Fourth Annual Report
2011

STATE OF THE ECONOMY

Devolution in Pakistan

INSTITUTE OF PUBLIC POLICY
Beaconhouse National University, Lahore

IPP's Fourth Annual Report
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Institute of Public Policy
Beaconhouse National University

Institutional backing is absolutely essential to policy makers of today, to guide their actions in promoting development and peace. These are times of change and challenge. There is a need for policy makers to base the policies on sound analytical work. Therefore, The Beaconhouse National University established the Institute of Public Policy (IPP) as an independent, private sector think tank for research on economic, social, political and foreign policy issues.

IPP's mission is to "work in the areas of importance for improving the welfare of the citizenry. Its work will focus in particular on public policies in areas of economics, social and political development, as well as on foreign policy".

Key activities of the Institution include: independent and objective analysis of the economy; strategic analysis of the concepts and doctrines in selected areas of public policy; research in the areas that are important for regional cooperation; seminars and workshops to bring together policy makers, experts and other members; funded research projects and dissemination of research findings with the view to enhance public awareness and contribute to debate on issues of public policy.

The IPP Executive Council consists of eminent personalities devoted to improvement of public policy in Pakistan. The members are:

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- Mr. Sartaj Aziz — Ex-officio Member, Vice Chancellor, BNU

Dr. Aisha Ghaus-Pasha is the Director of the Institute.

PREFACE

The fourth Annual Report of the Institute of Public Policy (IPP) is being released at a time of gloom and turmoil, not just in Pakistan but throughout the world. The after-effects of the global financial crisis of 2008-09 are still being felt, especially in Europe. The catastrophic earthquake and Tsunami disaster on 11 March literally shook the whole world. All nations with nuclear plants are now wondering, in the wake of the uncontrolled radiation of Japan's nuclear power plants, if there is any really safe and dependable source of affordable energy for the future. And as a climax to this turbulence, the social uprising in the Arab World, with thousands of young protesters revolting against their well entrenched dictators in Tunisia, Egypt, Syria, Yemen and Libya, has created unprecedented turmoil in a very volatile region of the world with far reaching ramifications for the geo-political landscape.

These global and regional events have naturally compounded the atmosphere of uncertainty and impending doom that has been spreading in Pakistan throughout the past four years. The demographic time bomb that has exploded in so many Arab countries is also ticking in Pakistan. This report analyzes the main problems that confront the economy and the society as a whole and offers some suggestions to the policy makers and other stakeholders to overcome these problems.

The key to the solution of many of these problems, especially inflation and unemployment, is in accelerating the growth of the economy and especially export-led growth. But to be meaningful, accelerated growth will require not only a higher level of private investment but also a pattern of growth that benefits the low income segments of society. The growing 'disconnect' between growth and living standards of the poor is caused partly by the rising share of inefficient and inequitable public spending and partly by very slow pace of job creation. The longer term social consequences of rising poverty and unemployment, as many developing countries have discovered, can be very high.

A very worrisome finding presented in this report is the imbalance between growth and investment. Despite a sharp reduction in the flow of foreign resources, the availability of domestic resources has grown by five percent per annum between 2008 and 2010. But these domestic resources did not promote investment because fixed capital formation actually fell by 13 percent over this period. They went to higher private consumption. This sharp and unusual increase in private consumption of the rich is clearly visible in the shopping malls, wedding halls and luxury hotels of Pakistan. It also reinforces the growing public perception that the rich are getting richer and the poor are getting poorer in Pakistan, not because of hard work and innovation but largely due to corruption, rent seeking and political patronage.

The basic message from the analysis of medium-run scenarios generated by the IPP Macroeconomic Model is that the economy today is poised on the 'knife edge'. With improved governance and implementation of a wide ranging reform agenda, the economy could get back to the path of relatively high growth. But with business as usual, that is, a weak coalition government with increasing propensity to populism as elections approach, we face the prospect of a major financial crisis within the next twelve to eighteen months.

The special focus of this year's Report is devolution and decentralization. This important subject has been addressed at three different levels:

First, devolution of powers and financial resources from the federal government to the provincial governments. The 18th Amendment of the Constitution, adopted by the Parliament after a broad-based consensus among all political parties in April 2010, has been a landmark event in the political history of Pakistan. It not only restores the balance of power between the President and the Parliament, but also could strengthen the federation by enhancing the degree of provincial autonomy. This is a welcome development, but its implementation would neither be easy nor smooth. As pointed out in Chapter-7, building up the capacity of the provincial governments to take over these additional functions will need some time. Meanwhile, the quality of service delivery to the people may decline, along with a fall in financial allocations for social sectors because of shortfall in resources promised under the 7th National Finance Commission Award (NFC) Award. Resources available with the provinces as such may not be adequate to discharge these new responsibilities. Emphasis will have to be placed by provinces on development of taxes on agriculture, services and real estate.

The *second* dimension of devolution is deepening the process of decentralization from the provincial to local level. It is really unfortunate that despite extensive experimentation over the past fifty years, Pakistan has not been able to evolve a sustainable system of local government. The basic cause of this failure to establish a durable system springs from the civil - military relationship in the governing structure of Pakistan. Whenever a military regime takes power in Pakistan, local government institutions start flourishing because these institutions are the only representative institutions and create a democratic façade in the country. But with the revival of national and provincial assemblies, the local government institutions set up by a military regime lose their importance and some new experiment is initiated to shift the focus of local political support to the parties in power. The Report presents some important recommendations, based on in-depth analysis, on how the functions and financial resources should be decentralized so that local government institutions are strengthened and not weakened.

The *third* part deals with grass-root decentralization through participatory institutions set up and managed by the people to get out of the poverty trap through social mobilization, empowerment and income generation. This section contains an objective analysis of participatory organizations working in Pakistan at present and the manner in which the coverage and effectiveness of different approaches can be expanded and improved.

I hope these recommendations, taken together, will provide useful guidelines to policy makers and other stakeholders as they grapple with these fundamental problems and challenges. Pakistan today stands at the threshold of history and history will not forgive us if we are unable to face these multi-dimensional and complex challenges with resolve, wisdom and sincerity.

Sartaj Aziz
Vice Chancellor
Beaconhouse National University

The Institute of Public Policy is grateful to the Asia Foundation for its financial support for the preparation, publication and dissemination of this Report.

FOREWORD

This, the fourth Annual Report of the IPP, is being released at a very difficult moment in Pakistan's history. Turbulence in the country's affairs has reached a very high level. This is reflected in the language of the Report. In fact our tone has become more somber with each Report. In 2008, we adopted a stance that showed worry but hope. That changed in 2009 to great concern and then a year later to a deep feeling of anxiety. This time the analysis we have presented reflects considerable apprehension about the country's future. In light of what is happening on the streets of the Middle East, we have given some attention to what political economists call "relative deprivation", the feeling and emotions generated among those is believe that they are being left behind while a narrow segment of the population is able to move ahead. This happens – or so a large section of the population believes – when the state fails to deliver the services the people want and only the state can provide. There is a consensus among the analysts who are studying the explosions in the Middle East that the reason why they happened has more to do with economics, not so much with ideology.

Both data and observation in Pakistan suggest that the feeling of deprivation is increasing rapidly in the country. There is also considerable and growing unhappiness with the quality of governance being provided. Democracy was supposed to bring all manner of benefits to the people. They have not materialized. And yet, there does not seem to be an interest in changing the structure of governance once again. Pakistan's past roller-coaster political ride with rule by the military alternating with rule by civilian politicians, with three different constitutional arrangements put in place and with two of these thrown over board, and with experimentation involving half a dozen systems of local government, Pakistan has reached the point where institutional changes should be at the margin. In spite of the scope of the 18th Amendment, this is what is happening. People's frustration with the quality of governance, we hope, will result in improving the framework within which it is being provided.

Since these reports are produced by a public policy institute, they are based on deep analysis and research. In 2009 we presented estimates of the cost to the economy of the power shortage and domestic terrorism. They were based on the methodologies developed at the institute. Last year we focused on detailing the outcomes of two important developments – the announcement of the 7th NFC and the passage of the 18th Amendment to the Constitution. Both will make the federating provinces more responsible for managing their affairs. We applauded these moves in the belief that a government that works closer to the people is a better government. This year we have provided further analysis into these two important initiatives by estimating their financial consequences. However, the important analytical advance we are making in this Report is the use of a multi-equation macroeconomic model, developed at the institute, to present two scenarios for the country's economy over the next four years.

The "best case" scenario is based on the assumption that the policymakers will gather the political will to take some brave decisions that will change the structure of the economy. These will be concentrated in particular on the fiscal side which then will reflect positively on other aspects of the economy. Were this scenario to become a reality, Pakistan would see its rate of Gross Domestic Product (GDP) growth increase from the paltry 2.2 percent in 2010-11 to 6.5 percent four years later, in 2014-2015. Under the “worst case” scenario, that sees further weakening in the policy stance, the rate of growth drops to 2.8 percent. The difference between these two scenarios is equivalent to Rs 9000 per capita. Reports are written, published and launched in the expectation that they will help the policy makers to make policies. One of our sponsors, Asia Foundation, requested that we make this Report available no later than the end of April. May and June are important policy making months and having our analysis at hand may help those who are charged with that function.

The Report is a collective effort by the same group of people who authored the previous documents. That said, I would like to thank in particular Aisha Ghaus-Pasha, Director IPP, for the extraordinary amount of effort put by her to see the Report hit the desks of the policy makers. Our thanks are also due to Asia Foundation for providing financial support for this effort.

Shahid Javed Burki
Chairman
Institute of Public Policy

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ACRONYMS

ABD	Asian Development Bank
AC	Assistant Commissioner
ADP	Annual Development Programme
AIT	Agricultural Income Tax
AJK	Azad Jammu and Kashmir
AKRSP	Aga Khan Rural Support Programme
ALPMGD	Agricultural and Livestock Products Marketing and Grading Department
API	Agriculture Policy Institute
BNU	Beaconhouse National University
CCI	Council of Common Interest
CDG	City District Government
CGT	Capital Gains Tax
CIM	Central Inspectorate of Mines
CO	Community Organization
CVT	Capital Value Tax
DCO	District Coordination Officer
DDWS	Directorate of Dock Workers Safety
DFID	Department for International Development
DNA	Damage and Need Assessment
DPP	Department of Plant Protection
DWE	Directorate of Workers Education
EDO	Executive District Officer
ENERCON	National Energy Conservation Centre
EOBI	Employees Old-Age Benefits Institution
EU	European Union
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FBS	Federal Board of Statistics
FDE	Federal Directorate of Education
FDI	Foreign Direct Investment
FE	Foreign Exchange
FED	Federal Excise Duty
FLL	Federal Legislative List
FSC&RD	Federal Seed Certification and Registration Department
GB	Gilgit Baltistan
GDP	Gross Domestic Product
GNI	Gross National Income
GNP	Gross National Product
GoP	Government of Pakistan
GST	General Sales Tax

HDC	Human Development Centre
HEC	Higher Education Commission
IC	Implementation Commission
ICOR	Incremental Capital Output Ratio
ICRIER	Indian Council for Research in International Economic Relations
ICT	Islamabad Capital Territory
ICTL	International Conference on Teaching and Learning
IMF	International Monetary Fund
IPD	Inverse Population Density
IPP	Institute of Public Policy
ITNE	Implementation Tribunal for Newspaper Employee
LGA	Local Government Act
LGO	Local Government Ordinance
LUMS	Lahore University of Management Sciences
MDGs	Millennium Development Goals
MEPPAI	Monitoring, Evaluation and Participatory Poverty Assessment Institute
MIS	Management Information System
MQM	Muttahida Quami Movement
MTDF	Medium Term Development Framework
NAB	National Accountability Bureau
NDMA	National Disaster Management Authority
NEC	National Economic Council
NFC	National Finance Commission
NGO	Non Governmental Organisation
NILAT	National Institute of Labour Administration Training
NPL	Non Performing Loans
NRO	National Reconciliation Ordinance
NRSP	National Rural Support Programme
NTB	National Training Bureau
NTCIP	National Trade Corridor Improvement Project
NTP	National Talent Pool
NWR	North Western Railways
O&M	Operation and Maintenance
P&D	Planning and Development
Pak EPA	Pakistan Environmental Protection Agency
PARC	Pakistan Agriculture Research Council
PASSCO	Pakistan Agriculture Storage and Supplies Corporation
PCCC	Pakistan Central Cotton Committee
PDDC	Pakistan Dairy Development Company
PEPCO	Pakistan Electric Power Company
PFCs	Provincial Finance Commissions
PFI	Pakistan Forest Institute
PIA	Pakistan International Airlines

PIBs	Public Investment Bonds
PIDE	Pakistan Institute of Development Economics
PIEDAR	Pakistan Institute for Environment-Development Action Research
PMI	Pakistan Manpower Institute
PMU	Project Management Unit
PODB	Pakistan Oil Seed Development Board
POL	Pakistan Oilfields Limited
PPA	Participatory Poverty Assessment
PPAF	Pakistan Poverty Alleviation Fund
PRSP	Punjab Rural Support Programme
PSDP	Public Sector Development Programme
PTDC	Pakistan Tourism Development Corporation
PIUs	Produce Index Units
RAC	Revenue Advisory Council
RGST	Reformed General Sales Tax
RSP	Rural Support Programme
SAFRON	States and Frontier Region
SAP	Social Action Programme
SBA	Stand-By Agreement
SBP	State Bank of Pakistan
SDPI	Sustainable Development Policy Institute
SOP	Soil Survey of Pakistan
SPDC	Social Policy and Development Centre
SRSC	Sarhad Rural Support Corporation
SRSP	Sindh Rural Support Programme
TI	Transparency International
TVO	Trust for Voluntary Organizations
UC	Union Council
UIPT	Urban Immovable Property Tax
USA	United States of America
VAT	Value Added Tax
VTIs	Vocational Training Institutes
WAPDA	Water and Power Development Authority
WB	World Bank
WPPF	Workers Profit Participation Fund
WTO	World Trade Organisation
WWF	Worker Welfare Fund
ZSD	Zoological Survey Department

Executive Summary

Still Stumbling but Seeking to Gain Balance and Move Forward

Executive Summary: Still Stumbling but Seeking to Gain Balance and Move Forward

This, the fourth Annual Report of the IPP, was written at an exceptionally difficult time for Pakistan. Times have been difficult for the country ever since the founding of the Institute and the preparation and publication of the annual reports on the state of the economy. But now in the spring of 2011 – the time of the writing of this Report – Pakistan's situation has become even more complicated with challenges emanating from several fronts. In the opening chapter of 2010 Report, we used the metaphor of a 'perfect storm' through which the economy had to navigate. The storm was affecting the country's economy, its political system and the national psyche. That metaphor seems even more befitting a year later when the dangers have increased exponentially, and policymakers as well as the citizenry is faced with tremendous amounts of uncertainty. Economies perform poorly when times are uncertain. Uncertainty also produces political and social anxiety. The most important task before the country's policymakers, therefore, is to create a degree of confidence among the citizenry. This has to be done by moving simultaneously on a number of different fronts. Islamabad and the provincial capitals need to be actively involved in improving the economic situation and to carefully devolve to the provinces a number of functions that were hitherto performed by the federal government.

Pakistan's economy today remains sluggish. While it has shown some resilience in the face of both natural disasters and the broad failure of public policy to address a number of structural weaknesses, the rate of economic growth remains low. In fact at this time, Pakistan is the worst performing economy in South Asia. Its current as well as projected rates of growth are less than one-half that of Bangladesh and one-third that of India. It has been rightly described as the 'sick man' of South Asia. The incidence of poverty is increasing, and the distribution of wealth and income is deteriorating. The country is getting increasingly isolated, unable to take advantage of the enormous changes in the global economy. One indication of the country's failure to integrate or link the economy with the international production system, is its declining share in world trade that originates in the developing parts of the world. More successful emerging economies have taken advantage of the rapidly changing and growing systems of international commerce and industrial production, but Pakistan has fallen behind.

Some of the country's more backward areas are becoming exceptionally restive. As political economists have been suggesting for several years, the feeling of 'relative deprivation' not only deepens resentment among those who are concerned that they have been left behind, their discontent also manifests itself in the form of a challenge to the authority of the state (Huntington, 1968). That is what the world has seen in the political explosion on the Arab streets. It is this discontent that has fed, to a considerable extent, domestic terrorism in Pakistan. As was emphasized in the previous two reports, continuing problems with domestic security have taken a heavy economic toll that may well last into the future. In fact in the 2009 Report, we broke new analytical ground by providing a quantitative estimate of the damage done to the economy by domestic terrorism (Institute of Public policy [IPP], 2009). We then estimated the cost of the 'war on terror' at $8.4 billion in 2008-09, equivalent to over 5 percent of the estimated GDP for that year. Indirect costs on account of loss of exports, slackening in foreign and domestic investments and decline in industrial output accounted for 83 percent of the estimated cost. Since 2004-05, the cumulative cost of terrorism was $31.43 billion, much greater than the amounts provided by the donor community in recognition of Pakistan's position as the frontline state in the war against terrorism and extremism (Ibid).

The rate of Pakistan's economic growth has also been held back by many structural problems that have been analyzed by a number of analysts and institutions, including the IPP. The rate of domestic savings remains low – it touched 13.4 percent in 2010 – which means continuing dependence on external assistance, some of which is provided by donors having strategic interests that may not match those of Pakistan. This puts enormous strains on the making of public policy, at times pushing the policymakers in the direction which may not be favourable for pursuing broader national interests, (this was demonstrated most recently by what has come to be called the Raymond Davis affair[1]). Domestic savings, which include both savings by the government and the private sector, remain low and have been steadily declining. A weak tax system means low public resource mobilization; the capture of a sizeable proportion of incremental national income by a small segment of the population, that has a strong penchant for consumption, also contributes to low rates of saving. The 2011 IPP Report provides robust estimates of the growth of consumption, in spite of the sluggishness of the economy, by a small group of people in all manner of privileges.[2] The capture by this class of the small amount of incremental national income, while the levels of poverty increase, contribute to the growing feeling of deprivation to which we have already referred above. This poses a serious problem for the policymakers which needs to be addressed. Unless dealt with some urgency, this feeling may translate into upheavals which the political system is not well equipped to handle.

Severe floods that devastated the country in the summer of 2010 contributed to Pakistan's economic difficulties. Various international and national agencies have estimated the number of people directly or indirectly affected by this particular natural disaster. More than a thousand people were killed while more than 20 million people were displaced. The number of affected people is more than one-eighth of the entire population, which has caused a severe damage to economic assets. Estimates have also been made of the amount of resources that will be required for rehabilitating the affected population, rebuilding the damaged and destroyed houses and the seriously affected infrastructure and of the resultant declines in the near and medium-term rates of economic growth. However, this once-in-a-century flood has also underscored an important weakness from which Pakistan suffers: the quality of governance. Various reports prepared by international agencies suggest that a large number of people affected by the floods remain unsettled several months after the disaster, still heavily dependent upon the largesse of the state and on international support. Poor governance was largely the reason for the less than appropriate response to the plight of these people. We deal with the issue of governance at greater length in the following chapter.

The institutional structures, that together make up the Pakistani state, have become progressively weak since the founding of the country 64 years ago. There are several reasons for this. Perhaps, the most important among them is the failure of a societal consensus on how people should be governed, resulting in constant experimentation that has gone on for six and a half decades as to the most appropriate structure of government. The country has alternated between civilian and military rule; the military was allowed to govern for 33 out of 64 years since the country gained independence. Three different constitutional arrangements were put in place, and half a dozen systems of local governments were experimented with. Constitutional provisions were not fully observed even when the civilians were in charge. In fact, the Constitution of 1973 was subverted soon after it was promulgated.

What lies in the country's economic future? We answer this question by developing two scenarios for the future – the best case and the worst case – and use a multi-equation macroeconomic model, developed for this report, to see what may happen to the economy in the years ahead. In the best case, Islamabad undertakes major tax reforms, starting with the budget of 2011-2012 , which includes the introduction of the comprehensive reformed generalized sales tax, the Reformed General Sales Tax (RGST). This will withdraw all remaining exemptions on goods and eliminates all distortions that have crept into the current system. Provincial sales tax on services will also be broadened. Wealth tax will be reintroduced, and a strong effort will be made to curb tax evasion. These measures will be seen as making the system more equitable and should improve compliance. In addition, the provinces will develop their tax systems to generate more resources from within their economies, taking advantage of some of the provisions in the 7th NFC of 2009.

On the expenditure side, the best case scenario focuses on improving the working of large loss-making enterprise on eliminating the problem of 'circular debt', that is constraining the supply of electric power from existing capacity, and careful review of the public sector development programme by placing emphasis on the completion of high priority projects. These measures will bring about a significant improvement in the government's financial situation.

Within the context of monetary policy, the best case scenario assumes that the State Bank of Pakistan (SBP) will have the autonomy to order its policies with the objective of containing inflation and not meeting the fiscal deficits of the federal government. The central bank will also let the market determine the exchange rate.

This package of measures will have a number of positive consequences including the resumption of tranche release by the International Monetary Fund (IMF), Pakistan's return to international capital markets, increase in foreign direct investment and resurgence in business confidence. With the pick-up in the rate of economic growth and increase in government revenues at the central and provincial levels, new fiscal space will be created so that there is significantly greater focus on social development and social protection policy. On the external side, there will be considerable improvement in the rate of growth in trade.

The model, referred to above, estimates the real GDP growth increasing from a low of 2.2 percent in 2010-11 to 6.5 percent four years later, the rate of investment increasing from 12.5 to 25.1 percent of GDP, the rate of inflation dropping from 14.2 to 9.8 percent and the fiscal deficit declining from 6.2 to 3.6 percent.

The worst case scenario produces a particularly grim picture of the economy. It is based on the assumption that the policymakers will not gather the political will to introduce the policy changes discussed above, allow further deterioration in the quality of governance, further decline in the delivery of public services to the citizenry including those provided by the large state-owned corporations and greater economic isolation of the country. There will be hemorrhaging of foreign exchange reserves due to a sharp increase in the current account deficit. By the end of 2012-13, foreign exchange reserves could reduce to the level equivalent to only two months of imports. There could be a serious financial crisis in the country by the second half of 2012-13, on the eve of the next set of general elections.

According to the worst case scenario, the rate of GDP increase is only 2.0 percent in 2011-12, increasing to 3.3 percent the following year, only to drop to 2.8 percent in 2014-15. The rate of investment declines from 11.5 percent to 8.5 percent, the rate of inflation increases from 14.5 to 20.1 percent and fiscal deficit grows from 7.0 to 7.6 percent. Real exchange rate drops from Rs 92 to the US dollar to Rs 133.

These illustrative scenarios raise the question of probability. What is the likelihood that the political system will have the wherewithal to introduce the reforms needed to move to the best case scenario? Or conversely, will the policy, not recognizing the consequences of inaction, allow the policy environment within which the economy is working to further deteriorate? Some of the recent developments suggest that building blocks have been gathered that could allow the construction of a political system more responsive to the needs of the people.

The country is currently operating under the Constitution adopted in 1973, but a number of aberrations crept into the basic document during twenty years of military rule, first under President Zia-ul-Haq from 1977 to 1988 and then under President Pervez Musharraf from 1999 to 2008. These were removed by the passage of the 18th Amendment, which went on to introduce a number of other changes as well to meet the needs of current times. In spite of the adoption of the Amendment, the county is living under a hybrid system of governance. The structure dejure is parliamentary, but defacto it is presidential. Governance, in other words, in terms of its quality and content is a problem that needs analysis, improvement and change.

Governance is one of the several themes to be explored in this report. This will be done in the context of two enormously important developments, that have taken place in the three-year period during which the current civilian government has held power at the centre and various forms of coalition administrations have governed in the provinces. The two developments were the announcement of the 7th NFC Award in November 2009 followed, in the summer of 2010, by the ratification by the Parliament of the 18th Amendment and its subsequent signing into law by the President. Taken together, the two initiatives will fundamentally restructure the way Pakistan will be governed in the future.[3]

The sequencing of these two efforts at reshaping the structure of the government was not in the correct order. Ideally, the 7th NFC Award should have come after the 18th Amendment was adopted. As already indicated, the Amendment devolved a large number of functions to the provinces from the centre. These functions had remained with the centre in spite of the promise made by the drafters of the 1973 constitution about their devolution within a period of ten years. In other words, the framers of the constitution had visualized a larger dose of autonomy to the provinces once the provinces had gained the capacity to handle the additional responsibilities. This might have happened had the process of political development not been interrupted by two military interventions, the first lasting for a little more than eleven years and the second a little less than nine years.

Even before the 18th Amendment was approved, the scope of provincial finances were reshaped by the 7th NFC Award issued in late 2009. The Award was qualitatively different from the previous revenue sharing arrangements in a number of important ways. The divisible pool – the pool of revenue shared among the provinces – was much larger in the new dispensation. The provincial share were determined on the basis of multiple criteria that included not just the size of the population, as in earlier arrangements, but also poverty (10.3 percent), revenue (5 percent), inverse population density (2.7 percent), special development needs of the smaller provinces, increases in straight transfers, and recognition that all taxes on services will go to the provinces. According to the budget estimates for 2010-11, Punjab's share in total federal transfers was 46.7 percent, Sindh's 26.7 percent, Khyber-Pakhtunkhwa's 17.1 percent and Balochistan's 9.5 percent. One result of the NFC Award would be to make the structure of finance in the country more federal – up until the 2009 NFC, federal government collected 92 percent of tax revenues. Among the world's large federations, the share of federal government in public expenditure in Pakistan at 72 percent was one of the highest. This will be reduced as a result of the 7th NFC Award and the 18th Amendment.

As discussed in the 2010 Annual Report, the 18th Amendment was a major cleansing effort.[4] Its more than one hundred clauses aimed not only to create new structures of government at the centre and in the provinces but also to redefine the relationship between the President on the one side and the Prime Minister and the Parliament on the other. The Amendment also laid the procedures for nominating judges to the provincial high courts and the Supreme Court, made the office of the Chief Election Commissioner autonomous of both the executive and the parliament and prescribed the procedure for appointing the head of the National Accountability Bureau (NAB). The fact that a number of the actions taken by the ruling coalition in Islamabad have been challenged in the Supreme Court, and that the court has on several occasions ruled against the administration shows that the establishment of a new political order is still at best a work in progress. That notwithstanding, there cannot be any doubt that properly implemented, the 18th Amendment can yield a system of governance that will be more responsive and accountable to the wishes and aspirations of the people. There cannot also be any doubt that a botched effort at implementing the provisions of the NFC Award and the 18th Amendment could deal a serious blow to the quality of governance and produce a great deal of confusion. As a result of the way some parts of the 18th Amendment may be implemented, the centre could seriously weaken. It also appears that the process of implementation is not supported by strong strategic work aimed at fully understanding the consequences of devolution.

