided the federal government is able to shed irrelevant structures and also is either successful in transferring redundant employees to the provinces or terminate their services. This is anticipated to be a difficult issue to resolve over the coming years as the redundant employees typically do not have the knowledge and skills to manage service delivery tasks but have significant political clout through their unions/associations.

41. Once the system becomes mature in FY 2015, the structure of government in Pakistan would have undergone a profound transformation from centralized federal power to centralization at the provincial level (see Table 12). For all economic and social services, provinces will assume a dominant role in policy making and service delivery. For an average citizen, then the government that would matter is the provincial government. What are the implications of such governance for responsive, responsible, fair and accountable governance is taken up in the next section.

Table 11 Fiscal Consequences of 18th Amendment

Fiscal Year	Indicator	Federal share	Provincial-Local Share
FY 2009-10	Revenue collection	94%	6%
	Revenues retained	65%	35%
	Expenditure share	66%	34%
	Residual Fiscal Gap after transfers	-1%	+1%
FY 2011-12	Revenue Collection	90%	10%
	Revenues retained	61%	39%
	Expenditure share	64%	36%
	Residual Vertical Fiscal Gap after transfers	-3%	+3%
FY 2014-15	Revenue collection	85%	15%
	Revenues retained	45%	55%
	Expenditure share	45%	55%
	Residual Vertical Fiscal Gap after transfers	0%	0%

Table 12 Fiscal Consequences of 18th Amendment on Direct Expenditure

Expenditure Function	Federal – FY10	Provincial –FY10	Local- FY10	Total- FY10	Fed- FY15	Prov – FY15	Local- FY15	Total- FY15
General Administration	74%	25%	1%	100%	20%	75%	5%	100%
Defense	100%	0%	0%	100%	100%	0%	0%	100%
Debt servicing	85%	15%	0%	100%	85%	15%	0%	100%
Public Order and Safety	30%	70%	0%	100%	30%	70%	0%	100%
Economic Services	26%	50%	24%	100%	10%	66%	24%	100%
Environmental Protection	3%	40%	57%	100%	1%	42%	57%	100%
Housing and Community services	0%	84%	16%	100%	0%	84%	16%	100%
Recreation, Culture and Religion	53%	32%	15%	100%	5%	80%	15%	100%
Education	14%	23%	63%	100%	5%	33%	63%	100%
Health	9%	51%	40%	100%	5%	55%	40%	100%
Social Protection	12%	27%	61%	100%	2%	37%	61%	100%
All	66%	25%	9%	100%	45%	55%	10%	100%

The 18th Amendment—Potential and Overlooked Issues

Potentials

42. The 18th Amendment has received plaudits from policy makers and scholars alike for its potential to improve the authorizing environment for a better functioning of the federal system (see IPP 2011). While such high expectations for a better functioning of the federal system may have to be tempered, the 18th Amendment, nevertheless, offers a number of positive potential payoffs. These include:

- Reducing the threat of military intervention. Its foremost merit would be to limit the threat of military adventurism. Pakistan military has a long tradition of intervening in domestic politics under one pretext or another—the last being that the Prime Minister did not follow the due process in removing the military chief. Such a temptation may be tempered in the event that critical responsibilities and decision making rests with the provinces rather than the federal government. Thus the 18th Amendment by shifting the power locus to the provinces may have paved the way for reduced military political adventurism in future. If this prediction materializes, then it would be considered as a crowning achievement of this constitutional reform. Brazil succeeded in keeping military at bay with its 1988 Federal Constitution (see Shah 1990) but in Pakistan such optimism may well turn out to be unrealistic if past political history was any guide.
- Toward greater harmony in federal-provincial relations. The 18th Amendment has reinforced provincial autonomy consistent with the original intent of the 1973 Constitution. By doing so, it has removed an important irritant in federal-provincial relations. It has narrowed the opportunity for arbitrary federal intervention in provincial affairs and therefore, may have gone some distance in limiting provincial discontent with federal policies. Through the proper working of the CCI, there is an opportunity to build trust and harmony in federal-provincial relations in Pakistan and thwart movements for separation spawned by federal unilateralism or high handedness of military regimes.
- Greater clarity in government accountability. With the new constitutional order both the policy determination and service delivery responsibilities are concentrated at the provincial level. This creates a great clarity for citizens in terms of which order of government to hold accountable for dysfunctional service delivery as the buck now clearly stops at the provincial Chief Minister's doorsteps.
- Moving the government closer to people. The 18th Amendment has also moved the government a few small steps closer to the people. If this leads to greater citizen participation in public affairs, it has the potential of making governments more responsive and accountable to people.

Important Overlooked Issues

43. While the discussion and debate leading up to the passage of 18th Amendment represented a unique opportunity—the only one after the enactment of the 1973 Constitution—this opportunity was largely lost as the 18th Amendment failed to address some of the fundamental challenges of fiscal federalism in Pakistan as discussed in the following paragraphs.

- An important missed opportunity in reforming multi-order governance in Pakistan. This would have required a comprehensive review of roles and responsibilities of all orders of government, federal, provincial, local and beyond government in delivering public services (see Shah et al. 1996 and Shah 1997 for pathways to such reform). Instead the amendment simply focused on devolving functions from the federal government to provinces to neglect of rationalization of central functions of the federal government, provincial functions of the provincial government and a complete neglect of the role of local government and beyond local government entities in public services delivery.
- The neglect of federal functions of the federal government. Securing a common economic union, a harmonized tax system, protection of minorities and disadvantaged groups, dealing with natural disasters, emergencies, calamities including floods and earthquake are considered among the core functions of the federal government but have been left out of federal domain. On the other extreme, a purely local function such as the People's Works Program has been centralized to the Prime Minister's (PM) Office as if the PM office did not have enough workload already.
- Natural resource ownership. For political and economic union, it is important that the ownership of the natural resources be vested in the nation as a whole and revenues from natural resources be not available to any order of government for current use but instead invested in a national heritage fund. All the citizens of Pakistan would hold equal shares of this fund and receive annual dividends as done in Norway. Various orders of government would be eligible to receive a fraction of the earnings from this fund for investment in long lived assets. In Pakistan on the other ownership of natural resources is vested in the provinces and current revenues accrue to the provinces. This creates both potential for Dutch disease as well as interprovincial conflicts. Pakistan has already experienced serious interprovincial conflicts in water and gas distribution across provinces.
- A roadblock to tax reform. In tax areas, by reasserting the powers of the provinces to tax agricultural income, capital gains and services, the Amendment may have blocked avenues for reform in creating a modern income and sales tax system in Pakistan and strengthened opportunities for tax evasion by enabling tax arbitrage for potential taxpayers by shifting income to agriculture and business expenses to higher taxed sector or sources of income.
- Finance does not follow function. Decentralized fiscal system works best when expenditure decentralization is accompanied by tax decentralization so that spending decisions and associated tax increases have to be presented to the public and defended. This puts a break on leviathan tendencies associated with reliance on higher level fiscal transfers to finance sub-national expenditures. The amendment