Also unresolved is the issue of financing the additional responsibility being devolved to the provinces. If all the ministries and divisions that will devolve to the provinces continued with their operations as at present, the provincial liability will amount to Rs 45.6 billion, of which Rs 7.3 billion will be on the additional expenditure on the employees that would be in the pay of the provinces. According to the current distribution of expenditure, 52.1 percent of this expenditure is in the domain of the central government, 20.4 percent in Punjab, 20.4 percent in Sindh, 8.2

percent in Khyber-Pakhtunkhwa and 2.1 percent in Balochistan. In addition, 232 development projects are being implemented by the ministries and divisions subject to devolution. Of these, 166 projects are likely to be assigned to the provinces. Over and above that, 66 vertical projects are also being implemented in the provinces. According to the Planning Commisssion, the cost of devolved development liabilities is of the order of Rs 202.3 billion, which increases to Rs 317 billion if the expenditure on Higher Education Commission (HEC) and some other special initiatives is included. Of this amount, Rs 151 billion is in Punjab (47.6 percent), Rs 86 billion in Sindh (47.6 percent), Rs 52 billion in Khyber-Pakhtunkhwa (16.4 percent) and Rs 26 billion in Balochistan (8.2 percent). Taking all these numbers together, the cost to the provinces of devolution would amount to almost Rs 363 billion. This is equal to 34 percent of the estimated share of the provinces in the transfers envisioned by the NFC Award. The proportion is much larger if we apply somewhat different arithmetic in putting this estimate in context. The revenue gain for the provinces was budgeted at Rs 222 billion for 2010-11. This will erode to about Rs 42 billion because of the shortfall in revenue collection and the increase in salaries of all government employees by 50 percent. This implies that additional revenue transfers due to the 7th NFC Award will not finance the additional liability from the transfer of functions under the 18th Amendment. This poses a challenge for the provinces which they should deal with by increasing their own resources rather than looking for more support from the financially stressed federal government. There is provision in the 18th Amendment to do precisely that. For instance Article 172 (3), while providing for equal ownership of federal and provincial governments of mineral resources, also implies sharing of incomes on a 50:50 basis. Initial estimates suggest that this provision could contribute about Rs 36 billion a year to combined provincial revenues. This, alongwith higher provincial tax mobilization, can help to manage and finance the functions being devolved. This report presents a resource mobilization strategy for provinces to substantially augment their revenues through, in particular, Urban Immovable Property Tax (UIPT) and Agriculture Income Tax (AIT).

However, the process of bringing government closer to the people must not stop with the strengthening of the provinces and making them more autonomous of central authority. It must also include the strengthening of the system of local government as it is imperative to recognize that many of people's basic needs can only be met, and several of the services they require can only be provided by the instruments of government that are closer to the citizenry. This means making local governments an integral part of the structure of governance.

Since Pakistan gained independence, it has experimented with half a dozen systems of local government. One historical trend is apparent: whenever the military was in power, it sought legitimacy for its rule by creating representative forms of government at the local level. The aim was to create a constituency of politicians that would owe allegiance to the military masters. In fact, the elections held at the local level did not allow the participation of political parties. When the civilians returned, they either dissolved the local government systems or heavily amended them seeing directly elected local government officials as their political competitors. This see-saw of the repository of political power has meant that the citizenry has been denied a working system of governance that functions at a close distance to it, and that could have constantly evolved to keep pace with the people's needs and changing times. Unfortunately, the same trend has manifested itself since the return of civilian rule in 2008. All provincial governments are currently engaged in recapturing the instruments of power from the local bodies created by the Local Government Ordinance (LGO) of 2001. The changes already made and those that are contemplated seem to be designed to meet the political needs of the people who wield power at the provincial capitals and not necessarily to benefit the citizenry. This Report has taken the position that the devolution of government as a process should not stop with the implementation of the 18th Amendment; it must also include the strengthening of local government institutions. Getting the provincial authority to create space, within which the local representatives of the people can work, is as important for those who hold the reins of power at the centre to allow room for maneuver to the functionaries operating at the provincial level.

There is one serious flaw in the way the current set of political masters have introduced the two sets of changes that will materially alter the structure of government in the country. Announcing the 7th NFC Award several months before the passage of the 18th Amendment meant that revenues were decentralized before expenditure responsibilities were assigned. Institutional experience with decentralization summarized in a World Bank (WB) report suggests that when that happens, central governments are forced to maintain spending levels with a smaller resource base (The World Bank [WB], 2000). That could also happen in Pakistan if the process of decentralization is rushed through in great haste.

The amount of disruption likely to result from the implementation of the 18th Amendment may affect the programs of the public sector. This of itself may not have serious consequences for the rate of economic growth, given the sharp decline in recent years in the proportion of the public sector development programme as a proportion of GDP. However, the likely disruptions may have adverse effects in two areas: delivery of public services and the regulatory front. These should be kept in view as the various groups and committees involved in the devolution process continue with their work. The small decline that is likely to occur in the rate of growth resulting from the disruptions and dislocations caused by the devolution process may be worth the cost if the end result is a structure of government that brings governance closer to the citizenry.

As in the previous IPP Annual Reports, this document also offers a number of suggestions to the policymakers to deal with the various problems they and the people currently face. Some of the suggestions have already been summarized in the context of the discussion above, of the best and worst case scenarios for the economy in the next four years from 2011-12 to 2014-15. Including those, our recommendations in the 2011 Report fall into five categories.

One, we are of the view that in the process of designing a growth strategy – an effort in which the Planning Commission is currently engaged – considerable attention should be given to the delivery of public services. The draft of the growth strategy paper, which the authors of this report have reviewed (Government of Pakistan (GoP), 2011), suggests that the Commission is likely to focus a great deal of its attention on making the private sector more efficient, effective and entrepreneurial. It would like to see the private sector stand on its own feet rather than continue to lean on the government, as it has done in the past six decades or so. The same approach was taken in the report issued recently by the Planning Commission's Task Force on Private Sector Development (Burki & Dawood, 2011). The Commission would also like to see a thorough reform of the structure of the civil services. This too has the support of a number of groups appointed by different administrations in the last few years. For instance, the Commission appointed by the administration of President Pervez Musharraf, during its waning days and headed by Dr. Ishrat Hussain, recommended a number of significant changes in the civil service structure including the monetization of a number of perks currently enjoyed by senior bureaucrats. This report, like others before it, was not acted upon and was simply shelved. While developing the private sector and making it less dependent on government support are the right approaches to follow and while the reform of the civil service structure is long overdue, it is important that the government's role – and by that is meant the roles of the government at all levels – must be strengthened so that appropriate services can be properly delivered to all segments of the citizenry.

The *second* set of recommendations offered in this report belong to an area that was dealt with in the previous reports as well. This concerns the need to increase domestic savings and tax-to-GDP ratio. This is one area where the critical issues are not technical. These, like the reform of the civil service structure, have also been the subject of serious inquiry by a number of groups and committees, some of them involving multilateral and bilateral donors. They are discussed in this report in the context of two growth scenarios prepared specifically to focus on these issues. The real issue is the presence (or absence) of political will. It has been recognized for long that the structure of politics is such that the rich and the well-to-do are not prepared to be appropriately taxed. They have managed to exploit – often with the help of the people whose job is to enforce the tax code – the various loopholes that exist in the system. Sometimes the system was deliberately designed to favour one class of potential tax payers over the rest of the population. The most egregious example of this approach was the way the framers wrote the Constitution of 1973. Clearly wanting to favour the landed class, they exempted agriculture incomes from tax. Not only that, the authority to tax agriculture was given to the provinces, thus dividing incomes into two categories: those that should be taxed by the provincial governments only and those that fell under the federal tax system. For these and many other reasons, the burden of tax is increasingly falling on the people who cannot escape the tax net – these usually include the salaried people in both the public and the corporate sector. It has happened again by the recently issued Presidential Ordinance in response to the pressure on the government by the IMF for the adoption of measures that would reverse the declining trend in tax-to-GDP ratio. That Islamabad resorted to a Presidential Ordinance rather than an act of the parliament is a clear indication of the ruling party's failure to line up broad political support behind increasing the incidence of taxes and increasing their reach. An equitable system of taxation that broadens the tax base and does away with exemptions is something that is urgently needed as a part of the strategy to bring growth back to the economy. Such a tax system, as discussed in the context of the best case scenario developed for the Report, will not only pull the economy back from the edge of an abyss, it will set it on a trajectory of sustainable growth at a reasonable level.

The *third* area relates to reorienting the structure of the economy so that it produces more for exports. This is an under-stressed area in the Planning Commission's growth strategy. Most development experts and economic historians recognize that no economically successful country ignored export orientation as one of the critical determinants of growth. In fact, as the WB pointed out in its seminal report on the economic transformation of the economies of East Asia, focus on trade with the outside world played a major role in the economic growth of East Asia countries (WB, 1993). In this context, some of the more prominent miracles could only occur because of the close involvement of the state in the process of production and helping to find markets for the 'winners'. This lesson from history and its implications for Pakistan are rightly emphasized by Dr. Parvez Hasan, one of the authors of the IPP Report, in his recently published memoir[5].

The *fourth* category of recommendations belongs to the broad area of ensuring good governance. This is the main thesis of this year's Annual Report. For progress to be made in this critical area, action is required on a number of fronts: ensuring responsibility, deliverability, and accountability on the part of the public sector. As has been pointed out in a number of recent reports issued by a variety of international organizations, in particular the Berlin-based Transparency International, there has been a steady decline in the quality of governance offered to the citizenry.

Finally, there are a number of suggestions throughout the report on making the process of devolution efficient, aiming to improve governance rather than having the opposite effect. We believe that the process should not be rushed through. There are a number of issues within the framework of the amendment that need to be carefully thought over. This is particularly the case for such vital sectors as education and health. Public debate on some of these would help to clarify the areas where the process being adopted will do more damage than good.

While these are difficult times for Pakistan, we will conclude with the hope that appropriate public policy initiatives would reverse some of the deteriorating trends that have been highlighted by the IPP, not just in this Report but in those that preceded it. Our presentation in the Report of two well developed medium-term scenarios for the economy is an effort to present the policymakers with a set of policies on which they could begin to work with some urgency.

Chapter - 1

The State of Pakistan Economy

Increasing Difficulties and Need for Hard Policy Choices

Chapter - 1
The State of Pakistan Economy
Increasing Difficulties and Need for Hard Policy Choices

It is a little difficult to talk about Pakistan's problems and the state of its economy at this time because of the great damage to output and totally unprecedented scale of human suffering and physical destruction caused by the floods. Furthermore in all aspects, governance that was already a serious problem, has deteriorated in the last several months. Politically, the government has become weak, and an emboldened opposition has successfully blocked economic adjustment measures necessary to stem a worsening macroeconomic situation. While the external payments situation has improved due to special factors, the fiscal deficits and public sector borrowing have reached record levels and rapid growth in money supply has reignited strong inflationary pressures causing widespread discontent. Meanwhile, the real economy remains hampered by relentless power and gas shortages and dislocation and further supply bottlenecks caused by the floods. The economic loss and difficulties caused by the floods come on top of mounting and well known economic problems over the last few years and have deepened the economic crisis.

Recent floods have been assessed to be the worst since 1929. According to the National Disaster Management Authority (NDMA), the floods affected seventy-eight districts and covered over 100,000 square km. The floods have affected more than 20 million people, (over one-tenth of Pakistan's population) with over 1,980 reported deaths and nearly 2,946 injured. About 1.6 million homes have been destroyed, and thousands of acres of crops and agricultural lands have been damaged with major soil erosion happening in some areas. The Preliminary Damage and Need Assessment (DNA), led by the Asian Development Bank (ADB) and the WB, estimate the total damage from the floods at $10.1 billion or 5.8 percent of 2009-10 Gross National Product (GNP). This includes both direct damage and indirect damage to physical and social infrastructure and economic sectors. The biggest loss was in agriculture and livestock sectors which account for a damage of $5 billion or half of the total. The reconstruction costs, estimated on three options, range from $8.7 to 10.9 billion.

Conceptually, the impact of floods can be divided into two components (a) the direct and indirect loss of output i.e. GDP during 2010-11 and (b) the loss of capital, damage in infrastructure and destruction of productive assets like plant, equipment and livestock. The latter would impact the streams of output in the future years.

Various estimates suggest that the floods are most likely to reduce the GDP growth by at least 2 to 2.5 percent during 2010-11 by decreasing it from the original target of 4.5 to 2 - 2.5 percent (Niazi, 2010). The loss of capital appears to be at least 4 percent of 2009-10 GDP. This suggests that till such time that the damage can be repaired, the long term growth rate would be depressed by 1.0 to 1.3 percent per annum assuming the average capital: output ratio to be in the range of 3 to 4. The actual impact on the rate of growth in the subsequent years would depend on the earnestness and the speed with which the reconstruction is taken up. It is assumed, however, that the reconstruction expenditure would be in addition to normal investment spending.

This is the fourth Annual Report of the IPP. Each year, our team has felt that the overall economic situation was worsening either because of new unexpected challenges or the government's inability to mount an effective and speedy response. In the light of recent developments, the theme of the 2010 report, State of the Economy: Pulling Back from the Abyss has become horribly urgent.

No doubt, democratic governments inherited huge economic imbalances. The rise of the economy under Musharaff was quick but so was its fall. The Musharaff Government and the caretaker government postponed actions needed to deal with large negative economic shocks that reduced GNP by an annual average of 2 percent in the last three fiscal years 2006-08. They also neglected structural problems in agriculture, exports and energy that had been emerging for some time.

Table 1.1
Major Macroeconomic Indicators

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
GDP Growth per Annum (%)	7.1	6.0	5.9	3.7	1.2	4.1
Fiscal Deficit (As % of GDP)	-3.3	-4.3	-4.3	-7.6	-5.2	-6.3
Current Account Deficit (as % of GDP)	-4.0	-3.9	-4.9	-8.4	-5.7	-2.0
GDP Deflator Change (%)	7.0	10.5	7.8	16.2	20.3	10.5
Consumer Price Change (%)	9.3	7.9	7.8	12.0	20.8	11.7
Change in Net Domestic Assets of Monetary System (%)	17.1	12.4	11.3	23.2	12.8	12.7
M2 Change (%)	19.3	14.9	19.3	15.3	9.6	12.5
Level of Foreign Exchange Reserves (Millions of US Dollars-at the End of the Period)	12,597.6	13,122.4	15,647.2	11,369.4	12,425	16,750
Gross Total Investment (as % of GDP)	17.5	20.5	20.9	20.5	17.7	15.0[a]
Gross National Savings (as % of GDP)	17.5	17.7	17.8	13.4	13.2	13.8[a]

[a] Numbers for these in two indicators are in current prices: Numbers for Gross Capital Formation Excluding Inventories (as percentage of GDP) in 1999-2000 Prices are Given as follows:

2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
15.3	17.3	18.4	18.1	15.5	14.3

Source: Pakistan Economic Survey, GoP; Annual Report, State Bank of Pakistan (SBP)
Monthly Statistical Bulletin, SBP

Though the new government initially took some important decisions to reduce energy subsidies and revive agricultural output (especially wheat production) through raising support prices, its overall response to deal with deteriorating macroeconomic situation was not strong or speedy enough. It unrealistically expected major donors to come to their rescue and tried to avoid recourse to the IMF. The result was that confidence in the currency weakened and there was large-scale capital flight. Foreign exchange reserves declined by nearly 60 percent between October 2007 and November 2008, and an emergency package with the IMF became necessary.

Progress of the programme with the IMF has not been satisfactory, except initially. Current account balance of payments deficit has been brought under control – partly because of reduction in energy subsidies, sharp cutbacks in private investment, continuing buoyant private transfers and recent rise in prices of textile exports. Foreign exchange reserves have risen but mainly because of the large infusion from the IMF. Tax revenues remain low, fiscal deficit remains high and strong inflationary pressures have re-emerged with large bank financing of the deficit.

Looking back three years, the economic management has been halting and very disappointing. The government has not succeeded in either stabilizing the economy or creating conditions for an economic turnaround that is urgently needed. On the macroeconomic front, the continuing large fiscal deficits, what they are financing, and the way they are being financed have created truly dangerous conditions in which inflationary pressures are growing and an inflationary spiral could develop.

GROWING INFLATIONARY PRESSURES

Historically, Pakistan has avoided prolonged periods of double digit inflation. In the past two periods of high inflation (the mid 70s and mid 90s), inflation peaked, as measured by the GDP deflator, at the annual average of 20.5 and 12.4 percent respectively in the worst three years. During the last three fiscal years, 2008-2010, inflation has averaged over 15 percent per annum and in this year 2011, this level could be exceeded (see Table 1.2).

Table 1.2
Price Trends

(*percent per annum*)

	GDP Deflator	Consumer Prices
2007-08	16.2	12.0
2008-09	20.6	20.8
2009-10	110.0	11.7
2010-11 (July to December)	N.A.	15.5

Source: Pakistan Economic Survey, GoP Pakistan; Annual Report, SBP

The factors influencing recent inflation have varied. During 2008-09, the cost-push inflation caused by very sharp rises in the international prices of food grains, edible oil and petroleum products was a critical factor in the price increases. But more recently, an underlying cause of a clear uptrend in prices is the continuing large fiscal imbalance and the large government borrowing from the banking system to finance it, though adjustments to higher prices of imported petroleum products and some reduction in subsidies and shortages caused by unprecedented floods, have also been contributory factors.

MONEY CREATION

The government net borrowing from the banking system during 2008-09 and 2009-10 totaled nearly a trillion rupees or 3.4 percent of GDP and, at Rs 450 billion in July-December 2010, was running at the rate of over 5 percent of GDP. Including the credit to public enterprises that increased by Rs 253 billion over the last two and a half years, it would appear that 90 percent of the growth in money supply (broad money M2) since the end of June 2008 can be attributed to the expansion of credit to the public sector. Net foreign assets of the banking system changed little over the period, and private sector credit growth was a very modest 5 percent a year.

Huge borrowing by the public sector is no doubt crowding out the private sector though other constraints on the private sector. Energy shortages, uncertain investment climate because of law and order situation, a lack of clear direction provided by government policies and high nominal interest rates have also dampened credit demand. Still, it is interesting that credit to the private sector at the end of 2010 was substantially smaller in real terms than at the end of 2008 and had come down to 21 from 30 percent of GDP over the period. The decline in the role of private credit is both a symptom and a cause of problems within the real economy and of the difficulties in revival of economic growth.

Revival of strong growth is badly needed to create jobs and curb what appears to be a rising incidence of poverty. Bringing the rate of inflation to single digits in a year or so is equally urgent. Pakistan has been very fortunate in the past that high inflation rates did not translate into high and rising inflationary expectations. But this could change if inflation persists and shows sign of acceleration. If high inflationary expectations take root and capital flight becomes endemic, the value of the rupee will become unstable, and the investment climate will become even more unfavourable. Wide international experience suggests that monetary stability, once seriously eroded, is very hard to restore, and sometimes requires draconian monetary measures that can easily push real interest rates on borrowing to extraordinary levels of 10 to 20 percent per annum causing serious economic distress before inflationary expectations are brought under control.

What are the chances that inflationary expectation would jump suddenly during the next year and cause further unexpected economic and financial distress? The evidence is so far mixed. The level of deposits in the banking system remains surprisingly high despite large negative interest rates. On the other hand, net additions to national saving schemes have fallen off from Rs 190 billion in 2009-10 to annual rate of Rs 130 in the July-December 2010. More importantly, nearly 90 cent of the auctions of Treasury Bills is for the duration of up to six months suggesting that refinancing needs rising fast. Perhaps the main reason why there is no financial panic – at least yet – is that the real effective exchange rate of the rupee has actually appreciated significantly since 2008-09. Real effective exchange rate appreciated 8.3 percent in 2009-10 as against real depreciation of 0.3 percent in 2008-09. It appreciated another one percent in July-December 2010 compared to the corresponding period last year.

The strength of the rupee reflects a vast improvement in the current accounts balance of payments during the last year and improvement in foreign exchange reserve position. The current account deficit during July-January 2011 was a negligible $81 million compared to $3.1 billion in the corresponding period of last year. The total foreign exchange reserves at the end of January 2011 stood at $15.6 billion as against $13.0 billion a year earlier.

But it will be a mistake if the immediately comfortable balance of payments position lulls the government to continued inaction on reducing macroeconomic imbalances. The balance of payments position has been helped by a number of special circumstances: the rise in the price of major exports, a further sharp rise in current transfers reflecting both much higher worker remittances and private donations related to floods and last but not least a very depressed level of investment activity.

The exuberance about export growth is excessive. As noted in Tables 1.9 and 1.10, Pakistan lost market share both in total manufactured goods exports and textile and clothing exports over 2005-08 to exporters from other major developing countries. As Table 1.3 shows, the total export receipts in calendar 2010 were little changed from their level in 2008. While textile exports were slightly higher in 2010 than in 2008, the improvement was entirely due to higher prices. While exact comparative figures are not available, there is no real indication that we have recovered market share lost over 2005-08. Meanwhile, the already heavy dependence on textiles and clothing has grown.

Table 1.3
Export Receipts

(*$ billions*)

	2007	2008	2009	2010
Total Export Receipts	18.2	21.2	18.3	21.5
Manufactured Exports	14.3	15.5	13.8	16.2
Textiles	10.2	10.4	9.6	11.1
Other Manufactures	4.1	5.1	4.2	5.2
Other Exports	3.9	5.8	4.6	5.3

Source: Balance of Payment Statistics, SBP

A much needed revival of investment would raise the current account deficit. Meanwhile, net official flows virtually disappeared during July 2010-January 2011 pending agreement with the IMF on a fiscal framework. Equally important, the rise in foreign exchange reserves compared to the low point in October 2008 ($7.5 billion) must be viewed against the large relatively short term obligations of over $8 billion to the IMF. Finally, as pointed out in the last year's Report, the net foreign liabilities position of Pakistan has deteriorated much more than the external debt position.

Even disregarding IMF conditionality or support, improvement of the fiscal situation has become a make or break issue for the Pakistan economy. Tackling of the deep fiscal problems that Pakistan faces would require making some very hard choices in a number of areas. Fiscal reforms would mean increasing tax revenue, reducing energy subsidies, sharply cutting back public enterprise losses and containing wasteful and low priority public expenditures. None of these difficult challenges have been tackled effectively in the past three years. The coalition government does not appear to be strong politically and is hampered by widespread perceptions of corruption and favouritism.

DEEP FISCAL PROBLEMS

At first glance, the fiscal deficit position might not appear to be too problematic. The overall fiscal deficit was 7.4 percent of GDP in 2007-08, dropped to 5.2 percent next year and then increased again to 6.3 percent in 2009-10 (see Table 1.4). But as IPP Reports have argued, the reported figures seem to understate the broader public sector deficit on two counts.

Table 1.4
Fiscal Trends

(*as percentage of GDP*)

	2006-07	2007-08	2008-09	2009-10
Total Revenue	10.2	10.0	9.2	9.3
Tax Revenue	14.9	14.3	14.1	14.2
Total Expenditure	20.7	21.7	19.3	20.5
Current Expenditure	15.8	17.7	15.6	16.4
Development Expenditure	5.0	4.0	3.5	4.5
Overall Deficit	5.8	7.4	5.2	6.3
Revenue Deficit	0.9	3.0	1.5	2.2

Source: Pakistan Economic Survey, GoP
Fiscal Policy, Pakistan Fiscal Operations

First, due to the overhang of energy subsidies that resulted in the most serious circular debt problem, a buildup of arrears to suppliers of petroleum products has continued and is actually resulting in the most unfortunate consequence that even the available electricity generation power is not fully utilized due to shortages of cash and non-payment of arrears. The circular debt now hovers around Rs 180 billion or 1.2 percent of GDP. There have been efforts to eliminate this circular debt through special bank borrowing, but apparently the continuation of unfunded subsidies have again and again led to the problem of circular debt and understatement of the fiscal deficit.

The second source of under statement of the fiscal deficit is the unfunded losses of public enterprises that are covered by bank borrowing or arrears buildup. According to various estimates, the current annual losses of principal public enterprises, Pakistan International Airlines (PIA), Pakistan Steel, Pakistan Agriculture Storage and Supplies Corporation (PASSCO) and Pakistan Electric Power Company (PEPCO), add up to 1.5 to 2 percent of GDP.

In the current year the fiscal situation has deteriorated further. The large increase in public servants' salaries of 50 percent, difficulties in implementation of RGST and the recent reversal of the energy price increases, necessitated by continuing rise in the international prices of oil, could push the narrowly defined fiscal deficit to 7 percent of GDP and the broader public sector deficit to above 8 percent.

Faced with the deteriorating fiscal situation, which according to official reports was headed towards 8 percent of GDP and increasing IMF pressure, the government has taken strong measures to reign in spending and mobilize additional revenue. The February 28 mini-budget is expected to yield a financial impact of Rs 120 billion or about 0.7 percent of estimated nominal GNP.

The government is expecting to raise Rs 57 billion from additional taxes and save Rs 67 billion from expenditure cuts. A major source of revenue would be the withdrawal of General Sales Tax (GST) exemptions and zero ratings that would yield Rs 25 billion. A 15 percent surcharge on income generates another Rs 20 billion in three months. Special excise duties have also been raised and effective excise duty on sugar increased.

The expenditure control measure include further cuts in development programmes, ban on fresh recruitment and purchase of durable equipment and 50 percent reduction in non-salary expenditure.

It should be noted that the much needed adjustments had to be promulgated through a Presidential Order which indicates that the parliament, the opposition, the media, and the general public do not realize the seriousness of the fiscal situation while decrying the rising inflationary pressures.

Clearly, the government should have acted earlier. But the introduction of RGST and a fundamental reform of income tax system remain pressing needs. The stopgap measures of income tax surcharge, freeze on recruitment, and cutting of non-salary expenditures are not basic solutions to the fiscal problem.

Notwithstanding the introduction of additional tax measures, the government has revised the Federal Board of Revenue (FBR) revenue collection target for 2010-11 downwards from Rs 1,667 billion to Rs 1,600 billion. Even if the target is met, there will only be a modest recovery in the tax-to-GDP ratio (that fell in the last two years) because the nominal GDP could increase by 17 to 18 percent during the current year.

Finally, we suspect that the development programme must be in a bit of shambles because most of the cuts have been either across the board or ad-hoc. IPP reports have been arguing for the last three years for a major restructuring and consolidation of the programme both at the central and provincial levels in light of new fiscal realities. Such reviews have become most urgent.

Pakistan's low tax-to-GDP ratio, among the lowest in the world, has been a perennial problem. During the last three years, the ratio has dropped further by nearly 1 to 9.3 percent of GDP in 2009-10.The failure to mobilize tax revenues despite a declining ratio is a fundamental predicament. A decade of tax reform has not yielded much result. The taxation on the rich remains light even though income disparities are widening. A reflection of the lagging tax effort is the provincial taxation which is now only 0.5 percent of GDP, less than half the level two decades ago. The low property taxation in a situation where real estate values have been climbing steadily is a direct subsidy to the rich and upper middle classes, who are the main beneficiaries of the municipal services. With greater delegation of functions to the provincial government, the political case for greater provincial tax effort has also become stronger.