missed the opportunity to realign finance with functions at various orders of government to have greater accountability.

- A missed opportunity in rightsizing the federal government. Even in implementation of the Amendment, the federal government failed to seize the opportunity to realign its organizational structure with the new mandate and instead retained all redundant employees and continued to finance vertical programs as if it was financing its line agencies rather than instituting grant program with specific objectives and accountability mechanisms. It has also allowed the Planning Commission, Higher Education Commission and the National Centre for Human Development to continue without rethinking their roles and the appropriate new institutional structures to perform those roles.
- The Federal government lacks access to financing instruments to secure a common economic union. The amendment also neglected to revisit the financing of provincial governments through fiscal transfers. NFC awards have twin objectives of dealing with vertical fiscal gap and horizontal equalization. With devolution of social services and infrastructure responsibilities to provinces, federal role in providing financing for these services, to set national minimum standards for merit services and to secure common economic union, gains prominence. But at present, there is no instrument available to further the spending power of federal government to advance national objectives.
- Increased risks to macro-stability with provincial government ownership of financial institutions. The 18th Amendment has also empowered provinces to borrow from domestic and international sources subject to conditions imposed by NEC. NEC may not be able to discipline such borrowing as provinces own banking and other financial and non-financial institutions. Non-arms length borrowing from such institutions may go undetected as happened in Australia in the 1970s under the (old) Australian Loan Council, in Brazil in the 1990s and more recently in China. In Brazil, such borrowing led to state and local government bankruptcies including the largest and richest state of Sao Paulo. In China local government are prohibited from borrowing but they use their autonomous enterprise to borrow from financial sector and then make transfers to local government. Such borrowing is estimated to be about one trillion Yuan and poses significant risks to macro-stability of China. The Chinese Government has recently taken steps to “discover” these loans and reduce the debt burden of local governments.
- Creating a potential for a jungle of confusing and contradictory regulatory standards with high transactions costs for business and citizens. Even the areas of its attention, the Amendment has created major anomalies. For example, national uniform standards are required for drug approvals, pharmaceutical regulations and food and agriculture safety inspections, control and disposal of hazardous materials and waste, water and air pollution and highway safety standards and consumer product safety standards and social safety nets. But all these areas have been relegated to the provinces creating potential for a jungle of confusing and contradictory standards with high compliance and administration costs. Imagine the consequences for business and consumers if each province decides to set up its own food and drug regulatory agency as stipulated by the Amendment.

- Potential for greater barriers to factor mobility. Finally and most importantly the 18th Amendment has failed to institutionalize any constraints to barriers to factor and goods mobility across the nation and instead has opened up potentials for such barriers by recognizing provincial authority to discriminate against non-residents. Article 27(2) overrides the safeguard against discrimination in employment by empowering provinces and local government to institute three years local residency requirements.

The 18th Amendment—Conceptual Perspectives and Lessons from International Practices on Multi-order Governance in an Information Age

44. In this, the paper takes a step back from the governance model adopted by the 18th Amendment and takes a conceptual and international perspective on the same issue. It reviews the pros and cons of the federalism model adopted by the 18th Amendment and its relevance for the information age, and reflects upon new governance structures required for economic success in the globalized and interconnected world. In doing so, it draws heavily upon the analysis presented in Shah (2010) and Boadway and Shah (2009).

45. The genesis of the 18th Amendment is the “holding together” view of federalism, also called the “new federalism”. It represents an attempt to decentralize responsibilities from federal government to states or provinces with a view to overcome regional discontent with central policies and forestall secessionist tendencies. This view is the driving force behind the current interest in principles of fiscal federalism in unitary countries and relatively newer federations such as Brazil, India and Pakistan and emerging federations such as Iraq, Nepal, Spain, Sri Lanka and South Africa. In Pakistan this was the primary motivation for unanimous consent to a recent passing of the 18th Amendment to the Pakistan’s constitution to empower provinces. The 18th Amendment eliminated the concurrent functions list (overlapping functions) and clarified separate and distinct responsibilities of federal and provincial governments. In doing so, it moved away from the earlier “layer-cake” model of dual federalism to a “coordinate authority” model. Under the layer cake model that prevailed in Pakistan till 2010, there was a hierarchical relationship among federal, provincial and local governments with the federal government at the apex as the dominant player. Under the coordinate authority model of dual federalism adopted by 18th Amendment, provincial government would enjoy significant autonomy from the federal government and local governments would be simply creatures of the provincial government.

Pakistan’s Dual Federalism Model: Potentials

46. The “coordinate authority” of dual federalism model empowers provinces and states. This is considered a welcome move as it moves decision making somewhat closer to people and it also has the advantage of dealing with ethnic and linguistic conflicts if provinces are numerous and are small enough in geographic area and represent population with relatively homogeneous characteristics and similar tastes and preferences for a menu of taxes and public services (as Cantons in Switzerland). If provinces are properly delineated as economic regions then they could also enhance efficiency of the internal common market by exploiting economies of scale and scope. They also have the potential to deal with inter-local spillovers and intra-regional inequities. Provincial governments can also be responsive to citizen preferences if provincial government is not captured by feudal, industrial and military elites. The absence of well developed communication and transportation system and a lack of urbanization also make provinces almost a necessity for countries that span a large geographic area. The above mentioned potentials have limited relevance for Pakistan as Pakistan has only handful (four) of large provinces with heterogeneous ethnic and linguistic populations and one dominant province having majority of population. Historical record from other countries shows that federal countries with less than eight constituent units have typically been politically unstable. The provincial boundaries in Pakistan are not

synonymous with economic region but historical accidents represent the best wisdom of the British colonial empire for control. There is also significant degree of feudal, military and elite capture of provincial governments. Pakistan has a well developed communications and road infrastructure network which also diminishes the economic relevance of the provinces.

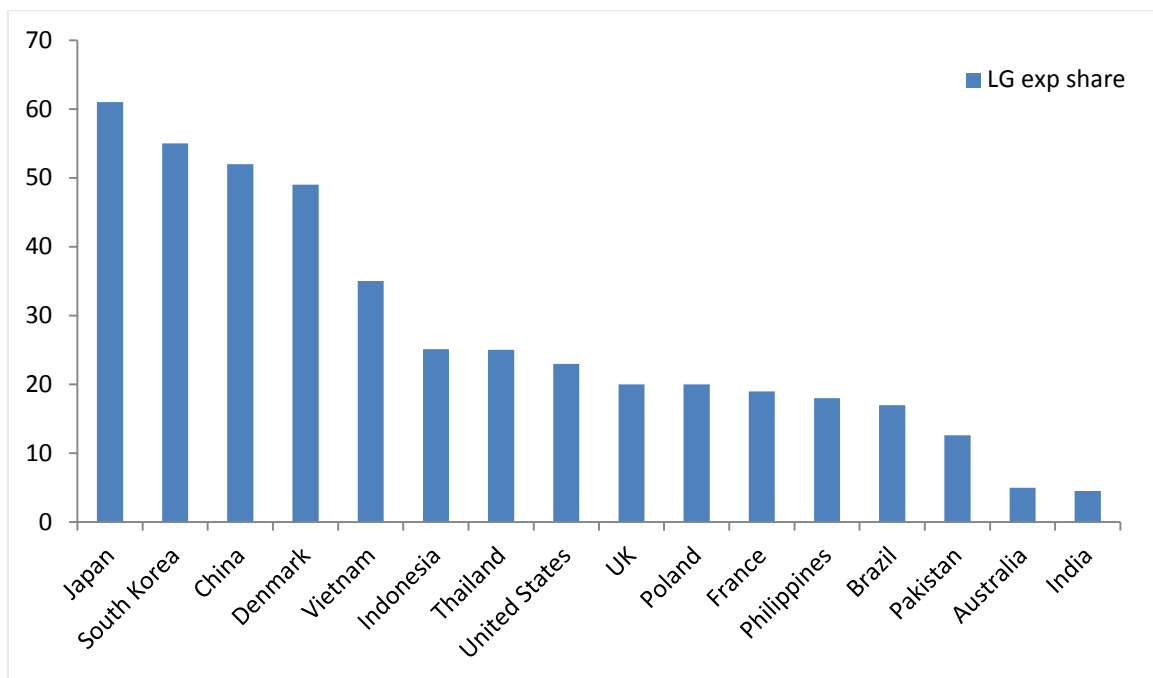
The Dual Federalism in Pakistan: Potential Pitfalls

47. The dual federalism model empowering provinces adopted by Pakistan in 2010, nevertheless, has significant conceptual shortcomings. These include:

- Tragedy of commons associated with common pool resources. Under dual federalism, both the center and the provinces compete to claim a larger share of the fixed national pie. This accentuates universalism and pork barrel politics leading to a tragedy of commons where all federating units outcompete each other in profligate spending and giveaways in taxes and subsidies. This tug of war over resources leads to zero-sum games and the resulting swings in the balance of powers within nations is a perpetual feature of dual federalism model. Pakistan manifests these tendencies as is evidenced by the past negotiations on NFC Awards.
- A Leviathan model of governance. Empowering provinces leads to a potential for greater duplication of government structures and processes at central and provincial levels leading to increased costs for the exchequer and higher transactions costs for citizens. This may also lead to overgrazing by politicians and bureaucrats. As a result the growth in the size of government becomes unrelated to quality and quantity of service delivery. Opportunism and pork barrel politics leads to governments acting as employment creation agencies detracting them from their primary role in financing public services. While there is no recent rigorous study available to refute or document the above consideration in Pakistan, an earlier study (see Shah et al. 1996) and causal empiricism suggests that during past two decades, public sector employment and associated expenditures on wages and benefits have grown at the expense of reductions in other operating and development expenditures.
- Agency problems with incomplete contracts. In most large countries, empowering provinces does not necessarily imply that the decision making moves closer to people. Provinces and states are often larger in geographic size and/or population than smaller countries. Governments of New York, California, Ontario, Sao Paulo, Punjab, Sindh, Balochistan and Indian states of Bihar and Gujarat have jurisdictions exceeding the size of many countries. Having decision making far removed from people implies that provincial governments have incomplete contracts with their citizens and could not be held to account by people at large. In countries where politics is dominated by feudal, military and industrial elites such as Pakistan, this leads to complete alienation of governments from their people. This lack of accountability in governance is further accentuated by a constraining of voice and exit options under provincial empowerment.
- Weaker and fragmented local governance. Empowered provinces create incentives for weaker and numerous local governments. The exigencies of provincial politics dictate that local governments are given straight jacket mandates with little resources and are kept under tight provincial reigns as done in India and Pakistan. The empowered provincial governments typically encourage local fragmentation in interest of higher degree of intrusive controls. In India, there are 254,119 local governments

responsible for a pittance (5%) of national expenditures. Most of these expenditures go toward financing the salaries and allowances of civil servants and 3 million elected officials with little left to deliver public services (see Figure 5). In contrast, in China where provincial role is restricted and local governments are empowered, there are only 43,965 local governments accounting for 51.4 percent of national expenditures (see Qiao and Shah 2006). In Pakistan, situation is similar to India with little resources and responsibilities at the local level. Modest increase in these resources and local autonomy granted during the previous military regime has already been stripped in Punjab and Sindh provinces more formally and informally in the remaining two provinces. In both Punjab and Sindh, provincial governments have acted to curb local autonomy and reintroduce provincial controls through the elite civil service. Deteriorating law and order situation has been the primary motivation for these reversals but these moves might forestall the emergence of good local governance in Pakistan