In a real sense, the raising of the ratio of tax-to-GDP is the most critical fiscal issue for the near term. Most Pakistani governments have avoided asking people for sacrifice either because of their weak political situation or their own vested interests and extravagant life styles. As a result of the low tax revenues, Pakistan has quite often run revenue deficits because tax revenues are insufficient to cover current expenditures. The revenue deficit (negative government savings) reached a peak of 3 percent of GDP once again in 2007-08 and was still 2.2 percent of GDP in 2009-10. This means that the country has continued to borrow fairly large sums just to meet its current expenditures. In order to meet needs of flood relief and reconstruction, massive cuts have been applied to development spending (4.5 percent of GDP in 2009-10) in the revised budget for the current year. Thus, it seems likely that in 2010-11 even a larger part of the total government borrowing would be spent on current expenditures. This would have consequences for future availability of infrastructure and growth.

Because the fiscal problem is multi-faceted, it must be attacked on many fronts. First and foremost, there is the need to reverse the declining trend of tax-to-GDP ratio. As the debate on the introduction of RGST has shown, there is strong resistance from both, the public and politicians, to a broad-based expenditure type taxation. Different constituencies have different concerns. Low and middle classes fear further increases in the cost of living. Many businesses, especially small businesses, fear that the instrument would be used to bring them into the tax net through improved documentation. Tax collectors, who routinely siphon off a part of the tax revenue that is lost, are also generally resistant to any tax reform.

Progress towards a full-fledged value added tax is necessary but is obviously proving difficult. Similarly, a thorough going reform of the income tax system is necessary. At present much of the revenue from income tax comes from withholding taxes on exports, bank interest – which are in Pakistan's case a form of indirect taxation – and tax on corporations and salaried individuals. Collections from non-salaried individuals are small and the number of households paying income tax is barely 3 percent of the total. Exemption of all agricultural income also greatly limits the effectiveness of taxation. It is necessary to make income tax a more elastic and more progressive instrument of taxation considering the rising income inequalities that are exacerbating social tensions. A high level representative commission, composed of politicians, businessmen, tax officials lawyers, senior administrators and economists should be set up to analyze the issue and make recommendations for the overhaul of the system. Examining the incidence of present taxation should be a part of this commission's work.

The need for taxation reform is real, but many experts believe that much larger collections will be possible even with the given system of taxation if the collection machinery was both efficient and honest. The collusion between the tax payer and the tax collector is a fundamental source of lost revenue. As mentioned above, despite a decade's work on improving tax administration, the results are poor partly because of vested interests and the lack of a political will.

Along with raising the tax-to-GDP ratio by 1 percent per annum to reach a minimum target of 15 percent in five years, the fiscal policy must enforce the rule that revenue account deficits would be eliminated in two years. Borrowing for current outlays creates an inherently unsustainable fiscal situation. The recommendation for eliminating negative government saving was first made in the Debt Reduction and Management Committee Report in March 2001 and was included as a target to be achieved by 2006-07 in The Fiscal Responsibility and Debt Limitation Law passed in 2002. But as noted above, large revenue deficits have re-merged and are contributing significantly to government bank borrowing. The institution for the next couple of years of strict austerity budgets both at the federal and provincial level and effective freezing of public servants' positions and salaries are necessary to eliminate revenue deficits.

The issue of energy prices cannot be separated from the fiscal deficit problem. Pakistan is a heavily energy dependent country. As a result of almost steady rise in international oil prices for the last several years, Pakistan’s oil import bill has more than trebled since 2003-04, and has averaged over $10 billion annually during the last three years. The terms of trade loss caused mainly by higher oil prices reduced real GDP by 2 percent per annum during the three years 2005-08 (IPP Annual Report, 2009). The needed economic adjustments were not undertaken in the final years of the Musharaff regime. The sharply rising costs were not passed on to the consumer especially in the case of electricity. Though the energy subsidies were cut after 2008, they still remain heavy especially in the light of the recent spike in the international price of oil. Consumer resistance to further hikes in tariffs has grown because of massive interruption of power supplies, perceived mismanagement of power systems including high system losses caused by technical deficiencies and theft of electricity with the connivance of staff.

There needs to be a comprehensive solution to Pakistan's energy sector problems. The government needs to do a better job of educating the public and the politicians on the imperative of speedy adjustment to international prices over which it has no control. The macroeconomic management should also pay more attention to the issue of handling external shocks, either positive or negative.

The government must also reduce its reliance on bank borrowing for financing the budget deficit. More urgently, the recourse to central bank financing must be strictly limited because it is fuelling inflation. It is necessary to revert to the use of Public Investment Bonds (PIBs) for meeting financing requirements that are not met from external sources and national saving schemes. The floating of PIBs of various maturities at regular intervals would help determine the interest rate structure. The immediate effect of these changes would eliminate the essentially zero net cost borrowing from the central bank and also raise total interest payments in the budget, putting further pressure on the governments to reduce non-interest current spending.

Reverting to a more normal financing of budget deficit would eliminate the hidden subsidy, which is implicit in the present reliance on central bank financing and to an extent in the borrowing from the commercial banks. This step, along with proper treatment of circular debt and public enterprise loss, would ensure full transparency in the fiscal deficits.

It is reasonable to assume that appropriately adjusted fiscal deficits have remained high for at least three years and have persisted at or above 7 percent of GDP and could exceed 8 percent in the current year if timely action is not taken.

A FISCAL ADJUSTMENT SCENARIO

Table 1.5
A Fiscal Adjustment Scenario, 2011-16
(*in percentage of GDP per annum*)

Uses		Sources	
Tax Revenues Increase	1.0	Deficit Reduction	1.25
Reduction in Losses of PEs	0.5	Development Spending	0.5
Non Interest Revenue Expenditure	0.5	Interest Costs	0.25

Source: Author's estimates

Clearly the fiscal deficits must be brought down, and the policy focus should not be only on level of the deficit but also on the mode of its financing, the pattern of expenditures, elasticity of tax revenues and burden of taxation. A drastic and sudden reduction in the deficit would not only be politically difficult but could cause a further slowdown in the economy and add to economic distress. A realistic but credible plan could have the following elements: bringing down the total public sector deficit by 1.25 percent of GDP a year, from an estimated 8 percent in 2010-11 to 3 percent in 2015-16, raising tax revenue by one percent point of GDP, cutting public enterprise losses each by 0.5 percent of GDP a year, reducing non-interest revenues expenditure by 0.5 percent of GDP, allowing critical social and development expenditure to go up by 0.5 percent of GDP a year and providing 0.25 percent per annum extra for more realistic estimates of interest costs of public debt (see Table 1.5). Meanwhile, the inflationary financing of the deficit should be halted and private savings be tapped by offering attractive rates including if deemed necessary, inflation adjusted bonds. The immediate targets should be the control of money supply and inflationary expectations.

None of this would be easy but a well spelled out three/four-year policy framework would help a great deal to restore private sector confidence and improve the prospects of investment revival.

SAVING-INVESTMENT IMBALANCE

The large fiscal imbalance is symptomatic of the broader issue of low domestic and national savings and historically heavy reliance on foreign assistance, external borrowings and in the last decade, of large private investment flows to finance the rather modest level of investment. Over time, there has been little progress towards greater self reliance.

It is particularly troubling, therefore, that the burden of adjustment required after 2007-08, when the current account balance of payments reached the totally unsustainable level of 8.4 percent of GDP, has fallen mainly on investment side.

Table1.6 shows that domestic availability of resources (Domestic Absorption) grew by over 5 percent between 2007-08 and 2009-10 despite a sharp and necessary reduction in the current account balance of payments deficit.

Table 1.6
Domestic Absorption of Resources in 1999-2000 Prices
(*Rs billions*)

	2005-06	2006-07	2007-08	2008-09	2009-10
Consumption of which	4297	4415	4518	4712	4946
(Private)	(3708)	(3883)	(3779)	(4206)	4372
Investment Including Stocks	924	1043	1114	1016	987
(of which gross fixed capital formation)	(841)	(955)	(1025)	(927)	(890)
Total	**5221**	**5458**	**5632**	**5728**	**5933**

Source: Pakistan Economic Survey, GoP

This was possible because the modest growth in GDP of 5 percent over 2 years was strongly supplemented by recovery in the terms of trade as oil prices fell from their peak level in the first half of 2008 and a very sharp increase in net in factor income from abroad (mainly worker remittances). Because of the latter two factors, Gross National Income (GNI) (GNP adjusted for the terms of trade gain/loss) growth averaged 4.3 percent per annum in the last two years compared with GDP growth of only 2.6 percent per annum. This enabled a significant increase in availability of domestic resources notwithstanding the impact of sharply reduced current account balance of payments deficit between 2007-08 and 2009-10.

However, all of the increase in domestic resources over 2008-10 appears to have gone to higher private consumption as fixed capital formation actually fell by 13 percent over these two years. Admittedly, the above figures on aggregate private consumption are crude because they are derived indirectly as a residue and may contain an element of errors and omissions. Furthermore, they do not reflect the effect of subsidies and indirect taxation. Finally, a portion of the public consumption, that is defence expenditures financed outside the budget, is also included under private consumption in recent years. But even allowing for most of these factors it would appear that private consumption per head increased by 4 to 5 percent over the years 2008-10.

The explanation of apparent contradiction between aggregate numbers and general public perceptions lies in the distribution of gains. "Major gains apparently have accrued to wheat farmers with large marketable surpluses. However, as unemployment has risen and food inflation has remained very high, it is difficult to avoid the impression that the low income groups who typically are net purchasers of food even in the rural areas have been squeezed. The incidence of poverty is thus likely to have risen". (IPP Annual Report, 2010)

In general also, it is not surprising that the elite have been able to protect their incomes and consumption because the structure of ownership of assets, access to economic rents, increasing corruption and the light burden of taxation on the rich continue to seriously compound and deepen the social inequities in the society.

On the one hand, the distribution issues have become critical. On the other hand, a heavy burden of economic adjustment has fallen on the fixed capital formation – a proxy for future growth. The ratio of fixed capital formation to GDP in constant 1999-2000 prices was 18.4 percent in 2007-08 but had fallen to 14.8 percent in 2009-10.[1] The most troubling decline was in the large scale manufacturing sector. The investment in this sector which had lagged even in the economic boom years (2003-07) registered a decline of 45 percent in real terms between 2006-07 and 2009-10 (see Table 1.7). However, buoyed by price supports, the agricultural investment has risen from Rs 70 billion in 2006-07 to Rs 120 billion in 2009-10 in constant prices.

Table 1.7
Investment in Large Scale Manufacturing in 1999-2000 Prices

	(*Rs billions*)
2002-03	121
2005-06	140
2006-07	142
2007-08	124
2008-09	94
2009-10	79

Source: Pakistan Economic Survey, GoP

The gross national savings rate dipped to a low of 13.8 percent of GDP in 2009-10, according to the SBP (Annual Report, 2009-10). The decline in national savings rate is notwithstanding a very sharp increase in worker remittances over the last few years and probably reflects a measure of capital flight as well as negative government savings. But, essentially it is relatively high level of consumption that explains the low levels of savings and investment in Pakistan.

Table 1.8
Household Consumption in Purchasing Power Parity Terms 2005
(*International $*)

	Per Capita Household Consumption		GDP Per Capita	
	2005	2009	2005	2009
China	1363	1903	4115	6200
India	1260	1633	2308	2970
Pakistan	**1550**	**1630**	**2184**	**2369**

Source: World Bank Data Bank

Table 1.8 shows that in 2005 Pakistan's per capita household consumption was higher than either in India or China even though Pakistan's per capita income was not much high than half the level in China and somewhat lower than India's. Since then the incomes and consumption levels have grown strongly in both China and India. Still Pakistan's per capita household consumption is 85 percent of the level in China even though China now has a per capita income more than two and a half times that of Pakistan. India now has a per capita income 25 percent higher than Pakistan but the same level of private consumption per head. Evidently, China and India have much higher levels of savings and investment – a key to their much higher rate of growth.

STABILIZATION AND GROWTH

Restoring macroeconomic stability and control of inflation deserve high priority. But it would be a mistake to assume that strong stabilization efforts can succeed in context of a stagnant economy. The structural changes that are necessary to put the finances on a sound footing, increased tax revenues, shifts at the margin from consumption to savings and investment and some redistribution of income from the well to do to the poor would really be possible only in an expanding economy.

Unfortunately, Pakistan faces several major and inter-linked constraints on growth; a continued difficult security situation, which is undermining the investor confidence in the economy and probably encouraging capital flight; a considerable loss of competitiveness in manufactured goods exports, that is accentuated by lack of adequate investments in industry and human capital; and still sizable macroeconomic imbalances, that limit the options for public spending and credit expansion. In the face of multi-dimensional challenges, future growth path is uncertain and revival to a desired high growth of 7 to 8 percent per annum, that would ensure sufficient job creation and reduce the incidence of poverty, is not yet in sight. The economy is at present operating well below capacity. The energy crisis, deeply aggravated by the circular debt problem, is adversely affecting industrial production and exports. Poor governance, typified by prevalence of corruption, large economic rents, insufficient attention to key appointments on merit, lack of credible accountability mechanisms that would ensure punishment for wrong doing, seriously hampers effective use of economic resources and results in loss of competitiveness. There are not sufficient incentives for new investments, innovation and productivity improvements.

Yet, if some of these issues begin to be tackled in earnest, revival of growth to 5 to 6 percent per annum should be possible even in the short-run of a couple of years. This revival is likely despite the overhang of poorly educated labor force, low levels of investment in key productive sectors of agriculture and industry and the setback due to floods.

In the short-run, resolving or at least easing the deep crisis in the energy sector, control of inflation and restoring financial stability appear to be the most pressing priorities. Simultaneous reforms in several key but inter-related areas could help not only economic recovery in the near term but would also lay the foundations of sustained high growth. *First*, at the most strategic level, the country needs to commit itself to increasing export-orientation. *Second*, recognizing that even in the medium-term Pakistan cannot match the investment levels of China and India, the search for higher growth must focus on improvements in productivity through skill formation, agricultural and industrial research, greater effectiveness of public spending through civil service and public education reform, and greater coordination in economic policies as well as implementation arrangements.

KEY ROLE OF EXPORT EXPANSION

Nothing in my view will be as critical for achievement of Pakistan's goals of inclusive and self reliant growth, that creates jobs and increases wages, as an outreach to the world provided greater export orientation is combined with critical foreign private investments in key export areas where Pakistan lags in competitiveness, technology, and access to markets.

During the last half century, Pakistan has missed numerous opportunities to expand exports especially manufactured goods exports, that have been the strong engine of growth in the global economy. Over decades there has been no clear vision about Pakistan's economic future, no real commitment to export-oriented growth, and no learning of lessons from what was happening in the outside world. It is worth noting that there has been no significant case of rapid economic growth in the last half century that did not fully exploit the opportunities offered by growing international trade.

It needs to be understood that it was not just the liberalization of trade that opened up the opportunities for developing country exports. As a result of the shifting dynamic comparative advantage, especially in labour-intensive manufactured goods, the share of developed countries (USA, Japan and EU) in world manufactured exports has been declining. It came down from 75.8 percent in 1980 to 63.8 in 2000 and had dropped further to around less than 60 percent in 2008 despite substantial enlargement of EU.

As a result of these developments, manufactured exports from sixteen major developing countries/entities rose 36 times over 1980-2008, from $94 billion in 1980 to $3.4 trillion and their market share expanded from 8 to 33 percent over the same period.

Almost all the market share lost by developed countries has been captured by Asian countries whose exports are increasingly dominated by manufactured goods exports. In the more recent decade, gains in export shares by Mexico, Turkey, India and Vietnam have been particularly impressive though they did not nearly match China's performance that has been in a category by itself.

No doubt there was a setback to international trade during 2009 due to worldwide financial and economic crises; world manufactured exports dropped by nearly twenty percent and exports from major developing countries exporters also suffered declines though not of the same magnitudes. However, a quick recovery has been on the way. During January-September 2010, the value of international trade was 23 percent higher than in the same period of 2009. For the year 2010, World Trade Organization (WTO) estimates that the volume of international trade will rise by 13.5 percent as against a decline of 12.2 percent in 2009. It is our strong belief that globalization will continue, and the comparative advantage in international trade in most labor intensive products will continue to move towards labor surplus economies like India, Pakistan, and Bangladesh.

Over time Pakistan has steadily lost ground in manufactured exports to all other major developing countries: its share in this group was 1.4 percent in 1980 but had fallen to 0.4 percent by 2008. Even excluding China, Pakistan's share has dropped more than 50 percent to 0.4 percent over 1980-2008 (see Table 1.9). There are three main factors for this relative decline and missed opportunities. *First*, Pakistan remains heavily dependent on relatively slow growing textile exports-it has also made less headway in faster expanding garment exports. Secondly, since 2005, it has lost market share in both textiles and clothing not only to China but also to emerging important exporters like India,

Table 1.9
World Manufactured Exports and Major Developing Countries' Market Share

	US$ Billion		Market Share (%)		
	1980	2008	1980	2005	2008
China	8.7	1329.6	0.80	9.6	12.7
Hong Kong	18.0	348.0	1.60	3.8	3.3
Korea	15.7	365.0	1.43	3.5	3.5
Singapore	8.3	236.9	0.76	2.5	2.3
Taiwan	17.4	222.3	1.59	2.4	2.1
Mexico	4.4	212.3	0.40	2.3	2.0
Malaysia	2.4	129.9	0.22	1.4	1.2
Thailand	1.6	127.2	0.15	1.2	1.2
India	5.0	112.2	0.46	0.96	1.07
Brazil	7.5	86.4	0.69	0.85	0.83
Turkey	0.8	103.8	0.07	0.82	0.99
Indonesia	0.5	52.7	0.05	0.54	0.50
Philippines	2.1	40.5	0.19	0.50	0.39
Vietnam	-	32.7	-	0.22	031
Pakistan	1.3	14.9	0.12	0.18	0.14
Bangladesh	0.5	13.5	0.05	0.12	0.13
Total for above countries	94.1	3427.8	7.82	30.88	32.78
World Exports	1,092.4	10458.1	100.0	100.0	100.0

Source: WTO Statistical Tables
Note: Figures for Singapore, Bangladesh and Vietnam relate to 2005

Turkey, and Vietnam. (see Table 1.10) Third, its record in fast expanding other manufactured exports whether sports goods, surgical equipment, automotive parts, or jewellery has been dismal and its presence in international markets is negligible. Pakistan missed out on purely non-cotton textiles in the 60s due to its restrictions and high import duties on inputs for mixed or synthetic textiles. It missed on electronics in the 60s and 70s and information technology in the 1990s. Lack of structural changes has been responsible for slow growth as well as low value added in exports.

Table1.10
Textiles and Clothing Exports of Major Developing Countries

	Textile Exports		Clothing Exports		% Chage in Exports	
	2005	2008	2005	2008	Textile	Clothing
China	41.1	65.3	74.2	120.0	59.0	61.8
Hong Kong	13.8	12.3	27.3	27.9	-11.2	2.3
Korea	10.4	10.4	2.6	1.7	-0.2	-32.5
Mexico	2.1	2.0	7.3	4.9	-6.8	-32.8
Malaysia	1.4	1.5	2.5	3.6	14.2	46.2
Thailand	2.8	3.2	4.1	4.2	16.2	3.8
India	8.3	10.3	8.6	10.9	23.9	26.3
Turkey	7.1	9.4	11.8	13.6	32.8	14.9
Indonesia	3.4	3.7	5.0	6.3	9.6	26.7
Philippines	0.3	0.2	2.3	2.0	-27.9	-13.5
Vietnam	0.7	1.6	4.7	9.0	126.1	91.6
Pakistan	7.1	7.2	3.6	3.9	1.4	8.4
Bangladesh	0.7	1.1	6.9	10.9	54.6	58.5
Total for Above Countries	99.0	128.1	160.8	218.9	29.4	36.2
World Exports	204.3	250.2	277.1	361.9	22.4	30.6

Source: WTO Statistical Tables
Note: Figures for Singapore, Bangladesh and Vietnam relate to 2005

There is some satisfaction that textile and clothing exports at the annual rate of $12.5 billion in July-December 2010 showed an improvement of over 25 percent over the corresponding period last year. But this represents largely a recovery from the low level in 2009. More importantly, a significant part of the improvement is due to the much higher prices of cotton and cotton goods in recent months.

How far we have fallen in the export field, compared to some of our peers and competitors, is also clear from Table 1.11 on the trend in exports of goods and services and the share of exports in GDP. Just three decades ago, Pakistan had greater export orientation than any of the countries in the table. Now, even the two continental economies, India and China, have a much larger export sector than Pakistan. Turkey, an inward looking economy in 1980, has transformed itself.

Table 1.11
Exports of Goods and Services

($ billions)

	1980	2000	2008	2009
Bangladesh	1.0 (5.0)	7.2 (14.0)	17.5 (20.0)	17.0 (19.0)
China	- (11.0)	279.6 (23.0)	1581.7 (35.0)	1333.3 (27.0)
India	11.3 (6.0)	59.9 (13.0)	302.8 (24.0)	258.8 (21.0)
Pakistan	3.2 (12.0)	10.1 (13.0)	25.5 (13.0)	22.2 (13.0)
Turkey	3.6 (5.0)	50.3 (20.0)	175.8 (24.0)	142.8 (23.0)
Vietnam	- -	17.1 (55.0)	69.7 (78.0)	62.9 (68.0)

Figures in parenthesis given share in GDP
Source: World Bank Data

Vietnam a new comer to the export field is now far ahead of Pakistan in just a couple of decades. In real terms, adjusted for rise in international prices, Pakistan's exports are estimated to have grown by an average of 4.5 percent per annum since 1980 compared to 9 percent annual growth in India – certainly not a stellar performer in the export field.

As a late comer to the field of manufactured exports, except in textiles and clothing, Pakistan faces formidable challenges. But, there are several grounds of optimism. First, Pakistan's market share in the world manufactured goods other than textiles and clothing is miniscule. Secondly, though right now Pakistan is not very competitive in textiles and clothing, the room for productive improvements is immense provided the right investments in modernizing industry and upgrading skills are made with the help of foreign partners. Pakistan should look for help to China as well as countries like Korea, Malaysia, Turkey, and Hong Kong that increasingly face limits on their textile and clothing exports because of rising wage costs. Thirdly, proximity to China and India, the two fastest growing markets in the world, offer great long-term potential though right now there are political obstacles in the way of expanding trade with India, and Pakistan actually has a large trade deficit with China. Finally, the potential of agricultural exports has not even begun to be explored seriously.

The country can and must try to regain some of the export ground it has lost over the years by not just setting ambitious goals but even more important, by developing policies and programmes, monitoring mechanisms and reversing the inward orientation and export bias that has characterized its trade policy regime in the past. Rapid export growth will not only revive the economy but can also create jobs at a relatively low cost of capital investment.

A multi prong strategy should focus on competitiveness of textile exports, overcoming constraints on garment exports and major diversification of exports not only in manufacturing but also information technology and high value agricultural exports. The goal should be to expand total exports by at least 10 to12 percent annually in real terms over the next five years.

The key instruments for achieving the ambitious but necessary export goals would be:

- A realistic exchange rate is absolutely necessary to maintain export competitiveness. Real effective exchange rate appreciated 8.3 percent in 2009-10 as against real depreciation of 0.3 percent in 2008-09. Rupee has appreciated very strongly against the Euro. Since Inflation is on the rise, a 10 to 12 percent nominal devaluation may be necessary in 2011 just to keep the real effective exchange rate from further appreciation.
- Joint public and private sector efforts to promote foreign investment in textiles, clothing and other promising export sectors with countries like Korea, Hong Kong, Malaysia, Taiwan, which are losing ground in labor intensive industries due to high and rising wage costs. The focus of these efforts should be to upgrade skills and technology and to make use of established export channels.

- Important recommendation in the Strategic Trade Policy Framework 2009-12 to reduce anti-export bias by withdrawal of protection from inefficient industries, minimization of taxation at investment stage and elimination or zero rating of customs duty on important inputs to textiles and clothing exports should be pursued strongly and an implementation report prepared.
- Closer coordination of commerce ministry policies and activities not only with textile ministry but all other production related ministries appears to be sorely needed.
- A special focus on expanding exports to regional partners especially China and India, the two fastest growing economies in the world. The large negative trade balance with these countries can provide some leverage.
- A special and speedy implementation review of the free trade agreement and establishment of free trade zone with China and assessment of their likely impact on exports in the near term.
- A similar review of key constraints and principal opportunities for expanding trade with India.
- Focus on the development of export supply chains using the work being done in the context of the National Trade Corridor Improvement Project (NTCIP).

PRODUCTIVITY IMPROVEMENTS

Productivity improvements may seem like an abstract idea. But actually there are countless areas where Pakistan lags in technology, productivity, and efficiency of resource use and where relatively quick improvements might be possible with concerted and more focused policy actions combined with strategic investments.

The present government has been rightly stressing the critical importance of reviving agriculture by improving the underlying growth rate of less than 3 to 4 percent per annum. The very sharp increase in the support price of wheat in late 2008 was a bold step and has delivered results but at a cost. There are obvious limits to government price interventions that add to the fiscal burden. Provincial governments must look for interventions that can raise productivity in the short term without huge costs.

Several areas appear specially promising. First, resources for agricultural research need to be expanded and more carefully targeted on crops and activities like livestock where potential for improvement in yields and expansion in exports appears especially strong. While agricultural research might not give quick results, the strengthening of the links between agricultural research and extension can have a high pay off. With a large majority of farmers being illiterate, well organized campaigns supported by political efforts to improve the effective use of agricultural inputs, seeds, fertilizer and pesticides could have an important pay off. Second, the adulteration in the supply of inputs, seeds, fertilizer, and pesticides remains a major problem. Effective regulation in this area could also yield important dividends. Third, the optimal use of available water resources remains a critical and strategic long term issue. But as the past experience has shown even in the short run public and private sector efforts to level land and line water courses can yield high economic returns. Restructuring of public sector programmes to find resources for quick yielding short-gestation projects would make sense. The political resistance to low water rates which accentuate the waste of water must be overcome. Increasing water rates would not only increase government revenue but also force the farmers to economize on the use of water and encourage them to make investments in land leveling. Finally, agricultural export potential especially in fruit and vegetable, remains greatly under-exploited. Here again the state efforts in removing bottlenecks continue to be important.

The productivity and competitiveness of country's largest industry, textiles and clothing, can be improved in a number of ways. First, the incentive structure should be tilted towards new technology enhancing investment rather than keeping the outmoded technologies and uncompetitive capacity alive. The government has, through its several bailout packages for the industry, discouraged obsolescence and has not encouraged scale-enhancing new investments. Meanwhile, greater investment in skill improvement and increased value added should be encouraged through suitable fiscal adjustments.