Figure 5 Provincial Empowerment is Associated With Weaker Local Governments 2010



Source: Shah 2010

- Stifling local innovations. Provinces and states often impose one size fits all straight jacket mandates that constrain local choices and flexibility and stifle any innovative approaches. In Pakistan, provincial ordinances in 2000 required all local governments, small or large, to have 16 departments and fixed number of positions. In United States, outdated state laws that are rooted in unjustified distrust of local decision making have stifled successful cities to develop and implement any coherent vision of their future and serve their residents better (see Frug and Barron 2008).
- Constraining good governance and strangling metropolitan growth. Empowered provinces typically block rationalization of local government functions especially when local government empowerment implies chipping away at their own powers. A classic example in this regard is the powers assigned to metropolitan areas under

dual federalism. Fiscal federalism literature suggests that large metropolitan areas should have autonomous two tier regional governments with powers equivalent to that of a province and with direct interface with the centre. For this reason, Tokyo, Shanghai and Beijing, Bangkok, Seoul and Helsinki local governments are treated by Japan, China, Thailand, South Korea and Finland respectively as provinces. In contrast, in India and Pakistan, where provinces are relatively more powerful, metropolitan areas with large populations and significant economic bases such as Mumbai (21 million people with a large and dynamic tax base), New Delhi, Karachi and Lahore among others are treated as typical local governments with limited autonomy. Such treatment deprives residents of the benefits of home rule and constrains their efforts in local economic development.

- Adverse impact on public service provision. Concentration of administrative power at the provincial level may create significant inefficiencies in public service provision. These inefficiencies can be exacerbated by breadth of provincial control. These controls may also limit private and not-for-profit sector participation in improving access to public services. Shah et al. (1996) document these concerns for Pakistan.
- Fragmentation of Internal Common Market. Empowered provinces also have the potential to create internal barriers to trade and factor mobility through domicile (residence) requirements and by creating protective regulatory and trade barriers across provincial borders. Mature federations like the USA have circumvented these problems through interstate commerce clause in the constitution. These barriers, however, are formalized in the political and bureaucratic system of India and Pakistan resulting in fragmented common economic union. The 18th Amendment has expanded the powers of the provinces to create barriers to factor mobility by allowing provinces to enact three years' domicile requirements for access to provincial public employment.
- Increased Threat of Succession. Empowering provinces represent a potential threat to the political union especially in countries with ethnic, linguistic and religious divides and having smaller number of provincial jurisdictions with one or more dominant provinces such as Pakistan. Fiscal federalism literature shows that as a rule of thumb all dual federalism models with less than 10 provincial jurisdictions are likely to face internal conflicts and potential political instability.
- Diminished economic relevance of intermediate order of government (provinces and states) under glocalized governance. Finally and most importantly globalization and information revolution are working to make the economic role of provinces largely redundant. Globalization empowers supranational regimes and local governments at the expense of national and provincial governments. Globalization also implies that international competitiveness of a nation is decoupled from its resource base but directly linked with its knowledge base. This suggests a greater role of national government in financing education and training. National government also assumes greater importance in social risk management due to vagaries of global system and social dumping by corporations to stay internationally competitive. National government also assumes a greater role in securing a common economic union. Provincial economic role on the other hand is on the wane as the information revolution makes national coordination and oversight over local governments and horizontal coordination at the local level through inter-local partnerships feasible as done in Finland. In view of the above pressures, states and provincial governments

are under growing tension to reposition their roles to retain economic relevance. The political role of states and provinces, however, remains strong in all nations and even on the rise in some nations as in Germany, Pakistan and India. In Germany, the Lander has assumed a central role in implementing European Union directives and in policy making for regional planning and development. In India, states have effectively blocked implementation of the 73rd and 74th amendments passed in 1992 to the Constitution empowering local governments. In Pakistan provinces have recently moved to scale back the fiscal and administrative autonomy of local governments. Economic interests in an information age on the other hand warrant that the modern role of a local government is to deal with market failures as well as government failures. This role requires a local government to operate as a purchaser of local services, a facilitator of networks of government providers and entities beyond government, and a gatekeeper and overseer of province/state and national governments in areas of shared rule. Local government also needs to play a mediator's role among various entities and networks to foster greater synergy and harness the untapped energies of the broader community for improving the quality of life of residents. Globalization and the information revolution are reinforcing those conceptual perspectives on a catalytic role for local governments. This view is also grounded in the history of industrial nations especially Nordic countries and ancient civilizations of China, India and Pakistan. Local government was the primary form of government until wars and conquest led to the transfer of local government responsibilities to central and provincial/regional governments. This trend continued unabated until globalization and the information revolution highlighted the weaknesses of centralized rule for improving the quality of life and social outcomes. This view is also relevant for carving and sustaining a competitive edge in international economic relations as demonstrated by the recent experience of China. Empowering local governments and strengthening their role in local economic development ushered China in an era of sustained economic growth and lifting billions out of the poverty trap (see Box 1).

Box 1 **China is Shining on World Economic Stage—Thanks to unshackling of local govt.**



China is an economic powerhouse poised to assume world economic leadership in the coming decades. It had a sustained record of economic growth (average annual growth rate in real per capita GDP of 10% over the past three decades resulting in nearly tripling of per capita income from 1978 to 2010) and prosperity. Its record in alleviating poverty is unparalleled in the economic history of the world—reducing poverty headcount rate from 31% in 1978 to less than 2% in 2008. These facts are well known. But what is less well known is that this came about because Deng Shao Peng in 1979 unshackled local governments and unleashed their innovative spirits and energies in pursuit of economic growth and local economic development.