Another important source of productivity gains can be the improved effectiveness of public spending. Public expenditures in Pakistan at 20 percent of GDP are not particularly large considering the high burden of interest payments. But there is general agreement that the quality and effectiveness of government, spending has been in a secular decline for quite some time linked to the broader issues of poor governance and decline of institutions. The serious deterioration in the quality of public education over the years and the public sector failure to fund critical power sector investment, even though the Public Sector Development Program (PSDP) in real terms grew enormously over 2000-09, are just two examples of ineffective spending and misplaced priorities. Even before the very sharp cuts that are being applied to the PSDP in 2010-11 in light of financial emergency, it was clear that the programme was spread too thin, was not clearly focused on key priorities, and did not give sufficient attention to quick gestation projects. A thorough review of development programmes both at the federal and the provincial levels has been overdue; now it has become extremely urgent because of dwindling resources. A major consolidation and restructuring of both current and development expenditure can yield economies as well as improve effectiveness.

In general, however, improvements in effectiveness of public expenditures can come only through better governance and effective decentralization. There have been two historic changes during the last year that have greatly improved the chances for a stronger and more harmonious Pakistan – a new NFC Award that transfers more resources to the provinces especially to Balochistan, and the 18th Amendment to the constitution that fully restores a parliamentary democracy while devolving much more authority to the provincial governments. These are steps that would strengthen the Federation and create conditions for a shared exercise of power. But this needs to be followed up by effective devolution to district level and below. The will for this appears to be lacking.

The case for devolving full responsibility for social sectors, especially education, to district level and below is strong. Without effective devolution, accountability mechanism will remain weak though safeguards to prevent elite capture or abuse will have to be put into place.

The major transfer of responsibilities from the federal government to the provincial governments under the 18th Amendment provides another important opportunity for integrating programmes and bringing about major savings.

The major solution of the governance problems including the greater role of local governments, the civil service reform, and building up of strong independent institutions requires both a vision and political will. The most immediate need is to restore the public trust in the government and the political leadership. The political leadership can gain greater confidence of the public only by greater transparency and accountability, control of corruption and a strong commitment to avoid waste and ostentatious behaviour.

POLICY COORDINATION

An important sub-set of governance is economic policy management and coordination. Pakistan has had in its history some major economic policy failures: lack of sufficient attention to exports, shifting attitudes to private sector, totally inadequate investments in human capital, neglect of population control and last but not least a persistent and excessive reliance on external resources for its development. But if one looks at the country's past plans and policies, the rhetoric was often right in terms of goals for higher savings rates, higher level of educational attainments, reduced dependence on external assistance etc. Big problems have been the lack of effective implementation, follow up and monitoring – simply learning what is going on and what is working and adjusting policies accordingly and consequently not learning from own and others' experience. This is where the contrast with countries like Korea is most striking.

How can implementation, monitoring, policy coordination be made more successful than in the past? Three areas desperately require urgent attention:

- Development of effective forums for dialogue and consensus building with the private sector

- Reinvigorating planning processes to monitor progress and deal effectively with economic crises and handling economic shocks
- Close coordination of economic policies across ministries, agencies, and provincial governments

There are no cases of development where economic progress has proceeded smoothly. Economic crises occur regularly either because of overheating of the economy or large external shocks like the energy price increases

Successful countries are able to quickly recognize changed economic circumstances and show flexibility, but poor performing countries postpone adjustment often at a great ultimate cost.

The lesson of history is that a crisis should not be allowed to go to waste and should be considered an opportunity to tackle deep seated problems. Better planning processes and close economic coordination cannot substitute for economic will but can certainly improve the chances of more rational decision making.

To conclude, a quick turnaround in the economy and the investor confidence would not be easy unless there is a marked improvement in the security situation and more visible evidence of better governance. However, with resolute action on governance front, public support for tough structural reforms can be mobilized and financial problems can be overcome. Strong economic revival might also be possible in three to four years provided government also gave greater thought to structural problems and presented a credible plan for dealing with constraints on growth and improving competitiveness. There are areas crying for attention: deep imbalance between consumption and investment, the pitiful tax revenues, neglect of exports, low level of investment in manufacturing, low level of agricultural and industrial productivity, low level of investment in human capital and a lack of firm commitment to strengthening of local government structures.

Chapter - 2

Medium-Term Outlook

Chapter - 2
Medium-Term Outlook

THE CURRENT SITUATION

Pakistan today is in the grips of an economic slowdown, with the GDP growth rate down close to the population growth rate and with high double-digit inflation, which is showing a persistent and rising tendency. The recent devastating floods have no doubt contributed to a loss of production, especially in agriculture. The loss of growth momentum is also due to a number of structural factors like a large energy shortage and the war on terror, which has dislocated economic activity and led to a loss of investor confidence.

Following the crises of 2008, the Stand-By Agreement (SBA) with the IMF had helped greatly in stabilizing the situation. Pakistan was able, subsequently, to complete four reviews successfully in this programme and receive assistance worth $8.7 billion. However, from 2009-10 onwards, economic conditions have begun to seem inappropriate. The root cause is the major deterioration in the fiscal position, due to lack of achievement of revenue targets, big increase in security spending, grants to cover large losses of state enterprises, etc. Consequently, as compared to the original fiscal deficit target of 4.9 percent of the GDP in the SBA, the actual deficit approached 6.3 percent of the GDP in 2009-10.

During the first six months of 2010-11, there was evidence of growing difficulties. The Finance Minister has warned that in the absence of strong policy actions the fiscal deficit could approach the peak level of 8 percent of the GDP. This has meant large bank borrowings, especially from the SBP, to finance the deficit. Currently, these borrowings stand at Rs 400 billion, which is almost 33 percent above the level attained during the corresponding period of the previous year. This has not only fuelled monetary expansion and led to an upsurge in the rate of inflation, but rising interest rates are also leading to a 'crowding out' of the private sector.

The rise in the fiscal deficit is due to a number of major policy reversals in recent months, arising primarily from failure of a relatively weak coalition government to implement the reform agenda agreed with the IMF. The RGST, involving removal of exemptions on goods and broad-basing to services, was to be implemented by October 1, 2010. But this did not happen due to strong political opposition and pressures from vested interests. Similarly, the policies of raising power tariffs and of adjusting Pakistan Oilfields Limited (POL) prices in line with the increase in the international oil price have been partially abandoned leading to a loss of significant revenues and rise in subsidies. Earlier, the decision to raise government salaries and allowances by 50 percent at budget time has added substantially to current expenditures of both federal and provincial governments. Due to slippages on the policy front, the Fund programme has effectively remained suspended since May 2010. Following a recent IMF mission belatedly, a Presidential Ordinance has been promulgated with additional taxation, expected to yield Rs 53 billion of revenue during the rest of the year.

There is a common perception that the fiscal situation is unlikely to improve due to postponement of structural reforms on the taxation and expenditures fronts as the political process moves into an 'election cycle', with a focus on populism. Elections are due in 2013 but may now be earlier. As opposed to these concerns, there is a degree of complacency arising from the present record level of foreign exchange reserves of over $17.5 billion and buoyancy in exports and remittances, which have led to a quantum reduction in the deficit in the current account of the balance of payments. There is need, therefore, for undertaking an economic scenario analysis for the next few years.

MEDIUM-RUN ECONOMIC SCENARIOS

The concern about emerging economic difficulties has been reflected in the previous Annual Report of IPP for 2010, which was aptly titled *Pulling Back from the Abyss*. One of the primary purposes of this Review was to develop forecasts upto 2014-15 of the economy in the following scenarios:

i) The SBA of the IMF is successfully completed by December 2010 as per the original timeframe, and Pakistan undertakes to meet the debt obligations to the IMF of over $13 billion from 2011-12 to 2015-16.

ii) The SBA of the IMF is not completed successfully, and Pakistan does not receive the last two tranches of over $3 billion.

At the time of printing of this report, the SBA of the IMF remains suspended since May 2010, and Pakistan has until September 2011 to implement the reform agenda agreed with the IMF.

It is clear that future economic developments will hinge crucially on whether business continues as usual, and there is little emphasis on removing the structural problems that have emerged, or if the present government or its successor implements a strong reform agenda covering areas listed in Box 2.1 and described in detail in the 'best case scenario' below.

Box 2.1
The Potential Agenda of Reforms

FISCAL POLICY

Taxation

- Development of Federal Taxes
- Development of Provincial Taxes
- Improvements in Federal Tax Administration
- Improvements in Provincial Tax Administration

Expenditure

- Reduction in Subsidies to Public Enterprises (including management of circular debt)
- Debt Management Policy
- Downsizing of Government (including cabinet)
- Policy on Administered/Regulated Prices(POL products, energy tariffs, procurement/support prices)
- Rationalisation of PSDP

MONETARY POLICY

- Degree of Autonomy of Central Bank and Limits to Borrowing by Federal Government
- Setting of Policy Rate by SBP
- Strengthening of Prudential Regulations
- Enforcement of Overdraft Limits on Provincial Governments and PSEs

BALANCE OF PAYMENTS POLICY

- No Intervention in FE Market
- Fixation of Import Tariffs
- Withdrawal of Export Controls
- Flotation of Bonds in International Market

OTHERS

- Social Protection Policy
- Implementation of the 18th Amendment Involving Transfer of Functions from Federal to Provincial Governments

Best Case Scenario

In this scenario, the government implements major tax reforms in the Budget of 2011-12, whereby comprehensive RGST legislation is introduced by the federal government involving withdrawal of all remaining exemptions on goods and elimination of distortions that have crept into the GST act, along with substantial broad-basing of the Provincial Sales Tax on Services. This is accompanied by measures to raise tax compliance by improving public perceptions of the equity of the tax system, like reintroduction of the wealth tax and strong measures to curb evasion in the payment of direct taxes.

Beyond these big moves, the provincial governments proceed to develop taxes like the agricultural income tax, urban immovable property tax and capital gains tax on property in line with the commitment made in the 7th NFC Award. The federal government focuses on measures to raise the quality of tax administration by strong campaigns against non-filers and under-filers, improvement of the audit process, introduction of mechanisms for curbing underinvoicing of imports and leakages in Afghan transit trade. Simultaneously, provincial tax machinery is strengthened on a functional basis.

On the expenditure side, top priority is given to improving the management and reduce losses of public enterprises/utilities like the Railways, PIA, Pakistan Steel, etc. Also, the problem of circular debt in the power sector is brought under control primarily through improvements in collection efficiency and rationalisation of power tariffs.

The Debt Management Policy is pursued effectively with the objective of reducing future debt servicing liabilities. Current expenditure of both levels of government is brought down by downsizing and practicing austerity wherever possible, including reduction in cabinet size. The policies on administrated/regulated prices are set in ways whereby domestic POL prices reflect fully the level of international prices and procurement/support prices of agricultural prices do not carry the weight of unsustainable subsidies. Finally, the PSDP is rationalised with allocations focused initially on completion of on-going priority projects and the size of the development programme increased subsequently as the fiscal situation improves.

Within the domain of monetary policy, the critical reform is the granting of greater autonomy to SBP under the new act, so as to limit the inflationary borrowing of the federal government from the central bank and to rigidly enforce the overdraft limits on the provincial governments and state enterprises. In the best case scenario, the SBP sets the policy rate primarily from the viewpoint of containing inflationary pressures. Given the enhanced vulnerability presently to Non Performing Loans (NPLs), stronger prudential regulations are put in place to protect the financial sector.

On the external side, implementation of the above reforms enables a resumption of the IMF programme and release of the two remaining instalments. This has a salutary impact on the flow of funds from other multilateral and bilateral donors. Also, the improvements in governance and strong policy actions contribute to a major resurgence in business confidence. Private investment in general and foreign direct investment in particular start rising once again. Government of Pakistan (GoP) begins to float bonds in the international capital markets. The Central Bank also adopts a policy of non-intervention in the foreign exchange market. The real effective exchange rate, consequently, more or less accurately reflects the state of the balance of payments. There is minimum resort to physical controls on exports (like food items, cotton yarn, etc), and private sector imports are allowed to the extent possible. Fiscal and other incentives are focused on achieving greater diversification of exports.

Other areas include, first, an upsurge in social sector expenditure, due especially to enhanced revenue transfers to provincial governments and, second, the resort to a more aggressive and better targeted social protection policy focusing not only on income supplements and food security but also on employment promotion. Coupled with higher growth, these policies lead to a fall in poverty once again after rising rapidly in recent years. Finally, over the next few months, the transfer of functions from the federal to provincial governments under the 18th Amendment takes place in an orderly and cost effective manner.

Worst Case Scenario

In this scenario, efforts at raising the tax-to-GDP ratio, especially through reforms like the RGST, continue to be effectively blocked by a coalition of political parties and vested interests. Provincial governments remain reluctant to develop their own revenue sources, especially in the period leading up to the elections and in lieu of larger transfers following the 7th NFC Award.

Given the existing problems of governance, including mismanagement and corruption, state enterprises continue to bleed heavily and require large and growing subventions from the exchequer. No conscious efforts are made to restrain current expenditure, and the burden of adjustment continues to be in the form of draconian cuts in development expenditure. The circular debt problem festers, and the power sector places large claims on the budget. The PSDP is increasingly exposed to 'pork barrelling', especially before the elections.

The act granting greater autonomy to SBP remains stuck in the Parliament, and the central bank comes under pressure to finance a big part of the large and growing fiscal deficit, thereby fuelling inflation in the economy. The problem of NPLs spreads in the economy, leading to a further loss of growth potential and enhanced vulnerability of commercial banks, which may eventually require fiscal injections for a bail out.

On the external side, the IMF-SBA remains suspended and comes to an end in September 2011. In the absence of the umbrella of a Fund programme, the international community becomes increasingly reluctant to make new pledges of support to Pakistan. Meanwhile, Pakistan has to continue honouring its debt servicing obligations, especially to the IMF and the multilateral development banks. In an environment of incipient crisis, the private sector becomes more shy and there is even the prospect of a flight of capital, triggered off by portfolio outflows from the stock market. As foreign exchange reserves decline, the exchange rate starts plummeting rapidly, thereby contributing to more import inflation in the economy. Overall, the economy enters a period of low and declining growth with high and rising inflation; consequently, the level of unemployment and poverty are likely to worsen sharply.

MACROECONOMIC FORECASTS

The contrasting set of forecasts of key macroeconomic variables in the two above mentioned scenarios are generated through the IPP Macroeconomic Model (described in Box 2.2). The results are presented below:

Box 2.2
Features of The IPP Macroeconomic Model

- Short-Run/Medium-Run-Keynesian
- Short-Run/Medium-Run-Keynesian
- Long-Run-Harrod-Domar
- 42 Equation Model
- Based on Consistent National Income Accounts from 1980-81 to 2009-10
- Models Consequences of:
  - Fiscal Policy
  - Monetary Policy
  - Trade Policy
- On Macroeconomic Imbalances, Inflation, Growth, Employment and Poverty
- Models Impact of Changes in World Economy
- Handy Tool for Policy Analysis and Scenario Building

Best Case Scenario

Decisive policy actions on the fronts of tax reforms and containment of current expenditure lead to a decline in the fiscal deficit from about 6 percent of the GDP in 2010-11 to below 4 percent of the GDP by 2014-15. The tax-to-GDP ratio rises by almost two percentage points while current expenditure falls by almost 1.5 percentage points of the GDP. Alongwith significant deficit reduction, this enables an increase in the level of development expenditure by almost 1.5 percentage points of the GDP.

The rise in public investment coupled with a recovery in private investment leads to an overall increase in the investment to GDP ratio by over 2.5 percentage points. There is a visible revival in the process or economic growth after the damage inflicted by the floods. From a GDP growth rate close to 2 percent in 2010-11, the growth rate rises to 5 percent by 2012-13 and reaches 6.5 percent by 2014-15, implying that the economy gets back after a gap of eight years to a trajectory of high growth. The growth response could be even more rapid if there is a reduction in the intensity of the war on terror and relative peace returns to the major cities of Pakistan. Foreign exchange reserves are bolstered in 2011-12 by the receipt of the last two tranches from the IMF SBA of over $3 billion. Alongwith the presently high level of Foreign Exchange (FE) reserves, this enables the economy to sustain the balance of payments in the presence of higher debt servicing obligations, particularly to the IMF. The exchange rate remains stable and could even appreciate somewhat in real terms. Very importantly, the rate of inflation is expected to come down to single-digit by 2012-13, due to a low rate of monetary expansion and limited imported inflation. The Model indicates that after 2012-13, the incidence of poverty starts falling in the country.

Worst Case Scenario

In this scenario, there is a real danger that the economy could plunge into a financial crisis by the second half of 2012-13, interestingly close to the time elections are to be held according to the normal schedule. This is caused by the haemorraging of foreign exchange reserves due to a rise in the current account deficit, unsuccessful completion of the IMF-SBA implying no further release of funds, commencement of significant debt servicing obligations to the IMF from 2011-12 onwards, reduction in net inflows from donors and continuing fall in Foreign Direct Investment (FDI). The exact timing of the crisis is, of course, difficult to predict. By the end of 2012-13, FE reserves could be down to about two months of imports. If business confidence starts falling before that happens, and there is a flight of capital then the crisis could hit the country in the earlier part of 2012-13.

Table 2.1
Macroeconomic Variables in The Best Case and The Worst Case Scenarios

	Unit	Scenarios	2010-11	2011-12	2012-13	2013-14	2014-15
Real GDP Growth	%	Best	2.2	4.4	5.0	5.5	6.5
		Worst	2.0	3.3	3.1	2.9	2.8
Investment	% of GDP	Best	12.5	13.1	13.7	14.4	15.1
		Worst	11.5	11.2	10.5	9.6	8.5
Rate of Inflation	%	Best	14.2	10.3	7.3	7.8	9.8
		Worst	14.5	11.9	12.5	15.7	20.1
Total Revenues	% of GDP	Best	13.6	14.2	14.9	15.3	15.8
		Worst	13.2	13.2	13.2	13.1	13.0
Tax Revenues	% of GDP	Best	9.7	10.5	10.9	11.3	11.8
		Worst	9.6	9.6	9.6	9.5	9.5
Total Expenditures	% of GDP	Best	19.5	19.5	19.5	19.4	19.4
		Worst	20.4	20.4	20.5	20.5	20.6
Fiscal Deficit	% of GDP	Best	6.2	5.3	4.6	4.1	3.6
		Worst	7.0	7.2	7.3	7.4	7.6
Stock of Government Debt	% of GDP	Best	54.5	52.9	52.2	52.7	53.8
		Worst	56.0	56.8	60.0	65.8	71.6
Debt Servicing	% of GDP	Best	4.5	4.1	3.9	3.9	3.9
		Worst	4.5	4.4	4.6	5.0	5.4
Exports of Goods and Services	% of GDP	Best	14.3	12.8	12.0	12.0	12.8
		Worst	14.3	13.6	13.9	16.2	20.4
Imports of Goods and Services	% of GDP	Best	20.2	19.8	18.8	18.9	19.7
		Worst	20.6	20.4	20.9	22.6	24.7
Current Account Deficit	% of GDP	Best	-1.2	-2.7	-2.8	-3.1	-3.0
		Worst	-1.7	-2.5	-2.7	-1.2	1.3
Foreign Exchange Reserves	Months of	Best	4.6	4.3	4.0	3.1	2.5
	Imports	Worst	4.5	3.6	2.4	0.9	0.3
Real Effective Exchange Rate	Index	Best	92.5	87.7	85.3	88.1	98.1
	(2009-10= 100)	Worst	92.7	90.1	94.8	110.8	133.2

Source: Estimates based on IPP Macroeconomic Model

In an environment of incipient crises and following the crises, the growth rate of the economy is bound to suffer severely and to essentially remain at below 3 percent. The inflation rate is likely to rise sharply once again, especially due to the large depreciation of the rupee, and exceed 20 percent by 2014-15. It is not surprising that the combination of low growth and high inflation is likely to lead to an explosion in poverty, with almost half the population falling below the poverty line in the next four years in the worst case scenario. The implications on the stability of government and on the security and law and order situation are too horrendous to even begin to contemplate.

The basic message from the analysis of medium run scenarios is that the economy today is poised on the 'knife edge'. With improved governance and implementation of a wide ranging reform agenda, the economy could get back to the path of relatively high growth. However, with business as usual, that is, a weak coalition government, with increasing propensity to populism as elections approach, we face the prospect of a major financial crisis within the next eighteen months or so.

Chapter - 3

Improving Governance to Produce Growth

Chapter - 3
Improving Governance to Produce Growth

INTRODUCTION

Is Pakistan a failing state, a failing economy? The citizens of the troubled Pakistani state may be reluctant – even embarrassed – to ask these and many other questions. But the fact remains that while we may not be prepared to discuss these matters, they are being addressed in a number of other forums around the world. To take one example: one of the authors of this report was invited by the Indian Council for Research in International Economic Relations (ICRIER) to speak on the issue of "Is the Pakistani economy collapsing?". ICRIER in New Delhi is one of the better known think tanks in India. It does serious research in the areas external to the Indian economy but which nonetheless will, in some way or the other, affect the country. It would matter for the Indians if the Pakistani economy collapses; it would put pressure on it in many different ways.

The response of the invited Pakistani speaker was that during his long tenure at the World Bank he had worked – in addition to several other assignments – on Latin America. As the Vice President responsible for the Latin America and the Caribbean Region, he saw many economies that were collapsing, had collapsed or were near collapse. There were several attributes shared by the countries in that situation. During hyper inflation when prices increased by anywhere between 100 to 1000 percent a year – sometimes even in smaller periods of time – as they did in the southern cone of Latin America (Argentina, Brazil, Paraguay, Uruguay), domestic currency practically ceases to exist. People begin to operate a barter economy. A plumber may work in the house of a dental surgeon only if the surgeon is prepared to attend to the plumbers teeth that needed some medical attention. The works get done to the satisfaction of the two parties involved but no money exchanges. Collapse of the banking system may cause a run on them, and the mattress in the house rather than a vault in the bank may become the repository of personal savings. In this situation, a great deal of money gets withdrawn from the economic and financial systems; this almost happened in Mexico in December-January 1994-95. Similarly, a country overwhelmed by external debt – or even domestic debt – may decide to default on one or on both; this happened not once but several times in Argentina and Ecuador. There may also be a complete breakdown of law and order as has happened in Haiti time and again, most recently after the devastating earthquake of last year.

Pakistan's economy and its society are undoubtedly under considerable distress, but they have not yet reached the situations described above. It can be said with some certitude that Pakistan's economy is not in a state of collapse. It faces many difficulties but there are ways for surmounting them. Actions are taking place on several fronts and they interact with one another producing uncertainty and anxiety. But, they ultimately succeed in moving forward the economy. Efforts are being made by a competent team of economic managers not only to steady the economy but to move it on to higher plane of growth. An incredibly powerful initiative has been launched to devolve many parts of the federal authority to the provinces. Taken together the announcement in late 2009 of the 7th NFC Award and the passage of the 18th Amendment to the constitution have the potential to revolutionize the structure of government. Properly implemented and in the spirit in which the authors of the amendment wrote, it could result in a significant improvement in the quality of government – the main theme of the 2011 Report of the IPP. One of the more important consequences of the successful implementation of these two initiatives may well be in improving the quality of governance.

There were many problems with the way the government handled the human and economic disasters created by the floods of the summer of 2010. Experts have called it the flood that comes once in a century. Much rehabilitation and rebuilding still needs to be done, but the fact remains that the country was not brought to a dead halt as a result of this major natural disaster. Then there is the problem of domestic terrorism that has been with us for a decade, ever since the 9/11 attack on the United States. As modeled in the previous reports, this development has cost a heavy loss of life and a heavy damage to the economy. Continuing domestic terrorism has also drawn foreign eyes towards Pakistan with not always happy results.

The important conclusion to be drawn from this quick overview of the current situation – one that we will offer over and again in the pages of this Report – is that public policies exist that can be adopted by a well-motivated set of leaders to deal with the admittedly difficult series of situations. In this context, it should be pointed out with some force that the several successes achieved by the protesters on the streets of the Middle East have given the clear signal to the ruling establishments in the developing parts of the world (in particular to those in the Muslim world where the development of political institutions, for whichever reason, has been weak) that people have a limited amount of tolerance for weak governance. It does not require foreign intervention of the type that occurred in Iraq and Afghanistan to change regimes. Even when political institutions such as parliaments, assemblies, and political parties do not exist in the form in which they should, people can come out on the streets and make their discontent felt in many ways. Once the people have decided to use the street to communicate their displeasure, technologies offer new opportunities for spreading the word. And once they are out in the street in large numbers, only the very determined or the very callous can hope to survive. As the columnist

David Brooks wrote recently for *The New York Times*, "the paradox is that if you want to be dictator, it is better to be narcissistic totalitarian than a run of the mill autocrat" (Brooks, 2011). The purpose of this brief digression into the affairs of the Middle East is to emphasize that ruling establishments can no longer totally ignore the will of the people. They need to ensure that the people's discomort for their situation does not make them desperate for bringing about change.

Following this brief stage-setting introduction we will move on to the main substance of the Report: the quality of governance, how poor it is, how it affects the performance of the economy, how it hurts the poor and less advantaged segments of the population and, finally, what can be done to move towards a better system. The position we will take here is that the complex set of endeavours that now go under the name of 'good governance' are essential to achieve a number of objectives: to speed up the rate of economic growth, to provided services to the people that only governments can deliver, to improve the distribution of wealth and income, to face internal security challenges and to keep the integrity of the state and its enemies at bay.

THE ECONOMY-POVERTY NEXUS

This brief overview of the Pakistani economy, as it has performed since the creation of the country more than six decades ago, is to underline some of the fault lines that exist under the economic structure. Pakistan's economy has now settled on a low-growth path, much lower than the average for the period since the late 40s. The average rate of GDP increase from the time the country became independent to the present – a period of almost 64 years – was 5.0 percent a year. As a result, the country's economy is 19 times larger than the size with which it was born. Since the population during the same period increased at an average rate of 2.6 percent per annum, income per head of the population grew by a 2.4 percent a year. An average Pakistani now is five times as rich as was his counterpart when the county was created more than sixty years ago. This was a respectable rate of increase in personal income, which allowed the country to keep a much smaller proportion of a considerably larger population out of poverty. There are no reliable estimates of the number of people who were absolutely poor in 1947 when the country was born. What is known though is that the areas that currently make up the Pakistani state were much poorer than the population in the areas of British India that became independent India. Then, the proportion of the poor in the Indian population was estimated by economists at 40 percent. It was, in fact, this number that led to the expression, "the bottom 40 percent" to refer to the society's poor. Given these estimates, it would not be seen as an exaggeration to say that at the time of its birth in 1947 some 55 to 60 percent of Pakistan's population of 30 million – or 17 to 18 million people – were absolutely poor.

A number of estimates are available for the current level of poverty in the country at this time. If we settle for a proportion of 35 percent of a population of 180 million in 2011, the size of the pool of poverty can be said to be 66 million. In other words, Pakistan's population since independence has increased six-fold while the pool of poverty has grown four-fold. In broad historical terms, Pakistan's economic performance, if viewed in the context of its impact on poverty, can be viewed as satisfactory – but not outstanding. China, for instance, is considered a success story having been able to reduce the incidence of poverty from 50 percent to only 10 percent over a period of 62 years. It was able to achieve this because of the sustained high rate of growth over a period of thirty years. Since 1979, when Beijing launched an ambitious programme of economic reforms, China's gross domestic product has increased at an average rate of 10 percent a year. Because of this period of sustained growth, China's economy is twenty times larger than it was in 1979 when Deng Xiaoping took over the reins of government.

What led to China's exceptional economic expansion were a series of reforms that covered a wide front. The economy responded quickly and vigorously since the base of growth was laid by Mao Zedong in the preceding thirty years. During that time the government provided universal education and primary health care and liberated women from virtual servitude. Without Mao there would have been no Deng. If the Chinese experience has a lesson to teach, it is that broad human resource development is vital for sustained economic growth. As will be discussed later, this important conclusion from the experience of China and other successful East Asian countries has not been fully incorporated by the Planning Commission in its draft growth strategy. Mao's approach was very costly in terms of lives lost while the conditions of those who survived were to improve after a lag of time. It would be more prudent for countries in Pakistan's situation to concentrate on producing growth, and improving human resource simultaneously and not sequentially as was done by the Chinese. Economic expansion will produce the space within which broad human development can be undertaken. Without growth, human resource development can a very painful process.

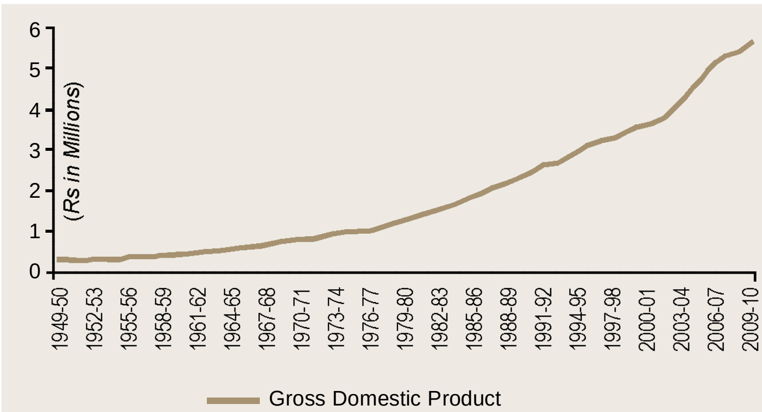
Growth, in other words, while essential for the alleviation of poverty, must be preceded by some human resource development. Empirical work done at the WB indicates that the rate of increase in GDP need to be twice as high as the rate of increase in population for the proportion of the poor to remain about the same. It could be a bit higher if the distribution of income is more skewed than is normal for developing countries; it could be lower if the national income is more evenly distributed. For a significant change in the incidence of poverty to occur, the rate of increase in GDP has to be at least three times the rate of growth in population. Applying these ratios to Pakistan's case, a GDP increase of 4 percent a year (about twice the present increase in the rate of population) could keep the incidence of poverty at about the same level as it is today – about 35 percent of the total. Anything lower would increase the incidence of poverty; anything higher would result in its reduction. In light of this, it is correct for the Planning Commission to focus on reigniting growth in the economy as the principal focus of the strategy it is currently designing; however, as has also been learned over and over, growth would not automatically trickle down and help the poor. Benefit from growth only works for the poor when new jobs are created; job-creation generally is the way the trickledown works.

GROWTH TRENDS IN PAKISTAN'S ECONOMIC HISTORY

Table 3.1
Percentage Growth Rate of GDP and Population

	1949-50 to 1959-60	1960-61 to 1969-70	1970-71 to 1989-90	1980-81 to 1989-90	1990-91 to 1999-2000	2000-01 to 2009-10
GDP	3.1	7.0	5.2	6.1	4.3	5.1
Population	2.5	2.9	3.2	3.1	2.4	1.8

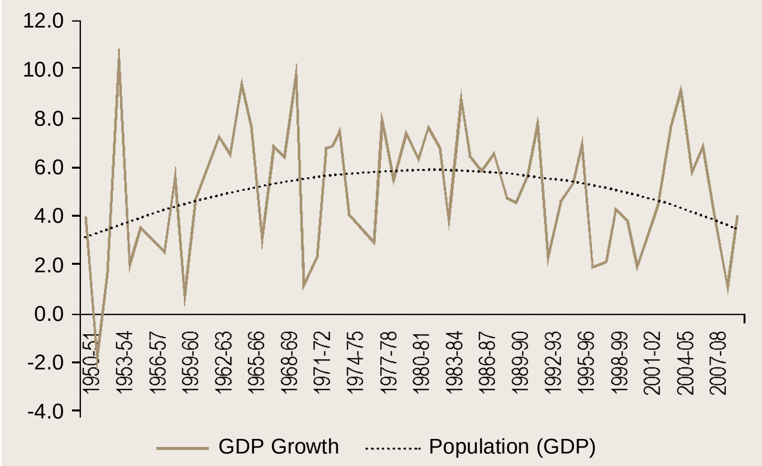
Chart 3.1
Trends in GDP Growth



However, as has been demonstrated by both the Planning Commission and the WB, the growth trend in Pakistan is following a downward-sloping curve. An urgent task before the policymakers, therefore, is how to reverse the trend and get growth going again. The historical growth experience is shown in Table 3.1 and the accompanying Chart 3.1 and 3.2. As the data of the Table show, the rate of growth in GDP saw significant variations in the past sixty years. The rate of growth was slow in the first post-independence decade with the GDP increasing by 3.1 percent while the population grew by 2.5 percent. Compared to the performance of the economy in the first half of the twentieth century, this was a respectable performance. The sharp increase in fertility that resulted from the important developments in public health care, which in turn was the result of the medical advances made during the Second World War, produced a significant increase in the size of the population. The South Asian subcontinent had not experience population growth rates of 3 percent or more that became common in Pakistan for several decades. This means that the rate of increase in income per head of the population was only 0.6 percent a year, not enough to do much with the large incidence of poverty that existed when the country attained independence. In addition, the country then had to deal with vast disparities in incomes between the two provinces, East and West Pakistan.

There was a sharp jump in both, the rate of growth in GDP as well as the rate of increase in population in the second post-independence decade (see Chart 3.2). This was to be the sharpest increase in GDP in Pakistan's history, not just in the level reached but also in the acceleration that occurred. A number of Pakistani economic historians have offered explanations for this extraordinary performance of the economy. There is consensus on three suggestions about the determinants of growth during this period. One, there was regime focus on developing a strategy that would help shake the country out of the anemic growth rate of the last decade. This was to be done by a revitalized Planning Commission that was given wide authority to lay down the strategies, plan and finance programmes and projects that flowed from the strategy and watch over their implementation. It helped that the high profile given to the Planning Commission drew a lot of talent into it. For several years, it was the place for the best and the brightest in the country.

Chart 3.2
Gross Domestic Product-Population Growth Comparison



The second important contributor was the easy foreign flows that became available once President Ayub Khan aligned his policy with that of the United States. In fact the ability to acquire relatively cheap money from the United States set the pattern of growth for the Pakistani economy. Growth was high when foreign flows arrived in large quantities; it declined when, for whatever reason, the flows were curtailed. This kept the economy on a rollercoaster ride. However, there is some evidence from recent development literature that foreign aid in Pakistan was negatively associated with long run GDP growth in the absence of macroeconomic fundamentals (Ahmed & O'Donoghue, 2010). The easy availability of aid during the periods when the leadership in Pakistan was able to align its own interests with those of the providers of foreign aid, was used as an alibi by those in power not to undertake some fundamental economic and social reforms.

The third important contributor was the encouragement provided to the private sector in terms of both incentives and capital to invest in the economy. While India across the border was putting the state on the commanding heights of the economy, Pakistan was giving encouragement to the private sector to lead. This was done by providing private entrepreneurs with capital and price incentives through taxing agricultural exports.

This model of development was turned on its head by the government following the one headed by Field Marshal Ayub Khan Pakistan's first military President. The decade of the 70s saw the wrenching of a structural change in the Pakistani economy which included virtual collapse of the entrepreneurship by private sectors. This happened because of the large scale nationalization, that occurred after the first wave of large industries being taken over by the government became ad hoc and highly capricious. The weather also turned sour and depressed the rate of growth in agriculture sector. The jolts to the economy, delivered by the civilian leadership led by Prime Minister Zulfikar Ali Bhutto, were severe enough to get the street back into action. Led by the Islamic parties the people on the streets demanded new elections to correct the palpable rigging that had marked the elections held in 1977, the first to be conducted under the constitution of 1973, largely a Bhutto artifact. When the Prime Minister demurred and the mood on the streets became ugly, the army intervened, took over the administration, charged Bhutto for several crimes including murder and finally hanged him.

The military back in power in 1977 under General Zia-ul-Haq stayed on for 11 years. The President had little interest in economic matters, leaving the management of the economy largely to such technocrats as Ghulam Ishaq Khan and Mahbubul Haq. While the two steadied the economy, they did little to address the structural problems the country faced: low domestic savings rate, low tax-to-GDP ratio, neglect of international trade and neglect of human resource development. It was once again the increase in foreign flows, this time to compensate the country for participating in the first Afghan war, that perked up the economy.

The military regime governed conservatively both in the economic and political fields. The pariah status, that Bhutto's execution had earned the new administration, changed quickly and quite dramatically by The Soviet Union's invasion of Afghanistan and Pakistan's willingness – in fact eagerness – to join the coalition led by the United States and Saudi Arabia to expel the invaders. A proxy war was the result, in which the boots on the ground were provided by Pushtun soldiers trained and ideologically motivated by dozens of seminaries set up in the many refugee colonies along Pakistan's long border with Afghanistan. After a decade of war, the Soviet Union pulled out of Afghanistan leaving behind rag-tag armies of largely indisciplined soldiers who were not made regulars and continued to operate. In return for its support, Pakistan received large dozes on foreign assistance which helped increase the rate of growth of the economy.

It was violence of a different kind that brought down the third military regime. In his case General Zia was the victim of likely sabotage of the plane that was carrying him that killed him and most of the military high command. This was in keeping with an unhappy tradition. Both Ayub Khan and Yahya Khan were forced out of office either by street violence as was the case with the former or the threat of its use in the case of the latter. A number of young military officers, who were extremely unhappy at the way the latter had governed and behaved in office, forced the general to leave. It was street violence that caused the demise of the Bhutto regime and its replacement by a military man. Although we are jumping ahead in telling the story, the fourth civilian to military change in the political order that occurred in October 1999 was also caused by semi-violent events – the order by the prime minister to keep the plane carrying General Musharraf in the air even though it was running out of fuel at persuaded the general's military colleagues to rebel and take over the government.

General Zia-ul-Haq's eleven-year regime interrupted by an unexplained air craft accident was followed by four governments headed by elected prime ministers. Three of these were dismissed by the presidents of the day on the grounds they could use under a constitutional provision introduced by President Zia to remove elected governments from office. The grounds under the infamous Article 54(b) authorized the president to dismiss serving prime ministers and his cabinets, dissolve the legislatures and order fresh elections if he was satisfied that the county was being misgoverned. The weight of this provision hung over the heads of the prime ministers. In each case of the dismissal, the president worked closely with the army chief of staff. Even though the army had no formal role in governance, it was always there lurking behind the scenes. The uncertainty produced by this style of political management meant that caution won over enterprise, and the serving administrations let the economy by and large drift. The only exception to this general rule of governance was the decision by the administration, that was in office from 1991-93, to open the economy and allow greater space to the private sector.

Two important conclusions emerge from this brief foray into Pakistan's economic and political history. *First*, the political see-saw that marked the first 60 years after independence meant that those who governed were not given time to reflect on important changes in the structure of the economy. By remaining constantly on the defensive, they allowed a number of vested interests to fill the political vacuum. It was thus that the civil and military bureaucracies filled the space that was created. *Second*, conditions outside the country created opportunities for moral hazard approach to financial management. Those who were in charge were confident that even if they drove the economy to the edge of an abyss, their outside friends would come to the rescue; this invariably happened. On top of the political see-saw came a financial roller-coaster that granted spurts of fast economic growth whenever external flows were generously available.

Pakistan, in other words, did not settle down to evolve a style of governance that would meet the needs of the people and the various regions into which the country is divided. For the first time in the history of the country, also because of several developments outside the borders that may have created the circumstances, the question of good governance has been brought to forefront of public concern.

GOOD GOVERNANCE AS A DETERMINANT OF GROWTH AND BETTER DISTRIBUTION OF ITS REWARDS

What are the determinants of growth? This question has been and continues to be of central interest for those who are pursing the disciplines of growth and development economics. In Pakistan's case, it is well understood that the economy must save more and invest more in order to get sustained growth embedded in the economic system. It is also now realized that by improving the quality of human capital, it is possible to get more growth out of the same amount of investment. It is possible to lower the Incremental Capital Output Ratio (ICOR) – the percentage of national income that needs to be invested to produce one percentage point of increase in gross domestic product – by introducing efficiency into the production system. Better educated and trained workers help to make the economy more efficient. The production system becomes more efficient also if transaction costs are reduced, by allowing inefficient firms to exit and by allowing new firms to enter. It is also important to improve the technological base of the economy. For that to happen, the state must invest more in education and also provide resources for activities that go under the name of research and development. Finally, there is a positive relationship between the ratio of trade-to-gross domestic product and the rate of increase in national income. These are all some of the elements in growth economics. When the state promotes all of them simultaneously, the results can be very rewarding. It is the emphasis on these factors in the production function that produced some of the many miracles in East Asia.

However, somewhat less understood is the relationship between the quality of governance on the one side and growth and poverty alleviation on the other. That good governance is essential for promoting growth, alleviating poverty and improving income distribution is a realization that has come only recently to developing economists. Initially the term 'good governance' was employed by the WB in the mid 90s to focus the attention of its borrowers on corruption. Given the sensitivity about the term 'corruption' in many parts of the world, the Bank used the word "governance" to connote the same line of thinking. Bank's analytical work began to underscore the damaging impact of corruption on economic development and growth. It also began to emphasis the fact highlighted by its empirical work that the burden of corruption fell move heavily on the poor.

Since the bank needed to define governance more fully in order to understand how it impacted on growth and poverty, it disaggregated the concept and developed a number of indices to connote its full import. This resulted in the production of a vast amount of literature that began to analyze how good governance aided growth and development and how poor governance contributed to poor performance. Numerous indices into which the term governance has been divided can be assembled into essentially three categories of activities: responsibility, deliverability and accountability. We will deal with each of these in turn.

Responsibilities means the mandates functionaries receive from the people when they are elected to represent them in different public offices. It also means the contracts non-elected functionaries enter into upon taking up positions as public servants. The state's responsibilities towards the citizens are enumerated in the various clauses of the constitution. Their definition begins with the preamble according to which "it is the will of the people of Pakistan to establish an order…wherein shall be guaranteed fundamental rights, including equality of status, of opportunity and before law, social and economic and political justice and freedom of thought, expression, belief, faith, worship and association subject to law and public morality…"[1]. The extent of the state's responsibility for delivering services differs, is usually determined by tradition and history and by how effective people are in exercising their influence on policymakers. Generally, the failure of non-state institutions to deliver what people desire leads to an extension in the reach of the state. The most obvious example is that modernization brings about the break-up of the extended family structure as more nuclear households are formed when married children move out, sometimes to more distant places in search of jobs and earning opportunities. This shifts the burden on to the state for providing security in old age, a trend that has been observed in the developed societies of Europe and North America. Much of the expansion in the role of the state in these countries was the consequence of cultural changes that occurred with modernization. The responsibility for providing security for those not working shifted from households to publicly funded institutions. This led to the creation of myriad systems of social security in the developed world.

The reverse in also true as the failure of the state to provide what were once regarded as its core functions were taken over by non-government institutions. In most of mainland South Asia – but in Pakistan in particular – the private sector has stepped in to provide quality education to the segments of the population that have the means to pay for it. Where such means were not available, religious schools, generally going by the name of 'madrassas', have become active. Consequently, Pakistan now has a segmented educational system with the public sector catering for the needs of two-thirds of the school-going population, private-sector schools serving one-third of the population, with religious seminaries taking care of five percent. This fragmentation in the system of education will have serious social, political and economic consequences. Some of these have already begun to manifest themselves.

Similar developments are occurring in the health sector. As is the case in education, the sector of health is also poorly funded; poorly staffed, often by ill-trained professionals; following outdated technologies and concentrated mostly in large urban areas. Even in the large urban cities, which claim disproportionate share of public expenditure on health care, the quality of service provided is of a much lower standard than demanded by the more affluent segments of the population. These groups are now being catered by the private sector. Some of the clinics run by private operators are able to keep abreast of modern technologies and techniques being deployed in more advanced societies.

Provision of security is the third important service the citizenry expects from a well-functioning government. Here again the public sector is failing. Not only are the public security services unable to cope with growing domestic terrorism, they have also failed to ensure peace by controlling ordinary criminal activity. Once again, the situation created by the failure of the state has led to the affluent turning to private firms to provide security. Security business is one of the fastest growing components of the service sector.

The final aspect of governance is accountability. This means how those responsible for serving the people in various capacities are held accountable. Accountability has several elements, the most important of which is the legal frame work and the judicial system that keep checks on the various functionaries of the state. Litigation is normally the means used by the affected people to ensure the protection of their rights against encroachment by the functionaries or instruments of the state. In some systems – Pakistan is among them – the office of the Ombudsman is available to entertain people's complaints. Several countries – again Pakistan is among them have set up separate systems operating under their own laws and using their own investigative and court systems to ensure accountability. Some of these devices for ensuring accountability are highly politicized. This has happened in the case of Pakistan. Accountability as an integrated system covering investigation of possible wrong doing, trial and sentencing of those who were suspected of having misused the powers entrusted to them was instituted by the first elected governments to take office after the end of the military rule under General Zia-ul-Haq. It was heavily amended by the second elected government and became highly politicized. When the military returned to power in 1999, it recreated the system by creating the National Accountability Board (NAB) with investigative and court systems that were responsible to it. The NAB structure failed to stem the rise in the level of corruption. The 2010 report issued by Transparency International (TI) suggests that Pakistan now has greater degree of corruption than was the case during the last military period.

Tackling the problem of poor governance requires a multidimensional approach. The subject has attracted a great deal of academic and institutional interest. Mahbubul Haq Human Development Centre, based in Islamabad, is one of the many that have worked in the area. In its 1999 report, that was devoted to the study of poor governance, the institution emphasized that Pakistan was not the only South Asian country dealing with this problem. "South Asia represents a fascinating combination of many conditions. It has governments that are high on governing and low on serving; it has parliaments that are elected by the poor but aid the rich; and societies that assert the rights of some but perpetuate exclusion of others. Despite the marked improvements in the lives of a few, there are many in South Asia who have been forgotten by the formal institutional governance. These are the poor, the downtrodden and the most vulnerable of the societies, suffering from acute deprivation on account of their income, caste, creed or religion. Their fortunes have not moved with those of the privileged few, and this in itself is a deprivation of a depressive nature" (Mahbubul Haq Centre for Human Development, 1999). Half a dozen years later the institution revisited the subject and its language acquired an edge of desperation. Governance constitutes for (ordinary people) a daily struggle for survival at the hands of public institutions. For them, lack of good governance means brutality, corruption in accessing public services, ghost schools, teacher absenteeism, missing medicines, high cost of low access to justice, criminalization of politics and lack of social justice. These are just a few manifestations of the crisis of governance (Mahbubul Haq Centre for Human Development, 2005).

Civil service reform and reform of the judicial systems are two of the several areas that need to be the focus of the effort aimed at improving the quality of governance. The first has been the subject of government attention from the founding of Pakistan to this day. In fact, the draft of the First Five Year Plan devoted a chapter on the subject. It was not acted upon largely because of the enormous amount of power the Civil Service of Pakistan had come to wield. Several other efforts were made, the last by the regime headed by General Pervez Musharraf. It appointed the National Commission of Government Reforms in May 2008 under the chairmanship of Dr. Ishrat Husain[2]. The Commission's report presents a programme of significant public service reform. Some of its suggestions no doubt influenced the Parliamentary Committee headed by Senator Raza Rabbani. The Husain Commission recommended the reduction in the number of federal ministries from the present 41 to 23 and the number of divisions from 46 to 31. Further it suggested that the 411 autonomous bodies, attached departments, corporations, councils, institutes and subordinate offices at the federal government should be regrouped into 177 autonomous bodies and 70 executive departments. District services should be constituted as a third tier of the public service system, that will have 1.2 million people out of total of 1.8 million. Under the Commission's programme a three tier system of public services will be created for the federal, provincial and district governments.

Currently, Pakistan is poorly governed when governance is interpreted using these three concepts. A strategy aimed at improving growth performance of the economy must direct its attention to improving these three dimensions of governance; failing which would mean that the resources of the state, and the fruits of growth would continue to be distributed inequitably. If this happens over an extended period of time, the result can be the types of revolutions we have seen on the Arab Streets. Democracy will not always prevent the unhappy to make their grievances known in the street.

THE CASE FOR DECENTRALISATION

Why is it important to focus on decentralization of the system of governance at such a difficult moment in Pakistan's economic history? The question is important because the country is so deeply engaged in the process at this moment. We believe that devolution of authority to lower levels of government – not only to the provinces but also to the institutions of local government – is one of the more important solutions to Pakistan's many economic, political and social problems.

To elaborate on this important point we go back to the writings published some decades ago by a Political Scientist and an Economist, both of Harvard University. Before Samuel P. Huntington gained fame for writing *The Clash of Civilizations* (Huntington,1998), a book in which he predicted that Islam and the West were destined to clash since the values each espoused could not be reconciled, he had established his reputation in academic circles by putting what he called 'relative deprivation' at the centre of political conflict. This thesis was developed in a book that appeared under the title of *Political Order in Changing Societies* (Huntington,1968). In explaining his hypothesis, he studied the rapidly growing economies in what was then called the Third World. The countries he studied in the 60s included Pakistan, which then had one of the highest rates of GDP growth in the developing world.

Rapid growth, Huntington maintained, produced a sense of deprivation among those who were left behind by the process of economic advance. In weak political systems discontent on the part of the relatively deprived could not be accommodated. This often led to political violence. Huntington's book, built around this argument, came out at the time when the regime headed by Field Marshal Ayub Khan in Pakistan had begun to crumble. The military regime came under pressure largely for economic reasons. Mahbubul Haq, the Planning Commission's chief economist under Ayub Khan, argued that a significant proportion of the wealth created during that time was captured by the very rich – by twenty two industrial, financial and commercial houses[3]. In an earlier work, Haq (1965) explained the model of economic growth that produced high rates of economic growth in Pakistan in the 60s. He then argued the case for the 'trickle down' approach to development. According to this approach, it was right to initially concentrate the attention of the state on generating high rates of growth in the expectation that it will ultimately reach the poorer segments of the population (Haq, 1965). Later he changed his stance arguing that a significant proportion of the wealth created by high rates of economic growth during the period of President Ayub Khan was captured by the rich. Haq's assertion, not supported by several other estimates[4], nevertheless gave substance to the feeling of relative deprivation as the military regime celebrated what it called the 'decade of development' (Khan, M. A.,1967). This resulted in a mass agitation against Ayub Khan, that was to lead to his political demise within matter of a few months. The Harvard professor felt that Pakistan had vindicated him by providing real time substance to validate his thesis.

Table 3.2
Annual Compound Growth Rate
2001-02 to 2007-08 by Quintile

	1st	2nd	3rd	4th	5th
Pakistan	2.5	3.6	3.4	4.2	5.9
Urban	2.2	2.2	1.5	1.7	3.1
Rural	2.6	3.9	4.1	5.4	8.9

Source: Bhatty (2011)

The other contribution for understanding the economics of political despair came from the economist Albert O. Hirschman, who published his book *Exit, Voice and Loyalty* (Hirschman, 1970), a couple of years after Huntington's treatise came out. In his book Hirschman suggested that those unhappy with their situation could exercise one of the three choices. They were likely to remain loyal to the system if the system found a way of accommodating them and dealing with their distress. If that did not happen, they would perhaps give voice to their unhappiness. If raising voice did not bring relief to the relatively deprived, they could exit the system in a number of different ways. Some forms of exit could be very destructive as has been the case for segments of the Pakistani population. While ideological considerations played some role in the rise of extremism in Pakistan, economics has been an important factor. One evidence of this is the recent work done by a graduate student at the Beaconhouse National University which shows the rise in incomes for various quintiles in urban and rural populations. (Bhatty, 2011) (see Table 3.2)

One very telling story, told by the estimates in the Table above, is the differentials in the rates of growth of the incomes in countryside; there the rates of growth of per capita incomes for the top quintile of the population increased more than three times the rate of increase for the lowest quintile. This led to a sharp rise in income disparities in rural Pakistan. The differentials were not as great in the urban economy. This may be one reason why extremism has taken root in the countryside, in particular rural/South Punjab.

There is sufficient empirical evidence from around the globe to suggest that feelings of relative deprivation result not only from income differentials but also from the inequality in the services to which they and other segments of the society have access. Poor governance means poor public services; the rich can buy most of these from the market place, for the poor government is the only source. This is the way the situation is evolving in Pakistan. The private sector is now involved in providing a number of vital services – education, health, and security for instance – but these are available for a price which the poor cannot afford. Not only the state has failed in providing these services to the poor and even if they are available, the quality generally is very poor.

One way of overcoming the deficit in the provision of services is to take the government closer to the people, give government departments the authority as well as the resources to provide the needed services and make the government functionaries accountable to the people needing the services. In its work in the Latin American and Caribbean region, the WB found that by making the local representatives of the government accountable to local communities the quality of services improved measurably. This was particularly the case in the sector of education where parents were given a role in supervising the system, which they did effectively even when they themselves were not very well educated (Burki, Perry & Dillinger, 1998). It is in this context and for this reason that the devolution programme under implementation holds a great deal of promise provided it is done with proper care. Therefore, the genesis of the 18th Amendment is rooted in the motivation for bringing government closer to the people and enhancing accountability in the system.

Chapter - 4

Changes in the Structure of Government: Pre and Post 18th Amendment

Chapter - 4
Changes in the Structure of Government: Pre and Post 18th Amendment

The years 2009-10 and 2010-11 will be memorable years in the history of Pakistan. The country witnessed hallmark developments, which constitute major advances on the path of decentralization of the type described in the earlier chapter. The case for decentralization, as one of the mechanisms to pull the country from the edge of abyss, has also been established[1]. These developments constitute 'opportunities' which, if implemented in letter and spirit, will lead to a quantum leap in fiscal devolution in Pakistan, enhancing provincial autonomy and strengthening the federation.