China has one of the most empowered local governments serving their residents from cradle to grave. Local Government command 89% share of public sector employment and 51% share of consolidated public expenditures. Other than defense, debt and foreign affairs that are the exclusive domain of the Center, all other functions including education, health, and social insurance are the responsibility of local governments. There is no uniform model and all local governments pursue their own unique approach to service delivery and local economic development. Contracting out service delivery to autonomous service units is practiced widely. The Provincial role is weak and largely limited to agriculture and providing coordination and oversight of local governments on behalf of the centre. Thus China while having a unitary constitution bears affinity to an hour glass model of federalism. There is strict government accountability to citizens at all orders through directly elected people's congress at each level. In addition, the Communist Party Oversight Committees at each level monitor citizen satisfaction as well as dissatisfaction (number of protests). Higher level oversight of local governments is based on objective results based criteria that incorporates: (a) local economic development performance measured by rate of growth of local per capita GDP; (b) local service delivery performance; and (c) citizen satisfaction.

Local government success is rewarded by greater local autonomy and sustained failure is punished by reduced autonomy and intrusive oversight and controls by higher order governments. As an aside, it may also be noted that in China there was prohibition on local borrowing. However, access to capital finance was critical in dealing with infrastructure deficiencies to foster local economic development. The Chinese local governments were able to overcome this constraint by borrowing through their autonomous agencies to finance capital spending on productive physical assets such as school buildings, hospitals, roads etc. A recent report by the State Audit Commission has confirmed that such borrowing did not pose any serious risks to macro stability in China.

Source: Qiao and Shah, 2006

Potential Risks: Province Building May Not Always Be Compatible With Nation Building

48. The 18th Amendment represents both opportunities and challenges. The following takes stock of major challenges that may arise from provincial empowerment.

Challenges to Peace and Order

49. As Pakistan has only a handful of unbalanced federating units, potential for federal-provincial and inter-provincial conflicts are significant and accentuated with empowered provinces and the CCI may not be in a position to deal with such hot button issues. There is even a greater potential of intra-province conflicts as is already happening in Sindh. Federal role in the war on terror may also be circumscribed as law and order functions especially police protection now primarily rests with the provinces.

Challenges to Good Government

50. As outlined earlier, 18th Amendment supported a model of multi-order governance which may not be in tune with the needs of Pakistan today. For this model to work well, Pakistan needs enlightened leadership and professional and specialized bureaucracy at the provincial levels that work selflessly in the interest of the nation as a whole rather than simply focusing on province building. These traits are not always found even in industrial countries. Downside risks, as discussed below, in the absence of appropriate checks and balances could be significant in such an environment as demonstrated by past history of Pakistan and other nations.

51. In absence of fundamental reforms in political parties' governance, political finance, land reforms and devolution to local levels, empowered provinces may not lead to greater participation and accountability and corruption and abuse of power may continue unabated. Provincial political leadership with short-time horizon may use provincial government agencies as employment creation agencies to entrench their support base and in the process creating a leviathan model of governance. Such leadership bowing under political pressures may permit increasing role of legislators in executive functions undermining integrity, rationality and accountability of public decision making. Such role is already pervasive in Pakistan and further entrenched by special allocations for each MPA (Member Provincial Assembly). Pakistan has a civil service culture of rotating appointment which accentuates this culture of mis-governance and lack of accountability. While it has mounted several commissions to undertake comprehensive civil service reforms—all such efforts were of no avail. The 18th Amendment may have made pursuit of such reforms even more difficult.

Challenges for economic development and service delivery

52. On economic and service delivery fronts, prospects for improvements are even more uncertain. Provinces may pursue “beggar-thy-neighbor” policies and create barriers to trade and factor mobility and thereby leading to a fragmentation of the internal common market. The 18th Amendment has made it easier to pursue such policies by recognizing provincial rights to discriminate against non-residents based upon residence requirements. Given the predominance of *Manna* from heaven transfers in provincial financing, provinces have no incentives to meet national minimum standards in public services and the federal

government has no levers to induce compliance. Such standards other than respecting basic human rights are intended to facilitate integration of slow growing provinces in the broader national economy by creating a level playing field. Under the new governance arrangements, land and tax reforms would also be more difficult to accomplish in view of split of “services” from “goods” and agricultural income from ordinary income. The reform of the revenue sharing system (the NFC Awards) to introduce results-based accountability while respecting provincial autonomy may also not be feasible as provinces are unlikely to have an interest in any arrangements that move them from the status quo of “autonomy without accountability” that comes with unconditional formula-based revenue sharing federal transfers (the so-called *Manna* from heaven transfers). In absence of legal framework for fiscal responsibility, risks to macro-stability though provincial non-arms length access to bank finance can be hardly overstated. Service delivery disruptions associated with political imperatives also cannot be ruled out.

The Way Forward: Reform is Eternal

53. In order to forestall risks enumerated above, the 18th Amendment must be seen as an important first step in a series of reforms to create a responsive, responsible, fair and accountable multi-order governance in Pakistan. These reforms agenda could include:

At the Federation Level

54. Intermediate run:

- To develop a coordinated response to ensure liberty and safety of life and property and ensuring the success of the war on terror.
- To institute a framework for ensuring that there are no barriers to trade and factor mobility.
- To develop a framework for transparency of all government operations and establishing compliance with the citizens's right to information.
- To institute a legal framework for fiscal responsibility binding on all orders of government. This framework should introduce hard controls with objective escape clauses on borrowing, deficits and debt and expenditures on wages and benefits as a share of public expenditure and prohibition on government ownership of financial sector institutions for all orders of government as was done in Brazil in 2000.