The first of these hallmark developments is the signing of the 7th NFC Award by the members of the NFC in the presence of the Chief Ministers of the four provinces and the Prime Minister on the 30th of December 2009. Agreement on this award was reached at the sixth meeting of the NFC held in Lahore earlier in December; the award came into force on 1st July 2010. It has been rightly acclaimed as a great achievement. It enhances significantly the share of the provinces in the federal divisible pool from 46.75 to 56 percent in the first year and 57.5 percent in the remaining years of the award. Punjab showed great accommodation by accepting multiple indicators for horizontal distribution, primarily for the benefit of the smaller provinces. It gave up its position that population should be the only criterion for allocating central government generated revenue.

The other major event which reinforces the process of strengthening provincial autonomy is the passage and signing into law on 9th April 2010 of the 18th Amendment to the Constitution by the President of Pakistan. With this Amendment the Concurrent List of the Constitution stands abolished, devolving the functions contained in this list largely to the provincial governments. This significantly enhances the range of functional responsibilities of provincial governments and constitutes an important step in bringing the government closer to the people. The subsequent sections trace the changes in the structure of the government following the 18th Amendment.

FUNCTIONAL RESPONSIBILITIES AND FISCAL POWERS

Allocation of functions between different tiers of government are defined in the Fourth Schedule of the Constitution of Pakistan. Prior to the 18th Amendment, the Fourth Schedule contained the Federal Legislative List (FLL) (Part I and Part II) and the Concurrent Legislative List. The functions performed by the federal government were included in the Federal Legislative List while the Concurrent Legislative List listed functions that could be performed by either level of government. In practice, some of the functions were performed by the federal government as well. The 18th Amendment has abolished the Concurrent Legislative List of the Constitution (entries 1-47 of the Fourth Schedule of the Constitution have been omitted) and has made changes in the Federal Legislative List, Parts I and II. Consequently, the structure of government has changed quite substantively. Annexure 3.1 gives the Concurrent List of the Constitution, which stands abolished and the functions transferred to the provinces with a major exception of electricity, which now falls into Part II of the Federal Legislative List.

Besides, the 18th Amendment has also made five deletions from the Federal Legislative List Part I. Box 4.1 presents changes in the Federal Legislative List Part I and Part II. Ports, national planning and national economic coordination along with census and extension of powers and

Box 4.1
Changes in the Federal Legislative List after the 18th Amendment

No.	Subject	Status	Transferred to
	PART I		
21	Major Ports	Deleted	FLL - Part II
32	National planning and national economic coordination including planning and coordination of scientific and technological research	Deleted	FLL - Part II
33	State Lotteries	Deleted	Provinces
38	Census	Deleted	FLL - Part II
40	Extension of powers and jurisdiction of members of police force belonging to any province to any area in another province, but not so as to enable the police of one province to exercise powers and jurisdiction in another province without the consent of the government of that province; extensions of the powers and jurisdiction of the members of a police force belonging to any province to railway areas outside that province.	Deleted	FLL - Part II
	PART II		
4	Electricity	Inserted	Concurrent List
5	Major Ports	Inserted	FLL - Part I
6	All regulatory authorities established under a federal law	Inserted	FLL - Part I
7	National planning and national economic coordination including planning and coordination of scientific and technological research	Inserted	FLL - Part I
8	Supervision and management of Public Debt	Inserted	FLL - Part I
9	Census	Inserted	FLL - Part I
10	Extension of powers and jurisdiction of members of police force belonging to any province to any area in another province, but not so as to enable the police of one province to exercise powers and jurisdiction in another province without the consent of the government of that province; extension of the powers and jurisdiction of the members of a police force belonging to any province to railway areas outside that province.		
11	Legal, medical and other professions	Inserted	FLL - Part I
12	Standard in institutions for higher education and research scientific and technical institutions	Inserted	FLL - Part I
13	Inter-provincial matters and coordination	Inserted	FLL - Part I

jurisdiction of members of police have been made a joint responsibility of the federal and provincial governments though the Council of Common Interest (CCI). According to the 18th Amendment, clause 154(1) "the council shall formulate and regulate policies in relations to matters in Part II of the Federal Legislative List and shall exercise supervision and control over related institution".

Box 4.2
Evolution of the Allocation of Functions among Different Levels of Government

Services	Account to 1973 and 2001 Devolution Plan	After 18th Amendment 2010 and 2001 Devolution Plan
Defence	F	F
International Trade	F	F
External Affairs	F	F
Census	F	F/P
Nationality, Citizenship	F	F
Posts and Telegrams	F	F
Currency Foreign Exchange	F	F
Public Debt	F	F/P
Telecommunications	F	F
Railways	F	F/P
National Highways	F	F
Major Ports	F	F/P
International Trade	F	F
Irrigation	P	P
Distribution of Inputs	P	P
Agriculture Extentions	P/L	P/L
Higher Education	P/L	P/L
School Education (Secondary)	L	L
School Education (Primary)	L	L
Preventive Health	L	L
Curative Health	L	L
Farm-to-Market Roads	L	L
Water Supply	L	L
Sanitation	L	L
Drainge	L	L
Solid Waste Management	L	L
Fire Fighting	L	L
Parks & Playgrounds	L	L

Note:
F = Federal
P = Provincial
L = Local

The consequent distribution of the functional responsibilities between the two tiers of government alters significantly. Evolution of functions among different levels of government is presented in Box. 4.2. The Box gives the allocation of functional responsibility before and after the 18th Amendment, 2010 and Devolution Plan, 2001. It may be mentioned that the local government system is in hiatus in three out of four provinces with Local Government Laws pending legislative approval. More will be said about local governments in Chapter 7. The conclusion that principally emerges from Box 4.2 is that following the 18th Amendment there is a more rational and balanced distribution of functions between the federal and provincial governments. Clearly, the 18th Amendment has empowered the provincial governments by assigning them more functional responsibilities. As a consequence, the following fifteen ministries stand devolved to the provinces:

1. Ministry of Special Initiatives
2. Zakat and Ushr
3. Youth Affairs
4. Population Welfare

5. Local Government and Rural Development
6. Education
7. Social Welfare and Special Education
8. Livestock and Dairy Development
9. Culture
10. Tourism
11. Food and Agriculture
12. Health
13. Labour and Manpower
14. Woman Development
15. Sports

In addition to the ministries earmarked for complete devolution, some subjects (selected function within ministries that will continue to exist at federal level) have also been selected for devolution. Approximately thirty two ministries will be retained at the federal level after the implementation of the 18th Amendment as described in the next chapter.

Turning next to changes in fiscal powers, thrust of the changes made in the 18th Amendment is on the functional side and amendments on fiscal side are minor, relatively speaking. The details are presented in Box 4.3. The gist of the amendments is the explicit recognition of sales tax on service and capital value tax on immovable property as a provincial subject which was implicit prior the 18th Amendment.

Box 4.3
Fiscal Powers - Amendments in Federal Legislative List Part I

45. Duties in respect of succession to property – Deleted
46. Estate duty in respect of property – Deleted
49. Taxes on the sale and purchase of imported, exported, produced, manufactured or consumed – (except sales tax on services – Inserted)
50. Taxes on the capital value of the assets not including taxes (on immovable property) – Inserted

SPECIAL PROVISIONS, FINANCE AND BORROWING

Besides the allocation of functional responsibilities and fiscal powers, the 18th Amendment has also made changes in Special Provisions of the Constitution, in the Finance, Audit and Borrowing Powers clauses, which are likely to have implications on the functioning of the economic system. Box 4.4 presents the Special Provisions pre and post 18th Amendment. The most important change relates to the composition and functioning of the CCI following the 18th Amendment. As shown in the box, the CCI has been greatly strengthened. It shall now be chaired by the Prime Minister, it shall meet once a quarter and it shall have a permanent secretariat. It shall comprise the Prime Minister, three Federal Ministers and the four Chief Ministers. The list of subjects on which the CCI will have policy control has been substantially increased by transfer of some of the subjects from the omitted Concurrent List, and some of the subjects from Part-I of the Federal

Box 4.4
Changes in the Special Provisions of the Constitution

Article	Pre 18th Amendment	Post 18th Amendment
	Council of Common Interest	
153	Composition:	Composition:
	2(a) Chief Ministers of provinces	2(a) Prime Minister
	2(b) An equal number of the federal government to be nominated by the Prime Minister from time to time	2(b) Chief Minister of provinces
		2(c) Three members from the federal government to be nominated by the Prime Minister from time to time
	3. The Primare Minister, If he is a member of the Council shall be the Chairman of the Council but, if at any time he is not a member, the President may nominate a Federal Minister who is a member of the council to be its Chairman	3. deleted
	4. The Council should be responsible to *Majlis-e-Shoora* (Parliament)	4. The Council shall be responsible to *Majlis-e-Shoora* (Parliament) and shall submit an Annual Report to both Houses of *Majlis-e-Shoora* (Parliament)
	Functions and Rules of Procedures	
154	1. The Council shall formulate and regulate policies in relation to matter in Part II of the Federal Legislative List and, in so far as it is in relation to the affairs of the Federation, the matter in entry 34 (electricity) in the Concurrent Legislative List, and shall exercise supervision and control over related institution	1. The Council shall formulate and regulate policies in relation to matters in Part II of the Federal Legislative List and shall exercise supervision and control over related institutions
		2. The Council shall be constituted within thirty days of Prime Minister taking oath of office
		3. The Council shall have a permanent secretariat and shall meet at least once in ninety days
	National Economic Council	
156	1.The President shall constitute a National Economic Council consisting of the Prime Minister, who shall be its Chairman, and such other members as the President may determine	1. The President shall constitute a National Economic Council which shall consist of: a) the Prime Minister, who shall be the Chairman of the Council b) the Chief Minister and one member from each province to be nominated by the Chief Minister and c) four other members as the Prime Minister may nominate from time to time
		2. The meetings of the Council shall be summoned by the Chairman or on a requisition made by one-half of the members of the Council
		3. The Council shall meet at least twice in a year and the quorum for a meeting of the Council shall be one-half of its total membership
		4. The Council shall be responsible to the *Majlis-e-Shoora* (Parliament) and shall submit an Annual Report to each House of *Majlis-e-Shoora* (Parliament).

Legislative List to Part-II of the Federal Legislative List as highlighted earlier. Some of the subjects which will now be in the policy control of CCI include major ports, electricity, all regulatory authorities, national planning, public debt, census, legal medical and other professions, standards of higher education and interprovincial matters and coordination. CCI will also have policy control over reservoirs in addition to (previous) natural sources of water supply.

Likewise the role of the National Economic Council (NEC) has also been strengthened, and provincial representation on it has been increased. It will meet at least twice a year and will submit a report annually to the Parliament.

Besides, Article 160 of the constitution which relates to the NFC has also been amended with the addition of the following two clauses:

> "(3A) The share of the Provinces, in each Award of National Finance Commission shall not be less than the share given to the Provinces in the pervious Award.
>
> (3B) The Federal Finance Minister and Provincial Finance Ministers shall monitor the implementation of the Award biannually and lay their reports before both Houses of Majlis-e-Shoora (Parliament) and the Provincial Assemblies."

Therefore, in future NFC shall not reduce the share of resources allocated to the provinces by the previous Commission, and there will be monitoring of the implementation of the Award. Also, provinces have become entitled, as of right, to the entire proceeds of the excise duty on oil (in addition to the excise duty on natural gas). Provinces have also been given power to raise domestic or foreign loans with the approval of the National Economic Council. Clause167 (4) has been inserted as follows:

"A Province may raise domestic or international loan, or give guarantees on the security of the Provincial Consolidated Fund within such limits and subject to such conditions as may be specified by the National Economic Council."

The effective impact of this provision has, however, been diluted with the federal government imposing the condition that this can be availed by the provinces only if they have no outstanding loans or overdraft. Also, the office of the Auditor-General of Pakistan has been strengthened. The Auditor General of Pakistan has been given a constitutional 4-year term of office and has also been empowered to audit the accounts of the federal and provincial governments and all their bodies, corporations and authorities through the insertion of the following clause:

> "170(2) The audit of the accounts of the Federal and of the Provincial Governments and the accounts of any authority or body established by, or under the control of, the Federal or a Provincial Government shall be conducted by the Auditor-General, who shall determine the extent and nature of such audit."

POLITICAL/JUDICIAL PROVISIONS

The 18th Amendment to the Constitution is more far-reaching in its impact than was perhaps intended by its authors. It not only attempts to cleanse the original constitution of the many distortions introduced into it by a succession of leaders that governed the country after its promulgation 1973. It also sets in place an entirely different structure of governance. At least on paper, some of the issues that have stood in the way of Pakistan's political development have been resolved. That this was done through consensus - the amendment received a unanimous backing in the parliament and represents one of the triumphs of the political order that began to take shape after the elections in February 2008. While real progress was made in defining a structure that will meet the needs of a very diverse population, what happens to it will depend to a considerable extent on practice - how various centers of power react to the enormous changes that are now in the process of being made.

The amendment has made progress in redefining three relationships: the relationship between the President and the parliament, the relationship between the centre and the provinces and the relationship between the judiciary on the one hand and the executive and legislative branches on the other. All these are being tested as the 18th Amendment's implementation begins to establish a new political order. It has become clear, while it was the intention of the amendment to circumscribe the powers of the President and give greater authority to the parliament and, therefore, redefine relationship between the President and the Prime Minister, not much has moved in terms of the focus of real executive authority. That has remained with the presidency since the person who occupies that office is also the head of the political party that governs from the centre.

Also remain unresolved is the relationship between the judiciary and the executive and legislative branches. This was tested by a court case filed in the Supreme Court that questioned the constitutionality of one of the provisions in the 18th Amendment leading to a debate within judicial circles and outside about the supremacy of the Parliament. Those who favoured no constraints on the recently empowered judiciary argued that even the Parliament could not pass an amendment to the constitution that violated its original intent. The Supreme Court side- stepped this issue by referring the case back to the Parliament and by suggesting the parameters within which the legislature could operate in so far as appointments of members to the Supreme and High Courts were concerned. This reference back to Parliament led to the passage of the 19th Amendment that allowed the judiciary a larger role in appointing judges. A new issue has emerged after the approval of the 19th Amendment: whether its provisions also apply to ad-hoc appointments.

The judiciary is also concerned about its ability to enforce its decisions that go against the authority of the executive branch. These will be tested as a number of important cases pending before it are decided by the Supreme Court. These refer to the implementation of the decisions relating to the National Reconciliation Ordinance (NRO) promulgate by the administration of President Pervez Musharraf.

Chapter - 5

Overview of Progress

Chapter - 5
Overview of Progress

TIMELINE OF DEVOLUTION

The devolution under the 18th Amendment is planned in three phases. Phase I was completed in December 2010; Phase II is currently underway (it should have been completed in February, but is now expected to be completed in March 2011). Phase III is also underway and is due to be completed by June of this year. In the first phase, five Ministries/Divisions have been devolved, in the second phase another five will be devolved, while the remaining eight divisions are expected to be devolved in the third phase as indicated below:

PHASE I	PHASE II	PHASE III
1. Ministry of Special Initiatives	6. Education	11. Food and Agriculture
2. Zakat and Ushr	7. Social Welfare and Special Education	12. Health
3. Youth Affairs	8. Livestock and Dairy Development	13. Labour and Manpower
4. Population Welfare	9. Culture	14. Women Development
5. Local Government and Rural Development	10. Tourism	15. Sports
		16. Statistics Division
		17. Environment
		18. Minorities Affairs

In addition to the Ministries/Divisions earmarked for complete devolution, some subjects (selected functions within ministries that will continue to exist at federal level) have also been selected for devolution. These include:

- Phase II: Ministry of Interior (Arms, Act), Ministry of Law and Justice, Ports and Shipping (inland waterways), Communication, Finance (State lottery), etc.

- Phase III: Initiatives that have a trans-provincial nature

The size of the federal secretariat would be reduced by 15 Ministries/18 Federal Divisions, by the end of June this year, thus reducing the number of federal divisions from 50 to 32 (see Box 5.1).

Box 5.1

Federal Ministries and Divisions Pre and Post 18th Amendment

Pre 18th Amendment		Post 18th Amendment		
		Phase I	Phase II	Phase III
1.	Cabinet Secretariat			
	● Cabinet Division	✓	✓	✓
	● Establishment Division	✓	✓	✓
2.	Planning and Development	✓	✓	✓
3.	Commerce	✓	✓	✓
4.	Culture	✓	✗	✗
5.	Defence	✓	✓	✓
6.	Defence Production	✓	✓	✓
7.	Economic Affairs & Statistics			
	● Economic Affairs Division	✓	✓	✓
	● Statistics Division	✓	✓	✗
8.	Education	✓	✗	✗
9.	Environment	✓	✓	✗
10.	Finance & Revenues			
	● Finance Division	✓	✓	✓
	● Revenue Division	✓	✓	✓
11.	Food & Agriculture	✓	✓	✗
12.	Foreign Affairs	✓	✓	✓
13.	Health	✓	✓	✗
14.	Human Rights	✓	✓	✓
15.	Housing & Works	✓	✓	✓
16.	Industries & Production	✓	✓	✓
17.	Information and Broadcasting	✓	✓	✓
18.	Information Technology	✓	✓	✓
19.	Inter-Provincial Coordination	✓	✓	✓
20.	Interior*	✓	✓	✓
21.	Kashmir Affairs & Gilgit Baltistan	✓	✓	✓
22.	Labour & Manpower	✓	✓	✗
23.	Law, Justice & Parliamentary Affairs	✓	✓	✓
24.	Labour and Manpower	✗	✗	✗
25.	Livestock & Dairy Development	✓	✗	✗
26.	Minorities	✓	✓	✗
27.	Narcotics Control	✓	✓	✓
28.	Overseas Pakistanis	✓	✓	✓
29.	Petroleum & Natural Resources	✓	✓	✓
30.	Population Welfare	✗	✗	✗
31.	Post	✓	✓	✓
32.	Ports & Shipping	✓	✓	✓
33.	Privatization			
	● Privatization Division	✓	✓	✓
	● Board of Investment	✓	✓	✓
34.	Railways	✓	✓	✓
35.	Religious Affairs	✓	✓	✓
36.	Science & Technology	✓	✓	✓
37.	Social Welfare & Special Education	✓	✗	✗
38.	Sports	✓	✓	✗
39.	Special Initiatives	✗	✗	✗
40.	States & Frontier Affairs	✓	✓	✓
41.	Textile	✓	✓	✓
42.	Tourism	✓	✗	✗
43.	Water & Power*	✓	✓	✓
44.	Women Development	✓	✓	✗
45.	Youth Affairs	✗	✗	✗
46.	Zakat and Ushr	✗	✗	✗
	Total 50	**45**	**40**	**32**

*Some subjects in the ministry to be devolved to the provinces.

EMERGING ISSUES

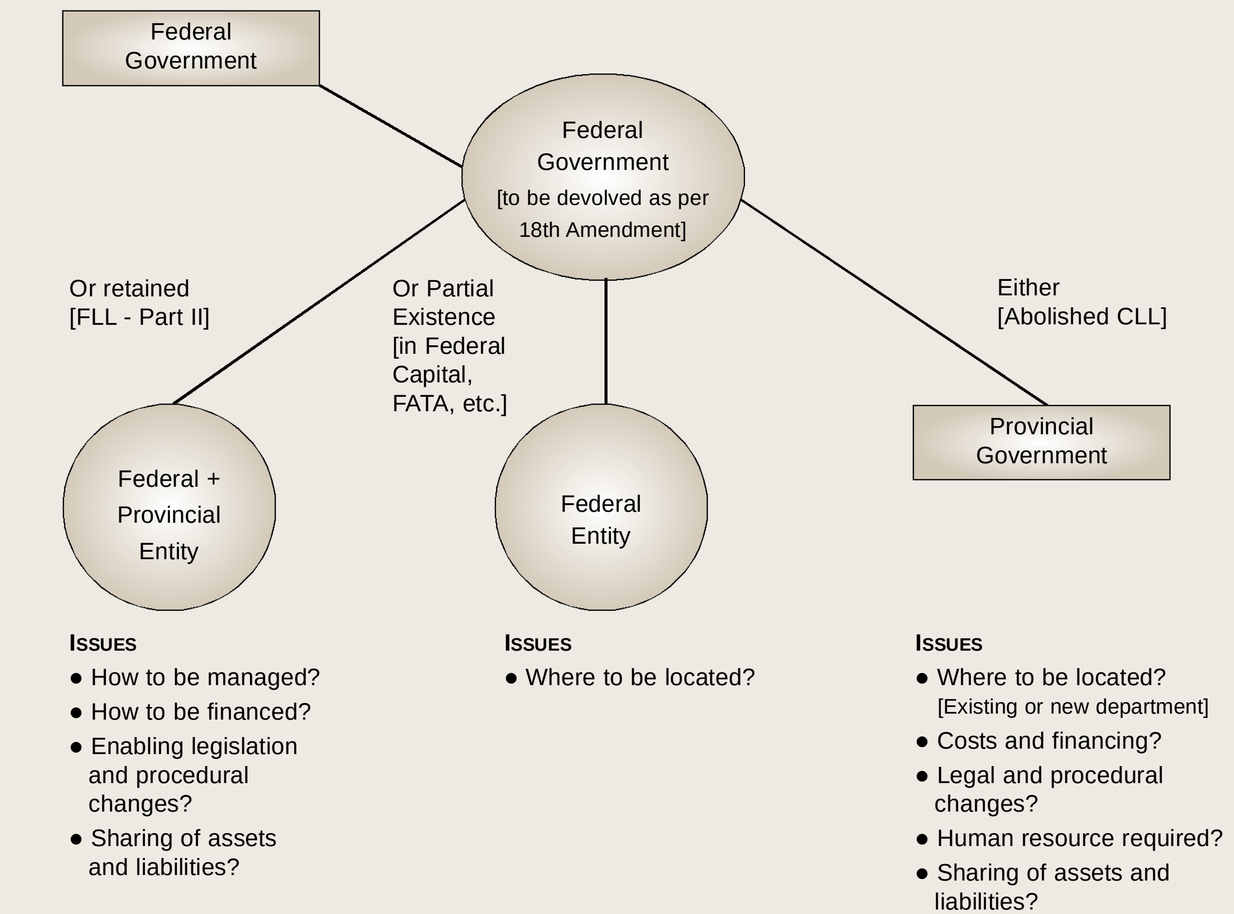
Devolution of the selected subjects is a complex task. A number of decisions are to be taken for smooth transfers and subsequent smooth functioning of the subjects. This is extremely important if quality of service delivery is not to be compromised in the post 18th Amendment era. Chart 5.1 presents the flow chart of some of the key decision to be taken in the process of devolution. The 18th Amendment has decreed that the devolved subjects are: (i) joint responsibility of the federal and provincial governments, (ii) partially retained at the federal level (as in the case of Islamabad, Federally Administrative Tribal Areas (FATA) etc.), or (iii) devolved to the provinces. In each of the above cases a number of questions have to be answered, such as, how will the subject be managed? How will they be financed? Does the enabling legislation exist? What are the changes involved in the procedures? What will be the human resource requirements for providing uninterrupted service at the provincial level? How will the assets and liabilities of the devolved ministries/divisions be shared?

These issues are complicated but need resolution. As an example, we cite the case of Ministry of Labour and Manpower. An emerging issue in the the devolution of the Ministry of Labour and Manpower is that federal and provincial governments differ over distribution of assets owned by the Worker Welfare Fund (WWF) and the Employees Old-Age Benefits Institution (EOBI). Financial deposits of WWF were estimated at Rs 81 billion, while EOBI has assets worth Rs 148 billion. These two institutions come under the Ministry of Labour and Manpower. The transfer of the ministry to the provinces is scheduled to take place by the end of March, but the issue is likely to drag on till June. Subjects such as labour welfare, provident funds, health insurance and old-age pensions are scheduled to be shifted to all provinces by June this year.

WWF provides grants to worker welfare boards, constituted in each province, to execute welfare projects. The FBR annually deducts two per cent of total income of all registered industrial units, whose income exceeds Rs 500,000; the deducted amount is placed at the disposal of WWF for utilization. Similarly, FBR collects five per cent worker wages in an industry, to be paid by the employer, and one per cent wages, to be paid by the worker, and places the funds at the disposal of EOBI. EOBI utilizes these funds for payments such as old-age pension, old-age grant and invalidity pension.

Since the adoption of 18th Amendment, discussions have been under way to decide on the devolution of organizational structure of WWF and EOBI, with allocation of their human resources and funds as well as distribution of existing assets to the provinces. As discussions are taking place over distribution of moveable and immovable assets, the Punjab government advocates distribution based on the location of registered industrial units and workers. Up to

Chart 5.1
Flow Chart of Decisions to be taken in the Process of Devolution



10,831 industrial units with 676,755 registered workers are operating in Punjab. On the other hand, the Sindh government is making the case for distribution to be based on source of collection and deduction of welfare fund and pension, as head offices of most of the industrial units registered under the two organizations, WWF and EOBI, are located in Karachi. Khyber-Pakhtunkhwa and Balochistan governments have proposed to continue the use of the existing formula, under which both provinces are receiving comparatively higher funds.

Another important question that arises in the process of devolution relates to the autonomous bodies attached to the ministries or divisions. Box 5.2 presents the list of departments/autonomous bodies affiliated with the devolved ministries. Devolution of the ministries will require decisions regarding the location of these bodies as well. Autonomous bodies such as Pakistan Tourism Development Cooperation (PTDC) are likely to be contentious as provinces are demanding equitable distribution of assets. Clearly, this is not always possible in the case of fixed assets such as buildings. There has been some discussion in the committee, formed by the government, about liquidation of such bodies and sharing of the proceeds among provinces on the basis of an agreed

Box 5.2
Departments Attached to the Devolved Ministries/Divisions

Ministry of Youth Affairs
- National Internship Program
- National Volunteer Movement

Ministry of Labour and Human Resource
- Central Inspectorate of Mines (CIM)
- Directorate of Dock Workers Safety (DDWS)
- Directorate of Workers Education (DWE)
- Implementation Tribunal for Newspaper Employee (ITNE)
- Labour Market Information System and Analysis Unit
- National Institute of Labour Administration Training (NILAT)
- National Talent Pool (NTP)
- National Training Bureau (NTB)
- Overseas Pakistanis Foundation
- Pakistan Manpower Institute (PMI)
- Workers Welfare Fund (WWF)

Ministry of Tourism
- Pakistan Tourism Development Corporation

Ministry of Social Welfare
- Directorate General of Special Education
- National Council for Rehabilitation of Disabled Persons
- National Council of Social Welfare
- National Trust For Disabled
- Trust for Voluntary Organizations (TVO)

Ministry of Environment
- National Energy Conservation Centre (ENERCON)
- Pakistan Environmental Protection Agency (Pak EPA)
- Pakistan Forest Institute (PFI) Peshawar.
- Zoological Survey Department (ZSD)

Ministry of Health
- Central Health Establishment
- Directorate of Malaria Control, Islamabad
- Federal Government Services Hospital, Islamabad
- Jinnah Postgraduate Medical Centre, Karachi
- National Institute of Child Health, Karachi
- Pakistan Institute of Medical Sciences, Islamabad

Ministry of Education
- Federal Directorate of Education (FDE), Islamabad
- Department of Libraries, Islamabad
- Higher Education Commission (HEC)

Ministry of Agriculture
- Agricultural and Livestock Products Marketing and Grading Department (ALPMGD)
- Agriculture Policy Institute (API)
- Department of Plant Protection (DPP)
- Directorate General of Food
- Directorate of Food Accounts
- Federal Seed Certification and Registration Department (FSC&RD)
- Pakistan Agricultural Storage and Services Corporation (PASSCO)
- Pakistan Agriculture Research Council (PARC)
- Pakistan Central Cotton Committee (PCCC)
- Pakistan Oil Seed Development Board (PODB)
- Soil Survey of Pakistan (SOP)

formula. However, so far, there is no clear strategy for dealing with the issue.

To facilitate the implementation of the devolution process and address such issues an Implementation Commission (IC) has been established. The IC is chaired by Senator Raza Rabbani and comprises eight members from different political parties. In total, 42 meetings of the IC have been held, four of which were directly chaired by the Prime Minister. The IC will exist till June 30, 2011. To facilitate its working, IC has formed committees to support the work on different aspects, for example, there is a Finance Committee headed by Ishaq Dar which has three members. IC will have to resolve the issues arising in the context of each subject on a case

Box 5.3
Functions, Earlier Allocated to the Devolved Ministries/Divisions Relocated at the Federal Level

	Tramsferred from		Functions	Transferred to
1.	Local Government and Rural Development Division	I.	Akhter Hameed Khan National Centre for Rural Development, Islamabad	Established Division
		II.	People Work Pgrogram (Rural Development Program)	Cabinet Division
2.	Population Welfare Division	I.	Planning and Development	Planning and Development Division
		II.	Dealing and agreement with other countries and international organizations in matters relevant to population planning program	Economic Affairs Division
		III.	Collection maintenance and other analysis of demographic and population statistics	Statistics Division (FBS)
		IV.	Mainstreaming population factor in development planning process in ICT, GB,AJK and FATA	Interior Division KA&GB Division , SAFRON Div.
		V.	Matters relating to national interest for population welfare and National Institute of Population Studies	Planning and Development Division
		VI.	Directorate of Central Warehouse and Supplies Karachi.	P&D Division
3.	Special Initiative Division	I.	Pakistan Dairy Development Company (PDDC)	Food and Agriculture Div.
		II.	Federal Project Management Unit (PMU) of Clean Drinking Water initiative and Clean Drinking water for all	Planning and Development Division
4.	Youth Affairs Division	I.	All international aspects of youth affairs including negotiations for bilateral and multi-lateral agreements for mutual assistance	Economic Affairs Division
		II.	Cooperation in this field and coordination of aid and assistance from foreign countries for youth affairs	
		III.	Youth Centers/Hotels located in federal capital	ICT Administration/ Interior Division
		IV.	National Internship Program	Establishment Division
		V.	Youth Centers /Hotels located in federal capital	
5.	Zakat and Ushr Division	I.	Collection of Zakat and Ushr	Religious Affairs Division
		II.	Disbursement of Zakat and Ushr to provinces and other areas as per formula approved by CCI	
		III.	Management and Distribution of Zakat and Ushr in the ICT, GB,AJK and FATA and the related /ancillary matters including distribution setup and monitoring/auditing thereof	Interior Division KA&GB Division SAFRON Division
6.	Culture	I.	Lok Virsa and Pakistan National Council of Arts, Texila Museum	Ministry of Information and Broadcast

to case basis. In the case of five ministries devolved so far, certain functions have been relocated at the federal level as presented in Box 5.3. There is need for proper specification of principles to decide on the location of particular subjects. The principles have to be based on economic and administrative criteria, and should ensure efficient delivery of functions, be transparent and non-discretionary and ensure cost effectiveness.

The provincial governments will also have to form their own committees to work out the absorption strategy of the devolved subjects. Punjab appears to be somewhat ahead of the other provinces. The province has made the strategic decision to locate 47 devolved subjects to 21 provincial departments (see Box 5.4); identified federal laws with major/minor amendments or new enactments required to be adopted by provincial governments for the devolved subjects; out of 72 laws that needed to be modified, 42 have been changed and of these, 27 laws have been

Box 5.4
Subjects Transferred to Departments in Punjab in the Wake of the 18th Amendment

	Name of Department		Subjects transferred
1	Population Welfare		Population Planning
2	Information, Culture & Youth Affairs	I.	Newspapers, books and printing presses
		II.	Ancient and historical monuments, archaeological sites and remains.
3	Labour & Human Resources	I.	Welfare of labour; condition of labour, provident fund, employer's liability and workmen compensation, health insurance including invalidity pensions, old age pensions.
		II.	Trade Union, industrial and labour disputes
		III.	Setting up and carrying on of labour exchanges, employment information bureaus and training establishments
		IV.	Regulation of labour and safety in mines, factories and oil fields
4	Literacy & Non- Formal Basic Education	I.	Curriculum, syllabus, planning, policy, centers of excellence and standards of education except standards in institutions for higher education and research, scientific and technical institutions
5	Tourism	I.	Tourism
6	Board of Revenue	I.	Bankruptcy and insolvency
		II.	Trusts and trustees
		III.	Transfer of property
		IV.	Evacuee property
		V.	Duties in respect of succession to property
		VI.	Estate duty in respect of property
		VII.	Capital gains on immovable property
7	Auqaf	I.	Islamic education
		II.	Auqaf
8	Excise &Taxation	I.	Opium, so far as regards cultivation and manufacture
		II.	Poisons and dangerous drugs
9	Zakat & Ushr	I.	Zakat
10	Transport	I.	Shipping and navigation on inland waterways as regards mechanically propelled vessels, and the rule of the road on such waterways; carriage of passengers and goods on inland waterways; and
		II.	Mechanically propelled vehicles
11	Social Welfare & Women Devision	I.	Social Welfare
		II.	Infants and minors adoption
		III.	Unemployment insurance
12.	Livestock & Dairy Devision	I.	Prevention of the extension from one province to another of infectious or contagious diseases or pests affecting animals
13.	Agriculture	I.	Prevention of the extension from one province to another of infectious or contagious diseases or pest affecting plants
14.	Higher Education	I.	Curriculum, syllabus, planning, policy, centers of excellence and standards of education except standards in institutions for higher education and research, scientific and technical institutions
15.	School Education	I.	Curriculum, syllabus, planning, policy, centers of excellence and standards of education except standards in institutions for higher education and research, scientific and technical institutions
16.	Special Education	I.	Curriculum, syllabus, planning, policy, centers of excellence and standards of education except standards in institutions for higher education and research, scientific and technical institutions
17.	Environment	I.	Environmental pollution and ecology
18.	Health	I.	Drugs and medicines
		II.	Prevention of the extension from one province to another of infectious or contagious diseases or pests affecting men
		III.	Mental illness and mental retardation, including places for the reception or treatment of the mentally ill and mentally retarded
19.	Home	I.	Arms, firearms and ammunition
		II.	Explosives
		III.	Removal of prisoners and accused persons from one province to another province
		IV.	Preventive detention
		V.	Measures to combat certain offences committed in connection with matters concerning the federal & provincial governments and the establishment of a police force for that purpose
		VI.	Production, censorship and exhibition of cinematograph films
20.	Law & PA	I.	Civil procedure
		II.	Law of Limitation
		III.	Arbitration;
		IV.	Actionable Wrongs (torts)
		V.	Administrator-general
		VI.	Official trustee
		VII.	Contracts
21.	LG&CD	I.	Marriage and divorce

approved by the cabinet; rules of business, 2011 have been framed in the light of the 18th Constitutional Amendment and have been approved by the cabinet.

FINANCING OF NEW RESPONSIBILITIES

As identified in the earlier section, financing of the devolved subjects is an important issue that needs to be resolved. A number of questions arise in this context: what will be the additional recurrent expenditure requirement of the provincial governments to perform these functions? How will the provinces finance these additional recurrent expenditures? What is the additional development expenditure liability in the case of schemes/projects underway in the devolved subjects? Do the provinces have the resource surpluses to finance these development expenditures? If not, what options exist to ensure completion of the development schemes/projects? Should indeed all development schemes initiated by the federal government be taken on by the provincial governments?

Answers to the above questions have to be agreed upon by both the federal and provincial governments prior to the devolution. If this is not done, the danger is that the quality of service provision will fall, directly affecting the people.

Current Expenditures

What will be the additional recurrent expenditure requirement of the provincial governments to perform the devolved functions? The way to assess this is to see what was budgeted for the devolved subjects at the federal level in 2010-11, prior to their devolution. Table 5.1 presents the current expenditure budgeted in 2010-11 for the devolved ministries. The five ministries already devolved are budgeted to incur current expenditure of Rs 4.2

Table 5.1
Current Expenditure on Devolved Ministries/Divisions
2010-2011 (BE)

(*Rs millions*)

Ministry	Total	Employment Related	Others
FIRST PHASE			
Local Government and Rural Dev.	143.7	81.7	62.0
Population Welfare	242.5	113.9	128.6
Special Initiatives	56.0	28.2	27.8
Youth Affairs	3707.7	19.9	3687.8
Zakat and Ushr	90.0	32.1	57.9
Sub Total	**4239.9**	**275.7**	**3964.1**
SECOND PHASE			
Culture	649.0	202.4	446.6
Education	4316.2	2649.9	1666.2
HEC	23220.0	-	23220.0
Total Education	27536.2	2649.9	24886.2
Livestock and Dairy Development	213.8	103.1	110.6
Social Welfare & Special Education	2840.5	449.8	2390.7
Tourism	238.3	55.2	183.1
Sub Total	**31477.8**	**3460.5**	**28017.4**
THIRD PHASE			
Environment	325.4	177.2	148.3
Food and Agriculture	1959.3	496.2	1463.1
Health	5435.5	1943.2	3492.3
Labour and Manpower	396.4	261.7	134.7
Minorities Affairs	237.3	22.1	215.2
Statistics Division	868.0	591.5	276.4
Sports	548.7	20.7	527.9
Women Development	99.8	42.1	57.7
Sub Total	**9870.4**	**3554.7**	**6315.7**
Grand Total	**45588.1**	**7290.9**	**38297.2**

Source: Finance Department, GoP

billion, Rs 0.3 billion of which is employee-related while the remaining, Rs 3.9 billion is on other operating expenses. For these five devolved subjects, employee related expenditure is only 6.5 percent of the additional recurrent liability. Largest recurrent liability is associated with the second phase of devolution. The current expenditure on the five ministries to be devolved in this phase is budgeted at Rs 31.5. billion in 2010-11. For these ministries, the employee related expenses are somewhat higher in proportionate terms (11 percent of total) compared to the ministries devolved in the first phase. The highest contribution to recurrent expenditures is of education, with HEC alone accounting for over Rs 23 billion.

Subjects scheduled to be devolved in the third phase have budgeted current expenditure of about Rs 9.9 billion in 2010-11. In this case employee related expenses are budgeted at Rs 3.5 billion, 35 percent of total current expenditure. Health and Food and Agriculture are the big sectors in this devolution phase. It is important to realize that many of the ministries/divisions which are to be devolved post – 18th Amendment are employment intensive, like education and health and, therefore, will lead to an increase in the non-discretionary component of provincial expenditures.

Overall, if all ministries/division are devolved to the provinces as they are operating at the federal level, the additional current expenditure liability on the provinces will be Rs 45.6 to Rs 7.3 billion on account of employee related expenses and Rs 38.3 billion on other operating expenses. Given the current regional distribution of these expenditures, about 52 percent is in the domain of the federal government (Islamabad, FATA, Gilgit Baltistan etc.), 17 percent is in the province of Punjab, 20 percent in Sindh, 8 percent in Khyber-Pakhtunkhwa and 2 percent in Balochistan[1] (see Table 5.2). There is of course the possibility that once devolved, the expenditure levels change. On the one hand, the provinces could and should attempt to economize on these expenditures by improving the efficiency of spending, thereby maintaining provision on lower expenditures. On the other hand, there may be some loss of spending efficiency in the transition stage and expenditure levels for current levels of service may actually go up. At this stage it is very difficult to quantify such possibilities or even assume them. One danger that, however, should be taken into account is the need for provinces to cutback on expenditures because of funding constraints, thereby compromising on service levels. Full expenditure funding has to be ensured. This takes us to the second question raised earlier in the section: how will the provinces finance these additional recurrent expenditures?

Provinces depend on revenue-sharing transfers from federal government to finance 80 to 90 percent of their expenditures. This dependence is a consequence of the imbalanced allocation of fiscal powers whereby the buoyant and broad based taxes are allocated to the federal government. As such, the additional recurrent liabilities will also be financed by the NFC transfers. The federal government is making the point that since the recently promulgated 7th NFC Award has significantly enhanced the share of provinces in the national resource pool, the

Table 5.2
Province-Wise Current Expenditure on Devolved Ministries by the Federal Government 2010-2011 (BE)

(*Rs millions*)

	Federal	Punjab	Sindh	KPK	Balochistan
FIRST PHASE					
Local Government and Rural Development	130.3	-	13.4	-	-
Population Welfare	210.0	15.9	16.7	-	-
Special Initiatives	56.0	-	-	-	-
Youth Affairs	1966.7	800.0	450.0	480.0	11.0
Zakat and Ushr	90.0	-	-	-	-
Sub Total	**2452.9**	**815.9**	**480.1**	**480.0**	**11.0**
SECOND PHASE					
Culture	418.6	68.7	134.4	19.6	7.7
Education	11092.1	6435.9	6178.9	2974.5	854.8
HEC	6984.1	6395.1	6011.5	2974.5	854.8
Livestock and Dairy Development	98.6	9.1	97.7	4.1	4.3
Social Welfare & Special Education	2563.0	124.1	76.3	55.7	21.4
Tourism	202.7	8.2	13.8	10.8	2.8
Sub Total	**14375.0**	**6646.0**	**6501.1**	**3064.7**	**891.1**
THIRD PHASE					
Environment	188.4	-	48.2	88.8	-
Food and Agriculture	1711.0	42.0	207.3	-	-
Health	3506.9	62.3	1819.0	25.5	21.8
Labour and Manpower	292.1	33.3	43.7	15.9	11.4
Minorities Affairs	232.3	1.3	1.2	1.2	1.3
Statistics Division	365.3	222.4	185.2	61.0	34.0
Sports	548.7	-	-	-	-
Women Development	99.8	-	-	-	-
Sub Total	**6944.5**	**360.3**	**2304.8**	**192.4**	**68.4**
Grand Total	**23772.4**	**7822.2**	**9286.0**	**3737.0**	**970.5**
Percentage of Total	**52.1**	**17.2**	**20.4**	**8.2**	**2.1**

Source: Planning Commission, GoP

provinces have got a revenue bonanza and, therefore, should finance the additional recurrent liabilities from the additional revenue transfers.

The provinces on the other hand are making three important points in response to this federal stand. First, the 7th NFC Award preceded the 18th Amendment. The provinces' case of higher vertical transfer from the federal government was based on the higher resource requirement to meet provinces' development targets for existing functional responsibilities. The case made by Punjab, for example, was on the ground that the province cannot meet its Medium Term Development Framework (MTDF) targets, which are based on international commitments like the Millennium Development Goals (MDGs), given the revenue transfer the province receives. There is some merit in their argument. Because additional functional allocations were not decided, therefore, they could not have influenced the resource allocation decision in the 7th NFC Award. Second, in effect the provinces are not receiving the bonanza of additional revenues the federal government claims that they are. This is due to the shortfall in federal tax collection during the course of the year. As the size of pie is smaller, the share going to the provinces' is smaller. Third, the federal government in the budget of 2010-11 unilaterally announced a 50 percent salary increase for all government employees. The provinces were not taken into confidence prior to the announcement. Since more than two-thirds of government sector employment is in the provinces, federal government's decision has enhanced provincial current expenditure substantially, eroding significantly the revenue gain to the provinces in the aftermath of the 7th NFC Award. Therefore, the provinces are arguing that the federal government fully fund the expenditure liabilities created by the devolution of Ministries/Divisions. The precedence exists in recent history. When the Devolution Plan of 2001 which entailed transfer of functions from provincial to local governments was promulgated, full funding was devolved from the provincial to local governments.

Development Expenditures

Turning next to the development side, currently there are 232 projects which are being implemented by the devolved ministries in all the provinces. Out of these, 166 projects can be clearly devolved to the province concerned. The throwforward liability of such projects is Rs 67 billion; over and above this, 67 vertical project are also being implemented in each of the province. The liability of these projects is Rs 202 billion. Projects of higher education (including HEC) create a further development liability of Rs 94 billion (including ICTL/Special Areas). Therefore, according to first estimates obtained from the Planning Commission, development liability devolved to the provinces following full implementation of the 18th Amendment is Rs 317 billion. Out of these Rs 151 billion is in Punjab, Rs 86 billion in Sindh, Rs 52 billion in Khyber-Pakhtunkhwa and Rs 26 billion in Balochistan (see Table 5.3).

Taking a deeper look into the province of Punjab, the provinces' total Annual Development Programme (ADP) was budgeted at Rs 193 billion in 2010-11. However, taking into account short fall in federal revenues and thereby revenue transfers to the province and diversion of resources to flood relief, the expected releases for ADP is around Rs 128 billion. The provinces' existing throw forward as of June 2010 was Rs 639 billion. Following devolution of Ministries/Divisions, the throw forward will further increase. Given the current size of the provincial ADP, this implies that the provinces' development outlays have been pre-emptied for about six years. This is a very large commitment. The province has already initiated prioritization of schemes, with emphasis on on-going projects and reduction in the throw forward. In the existing ADP, 2049 out of 3081, (almost 67 percent) are on-going schemes which are to be completed in 2010-11. Also, the stress is on undertaking projects that can be completed within a year to control the throw forward. Given this, will the province give full priority to the eighteen devolved projects, for example, in which only 5 percent of the expenditure has already been incurred? To the extent that these are vertical projects which have a foreign component, the province will perhaps have to carry on with

Table 5.3
Province Wise Summary of Projects/Vertical Programmes
in The Devolved Ministries

(*Rs millions*)

Province	No. of Projects	Cost	Expenditure	Throw-Forward	Application 2010-11	Planned Financing 2011-12	2012-13	2013-14	2014-15	2015-16	Total
Punjab	52	33500.1	11062.7	22439.5	3214.8	6166.2	5731.3	4810.5	2865.8	2865.8	22439.6
Sindh	48	29349.0	7997.3	21387.3	2456.4	5694.3	5311.9	4149	3316.4	2915.8	21387.4
Khyber-Pakhtunkhwa	27	18740.3	5663.1	13102.3	1181.3	3766.5	2930.9	3623.9	1908.9	872.0	13102.2
Balochistan	39	14867.1	4963.1	10056.6	1915.4	3439.0	2624.8	2312.8	1680.1	0.0	10056.7
Total	**166**	**96456.5**	**29686.2**	**66985.7**	**8767.9**	**19066.0**	**16598.9**	**14896.2**	**9771.2**	**6653.6**	**66985.9**
VERTICAL PROJECTS*											
Punjab	63	144728.4	32642.4	112086.0	13823.2	26397.8	23571.7	33605.4	28511.1	0.0	112086.0
Sindh	66	63144.7	13155.5	49989.1	6028.5	12161.9	10476.0	14917.2	12434.1	0.0	49989.2
Khyber-Pakhtunkhwa	64	35515.3	7248.1	28268.2	3401.1	7077.2	5846.0	8330.1	7014.9	0.0	28268.2
Balochistan	64	13378.3	1451.5	11924.8	1284.5	3038.4	2586.3	3650.7	2649.4	0.0	11924.8
Total	**257**	**256766.7**	**54497.6**	**202268.1**	**24537.2**	**48675.3**	**42480.0**	**60503.4**	**50609.5**	**0.0**	**202268.2**
TOTAL											
Punjab		178228.5	43705.1	134525.5	17038.0	32564.0	29303.0	38415.9	31376.9	2865.8	134525.6
Sindh		92493.7	21152.8	71376.4	8484.9	17856.2	15787.9	19066.2	15750.5	2915.8	71376.6
Khyber-Pakhtunkhwa		54255.6	12911.2	41370.5	4582.4	10843.7	8776.9	11954.0	8923.8	872.0	41370.4
Balochistan		28245.4	6414.6	21981.4	3199.9	6477.4	5211.1	5963.5	4329.5	0.0	21981.5
Total		**353223.2**	**84183.8**	**269253.8**	**33305.1**	**67741.3**	**59078.9**	**75399.6**	**60380.7**	**6653.6**	**269254.1**
HIGHER EDUCATION											
Punjab	55	25947.7	9144.3	16803.4	3227.9	3360.7	3360.7	3360.7	3360.7	3360.7	16803.5
Sindh	38	22627.2	7429.8	15197.5	2209.1	3039.5	3039.5	3039.5	3039.5	3039.6	15197.6
Khyber-Pakhtunkhwa	32	18041.6	6473.1	11568.5	2001.3	3470.5	3470.5	2313.7	2313.7	0.0	11568.4
Balochistan	12	5441.9	1263.6	4178.3	511.7	1253.5	1253.5	835.7	835.7	0.0	4178.4
Total	**137**	**72058.4**	**24310.8**	**47747.7**	**7950.0**	**11124.2**	**11124.2**	**9549.6**	**9549.6**	**6400.3**	**47747.9**
ICT/ Special Areas	31	23073.7	8612.3	14461.4	2142.3	2892.3	2892.3	2892.3	2892.3	2892.3	14461.5
All Pakistan (Vertical Programmes)	37	54925.8	23161.6	31764.2	5670.2	6352.8	6352.8	6352.8	6352.8	6352.6	31763.8
Grand Total	**205**	**150057.9**	**56084.7**	**93973.3**	**15762.5**	**20369.3**	**20369.3**	**18794.7**	**18794.7**	**15645.2**	**93973.2**
TOTAL INCLUDING HIGHER EDUCATION											
Punjab		204176.2	52849.4	151328.9	20265.9	35924.6	32663.7	41776.5	34737.5	6226.5	151328.9
Sindh		115120.9	28582.5	86574.0	10693.9	20895.6	18827.4	22105.7	18790.0	5955.3	86574.0
Khyber-Pakhtunkhwa		72298.1	19384.4	52939.0	6583.7	14314.3	12247.4	14267.7	11237.6	872.0	52939.0
Balochistan		33685.4	7678.2	26159.7	3711.6	7730.8	6464.5	6799.1	5165.2	0.0	26159.7
Total		**425280.6**	**108494.5**	**317001.6**	**41255.1**	**78865.3**	**70203.0**	**84949.0**	**69930.3**	**13053.8**	**317001.6**

* share of provinces determined by the population ratio

Source: Planning Commission, GoP

the commitment. But in cases where there is no foreign component, the province should perhaps have the option to evaluate the project and choose its continuation. This will become imminent, particularly, if federal funding is not committed for the project.

ENSURING DELIVERY OF SERVICES

Lack of adequate finance is not the only reason for Pakistan's relative backwardness in social development. It is unlikely that the country will meet some of the more important MDGs – to which it committed itself in December 2000. An equally important reason for Pakistan's relatively poor performance is institutional weaknesses at all government levels – at the center, in the provinces and at the local level.

Institutional weaknesses come in several different forms. The country lacks the capacity to do serious strategic work in order to set the priorities and determine the appropriate practices for reaching the citizenry with the services they need. This could – and should – be done in the Planning Commission and in the Planning and Development (P&D) Departments in the provinces. In drafting the growth strategy for the next five years, the planners at Islamabad are not paying enough attention to the important issue of delivering social services to the poorer section of the population. There is similar absence of thought in the provinces. This has had two consequences: some of the responsibility for providing social services has been left to the private sector and a number of donor agencies have sought to fill the gap in the formulation of plans and programs for improving social services delivery systems. Both fall-back approaches have serious short comings.

By turning to the private sector – in particular the part of the sector that provides services for a price – a large segment of the population gets to be excluded. The private sector has done a credible job of stepping in where the government has shown remarkable indifference towards playing a role. The result is that the rich and the well-to-do are able to get the services they need while the rest of the population remains poorly served. The non-profit part of the private sector is playing a role but it is essentially limited since it does not have a large resource base.

The other gap-filling approach – to rely on donor agencies for both finance and strategy – has also not worked. One vivid example of the failure in this regard is the Social Action Programme (SAP) which in the late 90s was funded by the WB. In spite of the expenditure of large amounts of resources, the SAP achieved little in terms of substances. The WB's own evaluation admitted to the near failure of the program.

Another problem with the delivery of social service is corruption, the incidence of which has been increasing at a worrying rate. This has been convincingly documented by organizations such as TI. Corruption is hard to combat when those who are incharge of providing services are not accountable to the people they are expected to reach. As discussed in other parts of the Report (see Chapter 7, Institutional Structure), the experience from a number of countries that have succeeded in improving the quality of services, holding the people responsible for providing them accountable had very positive consequences.

It is now recognized that bringing government closer to the people is essential for improving the quality of services provided by the public sector. This objective can be achieved if the process of devolution underway factors in three lessons history and experiences have to teach. The first is that the organization of the government must not stop at the center or at the provinces. It has to include the instruments of local government. Unfortunately because of the roller-coaster ride Pakistan has been on in terms of political development – alternating between military and civilian rule and also not settling down with one constitutional structure – the country has been engaged in constant experimentation. It has tried half a dozen systems of local government over the last sixty years instead of keeping one in place and improving it at the margin. Unfortunately, the decentralization program initiated by the passage of the 18th Amendment does not include the provision that the provinces will need to pass on both authority and resources to the institutions of government at the local level. There was much of good substance in the system of local government created by the LGO of 2001. This was underscored by the study produced by the IPP that examined the working of the system (IPP, 2008).

The second lesson history teaches and recent development in economic theory endorse is the importance of institutions in helping economies to move forward. As discussed in Chapter 7, Pakistan has treated institutional development with callous indifference. It allowed even well functioning institutions to wither away. This happened whenever there was a fundamental change in the way the government was run – either when regimes are changed by military actions or when new laws are brought on the books. During these periods of transition, there was preference for the new not for improving the well established. As pointed out elsewhere in this report, there is a distinct danger that some of the better functioning institutions will lose their relevance once the restructuring of the government as envisaged in the 18th Amendment is completed. This report used the likely fate of the HEC as a case study to illustrate this important point.