55. Long run:

- To develop a framework for tax base harmonization and income/sales attribution and allocation rules.
- To establish an autonomous tax collection agency for collection of taxes for a fee at all levels and supervised by a Board of Governors comprising all orders of government and the private sector.

At the Federal Government Level

56. Intermediate run:

- To conduct an overarching reform to realign structures with new responsibilities and work out a separation program for redundant employees and closing or restructuring of redundant institutions such as the Planning Commission, HEC and NCHD.
- To carry out fast track privatization and closing the Ministry of Privatization.

57. Long run:

- To consider contracting out tax collection to autonomous tax collection agency at the federation level.
- To conduct a review of federal transfers with a view to setting national minimum standards for merit goods across the nation by introducing output-based finance to ensure monitoring of results and performance accountability.

At the Provincial Government Level

58. Intermediate run:

- To conduct a strategic overarching review of provincial government finances and operations to ensure that the provinces can meet challenges in service delivery associated with the new empowerment.
- To introduce civil service reforms to reward task specialization and accountability for results.
- To establish service standards, introduce incentives for competitive provisions and citizens based accountability mechanisms.

59. Long run:

- To rethink the role of local government as the primary agent for service delivery, local economic development and improving economic and social outcomes and introducing legislation to make that role possible.
- To consider contracting out capital value taxation, agricultural income tax and services tax to the autonomous tax collection agency at the federation level.

60. Of course, this is an ambitious reform agenda and will take some time to materialize. An important first step is for all orders of government to subscribe to the objectives of such a reform agenda and developing strategies to accomplish these objectives through formal and informal means.

Concluding Remarks

61. Pakistan during its more than sixty years of existence has moved from crisis to crisis. An important reason for dysfunctional governance in Pakistan is lack of adherence to constitutional principles by the ruling elite. In the words of a Pakistani scholar, successive regimes in Pakistan have transformed Pakistan from a “state” to an “estate” for the ruling elites (Niaz 2010). While such a criticism may be unjustifiably too harsh, it nevertheless captures a growing negative perception about public sector performance in Pakistan. The 18th Amendment is well intentioned to bring a greater clarity in roles and responsibilities of various orders of government and to ensure greater provincial autonomy to reduce incentives for military interventions in the political system. This amendment, must however be seen as only the first and an incomplete step toward reforming public governance in Pakistan. To complete this process further, fundamental reforms are needed to ensure that the public sector serves public interest and secures a common political and economic union. Important steps in this direction would include devolution to local governments and a framework for fiscal responsibility and fiscal discipline for all orders of government. There is an enormous unfinished agenda for reform that needs to be undertaken over the coming years. A beginning must be made now by recognizing the need for reforms and developing a strategy to develop national consensus on the directions for reform. In the words of a Chinese philosopher, all long journeys start with small steps. The 18th Amendment must be seen as that first step in the long journey to restore Pakistan to its original glory. Indeed the reform process is eternal. We may never fully succeed but we must keep trying.

Annexure A.

Conceptual Perspectives on Multi-order Governance in an Information Age

62. In this the paper takes a step back from the governance model adopted by the 18th Amendment and takes a conceptual and international perspective on the same issue. It reviews traditional models of federalism and their relevance for the information age and reflects upon new governance structures required for economic success in the globalized and interconnected world. In doing so, it draws heavily upon the analysis presented in Shah (2010) and Boadway and Shah (2009).

Traditional Models of Federalism and Their Relevance for the 21st Century

63. Federalism represents either a “coming together” or a “holding together” of constituent geographic units to take advantage of greatness and smallness of nations. Traditionally it represented a “foedus” (treaty or compact or alliance) among states (provinces) “each of which recognized the legitimacy of an overarching central government to make decisions on some matters once exclusively the responsibility of individual member states” as done in the USA (Inman 2007). “Coming together” has been the guiding framework for mature federations such as the United States, Canada and more recently the European Union. The alternative “holding together” view of federalism, also called the “new federalism” represents an attempt to decentralize responsibilities from federal government to the states or provinces with a view to overcome regional discontent with central policies and forestall secessionist tendencies. This view is the driving force behind the current interest in principles of fiscal federalism in unitary countries and relatively newer federations such as Brazil, India and Pakistan and emerging federations such as Iraq, Nepal, Spain, Sri Lanka and South Africa. In Pakistan this was the primary motivation for unanimous consent to a recent passing of the 18th Amendment to the Pakistan’s Constitution to empower provinces. The 18th Amendment eliminated the concurrent functions list (overlapping functions) and clarified separate and distinct responsibilities of federal and provincial governments. In doing so, it moved away from the earlier “layer-cake” model of dual federalism to a “coordinate authority” model. Under the layer-cake model that prevailed in Pakistan till 2010, there was a hierarchical relationship among federal, provincial and local government with the federal government at the apex as the dominant player. Under the coordinate authority model of dual federalism adopted by the 18th Amendment, provincial government would enjoy significant autonomy from the federal government and local governments would be simply creatures of the provincial government.

64. Federal countries broadly conform to one of two models: dual federalism or cooperative federalism. A third model, the so called ‘competitive federalism’ where all governments have overlapping responsibilities and compete vertically and horizontally to establish their clientele of services, is simply a theoretical construct and not practiced anywhere. Under dual federalism, federalism compact is between federal and provincial governments and they have separate and distinct responsibilities and local governments are typically creatures of the provinces as in Canada, USA, India and Pakistan. Under cooperative federalism, central and provincial roles can assume one of three forms: interdependent spheres as in Germany, marble cake with overlapping responsibilities as in Belgium or independent spheres as in Brazil. In all these models with the sole exception of

independent spheres model, provinces have a strong constitutional role and local governments remain creatures of provinces and states.

65. The dual federalism model empowers provinces and states. This is considered a welcome move as it moves decision making somewhat closer to people and it also has the advantage of dealing with ethnic and linguistic conflicts if provinces are numerous and are small enough in geographic area and represent population with relatively homogeneous characteristics and similar tastes and preferences for a menu of taxes and public services (such as Cantons in Switzerland). If provinces are properly delineated as economic regions then they could also enhance efficiency of the internal common market by exploiting economies of scale and scope. They also have the potential to deal with inter-local spillovers and intra-regional inequities. Provincial governments can also be responsive to citizen preferences if provincial government is not captured by feudal, industrial and military elites. The absence of well developed communication and transportation system and a lack of urbanization also make provinces almost a necessity for countries that span a large geographic area. The above mentioned potentials have limited relevance for Pakistan as Pakistan has only handful (four) of large provinces with heterogeneous ethnic and linguistic populations and one dominant province having majority of population. Historical record from other countries shows that federal countries with less than eight constituent units have typically been politically unstable. The provincial boundaries in Pakistan are not synonymous with economic region but historical accidents represent the best wisdom of the British colonial empire for control. There is also significant degree of feudal, military and elite capture of provincial governments. Pakistan has a well developed communications and road infrastructure network which also diminishes the economic relevance of the provinces.

66. The dual federalism model empowering provinces, nevertheless, has significant conceptual shortcomings. These include:

- Tragedy of Commons Associated with Common Pool Resources.
- A Leviathan model of governance.
- Agency problems with incomplete contracts. Weaker and Fragmented Local Governance.
- Stifling local innovations.
- Adverse impact on public service provision.
- Fragmentation of Internal Common Market.
- Increased Threat of Succession.
- Diminished economic relevance of intermediate order of government (provinces and states) under glocalised governance.

67. In conclusion federalism (multi-order governance) practices around the world are focused on structures and processes, with little regard for outputs and outcomes. These practices support top-down structures with preeminent federal legislation (that is, federal legislation overrides any sub-national legislation). The central government is at the apex, exercising direct control and micromanaging the system. Hierarchical controls exercised by various layers of government have an internal rule-based focus with little concern for their mandates. Government competencies are determined on the basis of technical and administrative capacity, with almost no regard for client orientation, bottom-up

accountability, and lowering of transaction costs for citizens. Various orders of government indulge in uncooperative zero-sum games for control. This tug of war leads to large swings in the balance of power. Shared rule is a source of much confusion and conflict, especially in federal systems. Local governments are typically creatures of states or provinces and given straitjacket mandates. They are given only limited home rule in their competencies. In short, local governments in this system of “federalism for the governments, by the governments, and of the governments” get crushed under a regime of intrusive controls by higher levels of governments. Citizens also have limited voice and exit options.

68. The governance implications of such a system are quite obvious. Various orders of government suffer from agency problems associated with incomplete contracts and undefined property rights, as the assignment of taxing, spending, and regulatory powers remains to be clarified—especially in areas of shared rule. Intergovernmental bargaining leads to high transaction costs for citizens. Universalism and pork-barrel politics result in a tragedy of commons, as various orders of government compete to claim a higher share of common pool resources. Under this system of governance, citizens are treated as agents rather than as principals.

Multi-Order Governance Structures for a Globalized and Localized World

69. Globalization and the information revolution are profoundly influencing economic governance in both the industrial and the industrializing world. Globalization has lifted millions of people out of poverty and the information revolution has brought about a degree of citizen empowerment and activism in state affairs that is unparalleled in past history. They have also acted as catalysts for “reshuffling” government functions within and beyond nation states (Friedman 1999, Courchene 2001, Castells 1998, Shah 1999, 2002, Boadway and Shah 2009). Globalization has also meant liberating markets and bringing market discipline to governments. Recent global financial crisis has significantly shattered common faith in the workings of free markets. Providing bailouts to markets have also endangered the fiscal health of governments around the globe while creating a crisis in public confidence in national politics and leadership. Because of globalization, it is increasingly apparent that “the nation-state is becoming too small for big problems of life, and too big for the small problems of life” (Bell 1987).

70. In other words, nation-states are gradually losing control of some of their customary areas of authority and regulation, including macroeconomic policy, corporate taxation, external trade, environment policy, telecommunications, and financial transactions (see Box A1). Globalization is also making small open economies vulnerable to the whims of large hedge funds and polarizing the distribution of income in favor of skilled workers and regions with higher skills and access to information, thus widening income disparities within nations while improving overall levels of incomes and standards of living. Because of the information revolution, governments have less ability to control the flow of goods and services, ideas, and cultural products. The twin forces of globalization and the information revolution are also strengthening localization. They are empowering local governments and “beyond-government” service providers such as neighborhood associations, non-governmental, non-profit and for-profit organizations, self-help groups and networks to exercise a broader role in improving economic and social outcomes at the local level through greater connectivity to markets and resources elsewhere. Localization is leading to citizen empowerment in some areas while simultaneously strengthening local elites in others. Courchene (1993, 2001) has

termed the overall effect of these changes “glocalization”, which implies the growing role of global regimes and local governments and beyond government entities and changing roles of national and provincial (state) governments in an interconnected world. The culture of governance is also slowly changing from: a bureaucratic to a participatory mode of operation; from a command-and-control model to one of accountability for results; from being internally dependent to being competitive and innovative; from being closed and slow to being open and quick; and, from being intolerant of risk to allowing freedom to fail or succeed. Recent global financial crisis has hampered this change, but with improved macro-stability in future, the new vision of governance is expected to gradually taking hold in the 21st century (see Table A1). Nevertheless, in many developing countries, this vision may not take hold or may take a long time to materialize because of political and institutional difficulties.

Box A1 Emerging Rearrangements of Government Assignments: Glocalization

Beyond nation-states: Regulation of financial transactions, corporate taxation, international trade, the global environment, telecommunications, international standards, international migration, surveillance of governance conditions, global security and risk management, transnational production, investment and technology transfer, combating of money laundering, corruption, pandemics, and terrorism.

Centralization (federal functions): Social and environmental policy through international agreements, skills enhancement for international competitiveness, securing common economic union through bridging economic, social and digital divide within nations, social safety nets, oversight, financing of education, social services and technical assistance to sub-national governments.

Localization and privatization: all regional and local functions.

Table A1 Emerging Rearrangements of Government Assignments: Glocalization

20th century	21st century
Centralized or provincialized	Globalized and localized
Center that manages	Center that leads
Citizens as agents, subjects, clients and consumers	Citizens as governors and principals
Bureaucratic	Participatory
Command and control	Responsive and accountable
Internally dependent	Competitive
Closed and slow	Open and quick
Intolerance of risk	Freedom to fail or succeed
Focus on government	Focus on governance with interactive direct democracy
Competitive edge for resource based economies	Competitive edge for human capital based economies
Federalism as a tool for coming together or holding together	Global collaborative federalism with a focus on network governance and reaching out
Local governance based upon residuality principle, ultra vires, “Dillon’s rule”	Local governance based upon community governance principle, subsidiarity principle, home- or self-rule and shared rule
Limited but expanding role of global regimes with democracy deficits	Wider role of global regimes and networks with improved governance and accountability
Emerging federal prominence in shared rule	Leaner but caring federal government with an enhanced role in education, training, and social protection
Strong state (province) role	Ever-diminishing economic relevance of states

20th century	21st century
	(provinces) and tugs-of-war to retain relevance
Diminishing role of local government	Pivotal role of local government as the engine of economic growth, primary agent of citizens, gatekeeper of shared rule, facilitator of network governance; wider role of “beyond government” entities, mediator of conflicts, developer of social capital; purchaser but not necessarily provider of local services
Tax and expenditure centralization with revenue sharing and input based conditional grants to finance subnational expenditures	Tax and expenditure decentralization with fiscal capacity equalization and output-based national minimum standards grants

Source: Boadway and Shah (2009)

71. The three emerging trends resulting from this mega change in the shifting balance of powers within nations are: (i) the role of central government is slowly changing from that of a managerial authority to a leadership role in a multi-centered government environment with enhanced emphasis on securing a common economic union through economic and social risk management and dealing with economic and digital divide within nations; (ii) a steady erosion in the economic relevance of the role of the provinces (used inter-changeably with states in this paper)—the second (intermediate) tier, and (iii) an enhanced but redefined role of local government in multi-order governance to serve as the primary agent of people providing oversight on the shared rule and as a facilitator for network governance for economic and social uplift of its residents. Japan, Nordic countries, Switzerland and China appear to have local government role more consistent with the demands of new world economic order listed above. In these countries, intermediate orders of government have limited (China) or no role (Nordic countries).

72. The role of local government is expansive in Nordic countries (Denmark, Norway, Sweden and Finland), Switzerland and China. In Nordic countries, local governments act as the primary agent of citizens and provide a broad role in support of a client-oriented welfare state. For example, in Finland, local governments assume a predominant role in social services (Moisio, Loikkanen and Oulasvirta 2010). In Switzerland cantons (higher order of local governments) enjoy autonomy not only in fiscal matters but also in such areas as immigration, citizenship, language and foreign economic relations. China affords its local governments one of the strongest roles in local economic development. Local governments below provincial level employ 89% of the public workforce and command 51% of public expenditures. A unique feature of local government in China is that local autonomy varies directly with success in local performance as measured by local economic development, service delivery and citizen satisfaction

Some Lessons on the Role of Local Governments

73. Historical evolution and the current practices of local governance are instructive in drawing lessons for reform of local governance. There is great diversity in practice in local governance in industrial countries, but there are also some common strands. The diversity is in the institutional arrangements, which have evolved incrementally over a long period. This evolution has resulted in diverse roles for local governments and diverse relations with central governments across countries. In Nordic countries, local government serves as the primary agent of the people, whereas in Australia, that role is entrusted to state governments, and local government has a minimal role in local affairs.

74. There is no uniform model for local government size, structure, tiers, and functions across OECD countries. There are nevertheless a number of interesting common features. First, most countries recognize that finance must follow function to ensure that local governments are able to meet their responsibilities efficiently and equitably. Second, home rule is considered critical to meeting local expectations and being responsive to local residents. Therefore, local governments must have significant taxing, spending and regulatory autonomy, and they must have the ability to hire, fire, and set terms of reference for employees without having to defer to higher levels of governments. Only then can local governments innovate in management by introducing performance-based accountability and innovate in service delivery by forging alternative service delivery arrangements through competitive provision, contracting, and outsourcing wherever deemed appropriate as done in Finland (see Moisio, Loikkanen and Oulasvirta 2010). They can also facilitate a broader network of local governance and harness the energies of the whole community to foster better social outcomes. Third and most important, accountability to local residents has been the most critical success factor of local governance in industrial countries. This accountability is strengthened through democratic choice, participation, transparency, performance budgeting, citizens' charters of rights, and various legal and financing provisions that support wider voice, choice and exit options to residents.

75. In conclusion, a synthesis of the conceptual literature suggests that the modern role of a local government is to deal with market failures as well as government failures. This role requires a local government to operate as a purchaser of local services, a facilitator of networks of government providers and entities beyond government, and a gatekeeper and overseer of province/state and national governments in areas of shared rule. Local government also needs to play a mediator's role among various entities and networks to foster greater synergy and harness the untapped energies of the broader community for improving the quality of life of residents. Globalization and the information revolution are reinforcing those conceptual perspectives on a catalytic role for local governments. This view is also grounded in the history of industrial nations especially Nordic countries and ancient civilizations of China, India and Pakistan. Local government was the primary form of government until wars and conquest led to the transfer of local government responsibilities to central and provincial/regional governments. This trend continued unabated until globalization and the information revolution highlighted the weaknesses of centralized rule for improving the quality of life and social outcomes. The new vision of local governance presented here argues for a leadership role by local governments in a multi-center, multi-order or multi-level system. This view is critical to creating and sustaining citizen-centered governance, in which citizens are the ultimate sovereigns and various orders of governments serve as agents in the supply of public governance. This view is also relevant for carving and sustaining a competitive edge in international economic relations as demonstrated by the recent experience of China. Empowering local governments and strengthening their role in local economic development ushered China in an era of sustained economic growth and lifting billions out of the poverty trap.

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