The third lesson of some importance history conveys is to adopt holistic approaches rather than ad-hoc and truncated methods for addressing critical problems. Social development and the services that would bring it about the most important areas for government's involvement. What is needed is a grand strategy that involves the participation of many people and many institutions. As the several miracles in East Asia have demonstrated passion shown by senior leadership can produce remarkable results.

Chapter - 6

Strengthening Provincial Finances

Chapter - 6
Strengthening Provincial Finances

The previous chapter has demonstrated that provincial fiscal needs have increased significantly in the aftermath of the 18th Amendment. Clearly, provincial resources will have to be augmented. As such, it is important to analyze the provincial financial structure. Inter-governmental revenue transfers are the lifeline of provincial governments in Pakistan. These transfers account for over 80 to 90 percent of provincial revenues. This dependence is a consequence of the imbalance in the allocation of functional responsibilities and fiscal powers between the federal and provincial governments in Pakistan, which has given rise to large vertical imbalances. Though such vertical imbalances exist in other federations also, these are on the higher side in Pakistan. The federal government collects as much as 92 percent of tax revenues and the provinces, only 8 percent. Also, there is relatively greater centralization of functions, and the share of the federal government in public expenditure is one of the highest in Pakistan at 72 percent. Prima facie, there appears to be a case for decentralization from the federal to the provincial governments in Pakistan of both functions and fiscal powers.

The 18th Amendment has made marginal changes in the allocation of fiscal powers across different levels of government. As such, the high dependence of provincial governments on federal transfers is likely to continue in the foreseeable future. It is important that the transfers are designed not only to remove the imbalances but also to be equitable. We start with an assessment of the 7th NFC Award to highlight the differences in the revenue sharing arrangements due to the award, quantify revenue gain to the provinces due to the award and examine whether or not it is fiscally equalizing. This will be followed by an analysis of the implications of the award on provincial and federal finances. Finally, the last section analyses the resource generating capacity of the provinces.

AN ASSESSMENT OF THE 7TH NFC AWARD

Evolution of Revenue Sharing

Intergovernmental transfers have historically taken three forms: divisible pool transfers, straight transfers and grants and subventions. Prior to the 7th NFC Award of 2009, revenue sharing was taking place according to the provisions of the Presidential Order No. 1 of 2006, which made amendments in the Distribution of Revenues and Grant-in-Aid Order, 1997. We briefly describe the evolution of each of these components below:

Divisible pool transfers

Table 6.1 presents to the composition of the divisible pool of taxes in terms of which taxes were shared and the proportion in which these were shared between the federation and the provinces combined in the last four Awards. It seems that the trend has been to increase the size of the divisible pool. The 1991 NFC Award achieved this through inclusion of new taxes, specially excise duties on some commodities in the pool. The 1996 Award further strengthened the trend and included all federal taxes in the divisible pool. Since the divisible pool was substantially expanded, the share of provinces in the divisible taxes was reduced. The 2006 and 2009 NFCs have adopted the strategy of enhancing the provincial share in the divisible pool of taxes.

Table 6.1
Evolution of Divisible Pool in Various Awards

Divisible Pool	Shared Revenue Sources[a]			
	NFC 1991	NFC 1996	Presidential Order 2006[c]	NFC 2009
A. INCOME TAX[b]				
Personal	80%	37.5%	45%-50%	56%-57 ½%
Corporate	80%	37.5%	45%-50%	56%-57 ½%
Wealth Tax	-	87.5%	45%-50%	56%-57 ½%
B. SALES TAX	**80%**	**37.5%**	**45%-50%[d]**	**56%-57½%[e]**
C. EXCISE DUTIES				
Tea	-	37.5	45%-50%	56%-57 ½%
Tobacco	80%	37.5%	45%-50%	56%-57 ½%
Sugar	80%	37.5%	45%-50%	56%-57 ½%
Betel nut	-	37.5%	45%-50%	56%-57 ½%
All excise duties (Excluding GST)	-	37.5%	45%-50%	56%-57 ½%
D. EXPORT DUTIES				
Cotton	80%	37.5%	45%-50%	-
Jute	-	-	45%-50%	-
F. ESTATE AND SUCCESSION DUTIES	**-**	**-**	**-**	**-**
G. CAPITAL VALUE TAX ON IMMOVABLE PROPERTIES	**-**	**37.5%**	**45%-50%**	**devolved to provinces**

Source: Federal Budget Documents.

Notes:

[a] Share of the provinces combined.

[b] Excluding taxes on income consisting of remuneration paid out of federal consolidated fund.

[c] Provincial share was decided to be 45% for 1st Financial year and would reach 50% with subsequent increase of 1% per annum.

[d] Other than 1/5th of sales tax collected in lieu of zila/octroi transfer to be transfered to the province of origion.

[e] Sales Tax on services devolved to provinces.

Turning next to the revenue sharing formula between the provinces, revenues from the divisible pool of taxes have essentially been distributed among provinces on the basis of their population. The exception has been one-sixth of sales tax, which was transferred in lieu of octroi/ zila tax. This has been fundamentally changed in the NFC Award of 2009, with provincial shares computed on the basis of multiple criteria of population, poverty/backwardness, Inverse Population Density (IPD) and revenue generation/collection (see Table 6.2). In addition, the province of Khyber-Pakhtunkhwa has been given a one percent share in the divisible pool prior to distribution as compensation for costs of the War on Terror. For the first time, revenue sharing formula in the divisible pool is being used to ensure a degree of fiscal equalization through the inclusion of indicators like backwardness/ poverty and IPD, although the criterion of revenue generation/collection mitigates against this. The derived shares of the provinces are presented in Table 6.3.

Table 6.2
Revenue Sharing Formula among Federating Units

	Tax	Sharing Criteria (Weight)
NFC 1991	Divisible Taxes	Population (100%)
NFC 1996	Divisible Taxes	Population (100%)
Presidential Order 2006	Divisible Taxes	Population (100%)
NFC 2009	Divisible Taxes	Population (82%) Poverty (10.3%) Revenue (5%) IPD* (2.7%)

*Inverse Population Density

Source: Pasha, et. al. (2010)

Table 6.3
Shares of Provinces from the Divisible Pool in Various Awards

(*percent*)

Province	NFC 1991	NFC 1996	Presidential Order 2006	NFC 2009
Punjab	57.87 (57.87)	57.37 (57.87)	57.37 (57.36)	51.74 (57.36)
Sindh	23.29 (23.29)	23.29 (23.29)	93.71 (23.71)	24.55 (23.71)
KPK	13.54 (13.54)	13.54 (13.54)	13.82 (13.82)	14.62 (13.82)
Balochistan	5.30 (5.30)	5.30 (5.30)	5.11 (5.11)	9.09 (5.11)
TOTAL	**100.00**	**100.0**	**100.0**	**100.0**

Note:
Figures in brackets are population shares according to the last census conducted prior to the Award.

Source: Federal Budget Documents

Straight transfers

Besides divisible pool transfers, the federal government also makes straight transfers to the provinces. The institution of straight transfers from the federal to provincial governments of development surcharge on gas, excise duty on gas and crude oil and net hydel profits on the basis of collection initiated in 1991 NFC Award has been taken forward by the subsequent NFCs. In the 1996 NFC Award, royalty on gas and crude oil was also given to the provinces. In addition, Khyber-Paktunkhwa has been receiving net hydel profits from Water and Power Development

Authority (WAPDA) at a capped level of Rs 6 billion annually since 1991. The 2009 NFC Award resolved the outstanding issue of arrears of net hydel profits and development surcharge on gas. It also altered the basis of calculating straight transfers. As a proportion of inter-governmental transfers, straight transfers show a significant increase (see Table 6.4).

Table 6.4
Composition of Transfers from Federal to Provincial Governments

(*Rs billions*)

	Divisible Pool Transfers	Straight Transfers	Special Grants	Total Transfers
1990-91	32.1 (95.0)	1.7 (5.0)	- (-)	33.8
1991-92	47.5 (72.2)	16.3 (24.8)	2.0 (3.0)	65.8
1996-97	119.2 (85.5)	18.2 (13.1)	2.0 (3.0)	139.4
1997-98	104.0 (79.0)	20.3 (15.4)	7.4 (5.6)	131.7
2005-06	244.6 (77.4)	62.8 (19.9)	8.7 (2.7)	316.0
2007-08	403.1 (79.6)	70.6 (13.9)	33.0 (6.5)	506.7
2009-10	574.1 (80.0)	87.2 (12.1)	57.8 (7.9)	689.0
2010-11 (BE)	865.8 (81.0)	197.0* (18.4)	6.0 (0.6)	1068.7

Note:
Figures in parenthesis give share in total transfers.
*Inclusive of arrears and the sales tax on services like telecommunications.

Source: Federal Budget Documents

Grants/Subventions

Besides revenue sharing from the divisible pool and straight transfers, inter-governmental transfers have also taken the form of unconditional grants in Pakistan. Prior to the 1991 NFC Award the provinces were given grants to finance their revenue deficits. This created an incentive for provinces to increase their revenue deficits, undermining key principles of financial responsibility and fiscal prudence. The 1991 and 1996 NFC Awards promoted the concept of grants/subventions for fiscal equalization to smaller provinces. Special grants were given to the two smaller provinces equivalent to Rs 3.3 billion for Khyber-Paktunkhwa and Rs 4 billion for Balochistan. These grants were inflation indexed and were given for five years. Incentive of matching grants for higher fiscal effort to provincial governments was also introduced, subject to own revenue growth exceeding 14.2 percent. A maximum limit was, however, prescribed for the matching grant.

In the 2006 revenue sharing arrangements, total subvention/grants for provinces were enhanced from Rs 8.7 to Rs 27.7 billion, with the provision for further increases linked to the growth of net proceeds in the divisible pool. Punjab and Sindh, which were not given any grants in the 1996 Award, were entitled to receive Rs 3.1 and Rs 5.8 billion respectively along with Rs 9.7 billion and Rs 9.2 billion respectively for Khyber-Pakhtunkhwa and Balochistan. By 2009-10 these grants and subventions had increased to almost Rs 58 billion. The 2009 NFC Award has discontinued the use of grants/subventions as a mechanism of transfers. Only Sindh is getting a Rs 6 billion grant in lieu of abolition of octroi/zila tax grant.

To sum up, the 7th NFC Award is different from the previous revenue sharing arrangements (the Presidential Order 1, 2006) in the following important ways: the divisible pool of taxes is larger, the share of the provinces in the divisible pool is higher, the provincial share is divided among the provinces on the basis of multiple criteria, special developments needs of the smaller provinces of Khyber-Pakhtunkhwa and Balochistan are taken into account, there is an enhancement in straight transfers and finally all taxes on services have been recognized to be provincial subjects (including the federal excise duty levied on services).

In conclusion, by and large, intergovernmental transfers between the federation and federating units have evolved within the broad, highly progressive overriding philosophy of promoting fiscal decentralization and fiscally strengthening the provincial governments, which have over the years, and now more so, are expected to play a very important role in the provision of basic social and economic services. Budgeted increase in revenue transfer to provinces due to the 7th NFC Award is presented in Table 6.5. Transfers to provinces are budgeted to be higher by Rs 222 billion in 2010-11 because of the 7th NFC Award. In other words, transfers would have been lower by over 27 percent if revenue sharing in 2010-11 had continued to take place according to the previous revenue sharing arrangements. The revenue gains presented are those budgeted at the start of the fiscal year 2010-11. An important emerging issue is the realization of the gain. Indications after the first eight months in the current year are of a shortfall of close to about Rs 75 billion.

Table 6.5
Budgeted Increase in Revenue Transfer to the Provinces due to the 7th NFC Award

(*Rs millions*)

	2010-11
Transfer to Provinces	
Under Previous Revenue Sharing Arrangements	811.6
Under 7th NFC Award	1033.6
Increase	222.0
Percentage Increase	27.3

Source: Federal Budget Documents

While the new revenue sharing arrangements have transferred more revenues to the provinces, an important question that remains to be answered is whether these will be successful in reducing fiscal disparities across provinces.

Are Intergovernmental Transfers Fiscally Equalizing?

Table 6.6 presents the provincial shares in total federal transfers in the last four NFC Awards, for years just before and after a particular award. Clear patterns emerge from the Table. First, the share of the largest Province Punjab has declined over time. Punjab received over 55 percent of federal transfers just prior to the 1991 NFC Award. Thereafter its share has declined, showing temporary recovery prior to the 1996 NFC Award. The share of Sindh increased significantly in the late 90s and in the earlier part of last decade. Khyber-Pakhtunkhwa's share in transfers

Table 6.6
Share in Total Transfers by Province

(*percent*)

	1990-91	1991-92	1996-97	1997-98	2005-06	2007-08	2009-10	2010-11 [BE]
Total Federal Transfers (Rs in Billion)	33.8	65.8	139.4	131.7	316.0	506.7	718.3	1068.7
Punjab	55.3	45.1	51.3	47.0	47.1	47.3	47.2	46.7
Sindh	24.0	23.9	24.9	23.8	30.1	29.8	29.3	26.7
KPK	12.7	19.0	15.9	17.8	14.4	14.8	15.2	17.1
Balochistan	7.9	12.0	7.9	11.4	8.4	8.0	8.3	9.5
Pakistan	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Federal Budget Documents

peaked after the 1991 NFC Award, increasing to 19 percent but declined thereafter. The 1996 NFC Award did attempt to restore the provinces' share, but the 2006 arrangements further lowered it. The 2009 NFC Award attempts to redress this. As far as Balochistan is concerned, both the NFCs Awards of 1991 and 1996 had enhanced its share in federal transfers to above 11 percent but this trend was not maintained subsequently.

Table 6.7
Relative* Per Capita Transfers by Province

	1990-91	1991-92	1996-97	1997-98	2005-06	2007-08	2009-10	2010-11
Punjab	0.953	0.778	0.884	0.810	0.821	0.824	0.822	0.815
Sindh	1.030	1.026	1.069	1.021	1.270	1.257	1.235	1.127
KPK	0.948	1.418	1.186	1.328	1.043	1.072	1.099	1.234
Balochistan	1.453	2.264	1.491	2.151	1.647	1.569	1.565	1.857
Pakistan	**1.000**	**1.000**	**1.000**	**1.000**	**1.000**	**1.000**	**1.000**	**1.000**

*Ratio of share in transfers to share in population

Source: Author's estimates

Given this pattern and trend, what do these transfers imply in terms of relative per capita transfers to each province? Table 6.7 gives the relative per capita transfers (defined as ratio of share in transfers to share in population). It appears that Punjab has always been getting less than its population share. Sindh has always had a share higher than its population, and its relative per capita transfer has, more or less, systematically increased over time except in the latest award. Per capita transfers to Khyber-Pakhtunkhwa demonstrate a varying trend, increasing under the 1991 and 1996 NFC Awards, and declining thereafter till the 2009 NFC Award. Balochistan has always received a higher per capita transfer than any other province. However, the magnitude of the transfer has varied, increasing to a high of 2.26 in 1991-92.

Interestingly, per capita transfers to the smaller provinces have been the highest in the immediate aftermath of NFC Awards. This implies that the awards, by and large, have made an effort to compensate the smaller provinces for their limited fiscal capacity. The only exception is the 2006 ad hoc revenue sharing arrangements when the change in relative per capita transfer to the smaller provinces was either minimal (Khyber-Pakhtunkhwa) or negative (Balochistan).

Box 6.1
Have Intergovernmental Fiscal Transfers been Equalizing in Pakistan?

	Divisible Pool Transfers	Straight Transfers	Special Grants	Total Transfers
NFC Award, 1991	Neutral	Yes	No	Yes
NFC Award, 1996	Neutral	Yes	Yes	Yes
Presidential Order, 2006	No	No	No	No
NFC Award, 2009	Yes	No	Yes	Yes

Source: Author's estimates

To answer the question as to whether intergovernmental fiscal transfers have been instrumental in removing fiscal disparities across provinces, (Pasha and Pasha, 2010) estimate the Fiscal Equalization Index for the four provinces. Box 6.1 presents the basic finding of the study. The authors conclude that there was a breakdown in fiscal equalization in Pakistan prior to the 2009 NFC Award. The ad hoc arrangements of 2006 announced by the then president had clearly failed to improve equity in intergovernmental revenue transfers and had, therefore, been unsuccessful in achieving its basic objective. The 1991 NFC Award followed by the 1996 and the 2009 NFC Awards, have, however, contributed to fiscal equalization. They also conclude that fiscal equalization significantly dampens towards the end of the tenure of a particular award, highlighting the need for timely announcement of awards. It is important that consensus is developed among the federation and the four federating units so that an agreement can be reached. This can be facilitated by more accurate data bases and analysis on indicators and on incidence of the federal taxes. This requires substantial strengthening of the NFC secretariat in the Ministry of Finance.

FINANCIAL IMPLICATIONS OF THE 7TH NFC AWARD ON THE FEDERAL AND PROVINCIAL GOVERNMENTS

The 7th NFC Award of 2009 envisages substantial enhancement in the transfers to the provinces. It is bound to have a significant effect on the finances of both levels of government. The first set of post-NFC budgets have been announced for 2010-11. Some of the consequences of the award have become visible. The federal government is pushing for a strong fiscal adjustment by reducing the target for the consolidated fiscal deficit from 6.3 percent of the GDP in 2009-10 to 4 percent in 2010-11, as part of the agreement in the on-going SBA with the IMF. This is predicated, first, on a virtually zero growth in federal current expenditure and a modest growth in development expenditure coupled with a relatively strong fiscal effort and, second, on the inability of the provinces to absorb fully the large post-NFC increase in transfers in the short run, thereby leading to a large build up in cash balances of upto one percent of the GDP.

A number of questions have risen already with regard to the implications of the radical change in inter-governmental relations after the 7th NFC Award. Has the underlying structural fiscal deficit been raised once-and-for-all by the award? What is the incentive for the federal government in a democratic dispensation to raise the tax burden and incur the political costs thereof while transferring a major part of the additional revenues to the provincial governments, which may be on the other side of the political divide as is the case currently in the largest province, Punjab? Given the quantum jump in transfers, are the provinces likely to show financial discipline or engage in runaway spending and waste scarce public resources? Should incentives be put in place on top of the award to promote greater fiscal effort and economy in current expenditure by provincial governments?

(Pasha, et. al., 2010) have developed a theoretical framework to attempt an answer to these questions. The key conclusions are:

Federal Government

- Tax revenues of the federal government have a negative relationship with the share of revenues retained from the divisible pool. Therefore, historically the federal government has tended to enhance its fiscal effort in the aftermath of awards which mandated larger transfers to the provinces. A similar response can also be expected after the 7th NFC Award, which has led to a big decline in retained revenues. Also, it appears that a one-rupee increase in non-tax revenues leads to a decline in fiscal effort of almost 34 paisas.
- Current expenditure of the federal government appears to be largely invariant with respect to the share of retained revenues in the divisible pool. There are strong downward rigidities with respect to expenditures on debt servicing, defence and general administration.
- The inability of the federal government to contract, following an award which transfers more resources to the provinces, is the basic behavioural assymetry which could lead to an increase in the underlying structural fiscal deficit. The other part of this asymmetry is the likely rapid expansion in provincial budgets following the receipt of larger transfers.
- Development expenditure of the federal government does appear to be responsive to the availability of resources. However, there is a process of lagged adjustment here as the coefficient of the previous years' level of development expenditure is large and significant. This implies that the federal PSDP will take some time to come down to the desired size, given the fall in growth of net revenue receipts in the first year after the 7th NFC Award.

Provincial Governments

- There is a negative relationship, between provincial own tax revenues and the level of transfers from the divisible pool. The provinces are inclined to slacken their fiscal effort in the event of a favourable award, like the latest dispensation. This is another factor which contributes to an increase in the consolidated fiscal deficit. However, the magnitude of the behavioural response is small. A one-rupee increase in transfers leads to a five-paisa fall in provincial tax revenues.

- Current expenditure of provincial governments appears to respond quickly and strongly to larger transfers. The absence of a significant lagged variable indicates that the process of adjustment is more or less, instantaneous. A one-rupee increase in transfers leads to a more than 40 paisa rise in current expenditure.
- The combined ADP of the provincial governments also appears to be linked to the size of the revenue surplus, which is likely to be larger when transfers increase. However, there is a process of lagged adjustment here indicating that, especially in the case of the smaller provincial governments, there are limits to absorption capacity, in terms of implementation of a larger portfolio of projects.

Results of the empirical analysis of past fiscal behaviour indicate that in the aftermath of an award, which expands the share of provinces, the consolidated fiscal deficit tends to rise because there are no corresponding cutbacks in federal current expenditure, the fall in the size of the PSDP is accomplished with some time lag, while provincial current expenditure rises rapidly in response to larger transfers. This impact is somewhat moderated by the launching of a more intensive fiscal effort through tax reforms by the federal government to at least partially make up for the loss in net revenue receipts. Also, provincial ADPs take some time to fully adjust upwards. The net impact on the overall fiscal deficit of the Award has been projected to be Rs 48 billion. That is, the fiscal deficit is 0.3 percent of the GDP higher than it would have been in the absence of the 7th NFC Award.

Incentive Scheme for Provincial Government

The basic factors contributing to increase in the fiscal deficit are the decline in the fiscal effort of provincial governments and a big increase in expenditure in the anticipation of larger transfers mandated by the NFC Award. One way in which this tendency can be mitigated is to provide an incentive to provincial governments as part of the award in the form of a matching grant equal to the increase in self-financing of expenditure in relation to some minimum benchmark level, which will, of course, depend on the fiscal capacity of a particular provincial government. The theoretical framework developed by Pasha and Pasha (2010) undertakes an analysis of such an incentive package on the fiscal behaviour of the provincial governments.

The authors conclude that a matching grant linked to increase in self-financing will reduce the negative effects of the increase in transfers following an Award. It is recommended that such a scheme be put in place as part of the NFC Award, if not in the present award then in the next award. The 11th Finance Commission of India has incorporated the same type of incentive with a view to provide for better financial management and greater fiscal discipline. As such, 7.5 percent of the revenues to the states is to be shared on the basis of the measure of financial discipline corresponding to the ratio of own revenue receipts to total revenue expenditure.

Conclusions and Policy Implications

Clearly the nature of public finances of Pakistan has changed substantially due to the 7th NFC Award. It constitutes a level of fiscal decentralization which can be viewed as a great 'opportunity' for the provinces to improve the well-being of their residents. However, it is important to realize that this opportunity has been created by the federal government at a high cost to its own finance. Therefore, it is essential that this 'opportunity' really gets translated into welfare gains and is not wasted. For this to be achieved, the onus is on the four provincial governments. Behavioural consequences over time are likely to be the following:

1. There will be a shift of development focus from the federal government to the provinces. The provinces combined are budgeted to carry out development programme approaching Rs 340 billion in 2010-11, perhaps for the first time exceeding the federal PSDP. The fast growth in development spending will require enhancement in capacity to design, execute and manage a larger portfolio of projects. The absorption capacity of the provinces, particularly the smaller provinces, will need to be significantly strengthened. Also, given that social services are mostly in the provincial domain, prospects for higher outlays on education and health have improved. This could confer more direct benefits to the people.
2. Vertical programs in all likelihood will be transferred to the provincial government after the 18th Amendment, and provinces will have to make a choice whether to continue with them. Given the paucity of resources, there is an opportunity to eliminate or cut down low priority activities.
3. For the medium-term consequences to be favourable, the following conditions need to be fulfilled:
   - It is important that given the higher transfers from the federal government, provinces do not slacken their own fiscal effort. The additional transfers should essentially supplement and not substitute for provincial own revenues. Provinces, particularly the bigger provinces, have two large and buoyant tax bases under their fiscal jurisdiction, real estate and agricultural income. Proper exploitation is essential not only to enhance the overall federal and provincial consolidated tax-to-GDP ratio but also to make the burden of tax system more equitable. This subject will be taken up in the subsequent section.
   - Provinces must avoid profligacy in current expenditures. Prudent spending strategy is an important pre-requisite for the realization of the 'opportunity' that the 7th NFC Award has opened up. Additional resources should increasingly be used for development and largely routed towards backward regions and pro-poor sectors.

- The provinces may develop MTDFs, taking into account the additional funding available. These will help the provinces strategize and prioritise their development priorities, facilitate proper planning and management of spending and, very importantly, route spending in accordance to the development needs of their province thereby avoiding ad-hocism and populism. Also, the MTDFs should feed into the 10th Five Year Plan which the Planning Commission is in the process of preparing. Proper dovetailing of the planning exercises at the federal and provincial level will enhance the credibility of the exercise and ensure development outlays which are essential to enhance the growth potential of the country.

The 7th NFC Award also has significant implications for the federal government, which are as follows:

- It is clear that following transfer to the provinces, the federal fiscal position can become unsustainable. The increase in the underlying structural deficit by 1.4 to 6 percent of GDP is clearly untenable. The structural deficit has to be brought down. The first thing that has to be done is to cutback federal current expenditures. There is, of course, a non-discretionary component in the federal current spending like debt servicing and basic defence. While protecting the base, the federal government will have to pose some very important but unavoidable strategic questions like how best to achieve some savings in federal spending?
- Sharper prioritization of the federal PSDP has become indispensible. Considering that the focus for development has largely shifted to the provinces, pruning of development programme at the federal level is essential. Currently, the throw forward of federal projects is very high at over Rs 3 trillion. With an annual development expenditure of around Rs 280 billion, projects on an average will take nine years to complete. New projects' approval should be stopped for some time unless such projects have very high priority.
- The linchpin in the strategy to keep the federal fiscal position sustainable is to enhance the level of resource mobilization. The country is stuck at a tax-to-GDP ratio of less than 10 percent, even at times when the tax bases grew in real terms in excess of 7 percent. The tax-to-GDP ratio has shown a tendency to decline in recent years. The strategy of resource mobilization has to focus on base broadening and improvements in tax administration.
- Effective functioning of the NFC Secretariat is also necessary. The provinces now have to play a very strong role in the national development scenario. The NFC Secretariat will not only have to keep a database of provincial finance but be pro-active in communicating best practices, special policies and innovations taken by state governments both nationally and internationally. The purpose is, of course, not to step in on provincial autonomy but to support and strengthen the federating units. The NFC

Secretariat has to play a supportive role to the NEC in matters pertaining to national development.

In conclusion, the 7th NFC Award has major implications for both the federal and provincial governments in Pakistan which will require well thought out, coherent policy responses by the two levels of government. Also, some elements that should have been sorted out in the NFC Award still remain pending. Provincial distribution of sales tax on services, discussion on measures to ensure financial discipline (mentioned in the terms of reference of the NFC), and incentives for higher fiscal effort by provincial governments are part of the unresolved agenda. While the euphoria of the NFC Award still exists, these are issues that can be taken by the federal and provincial governments in the spirit of national solidarity.

PROVINCIAL RESOURCE MOBILISATION

The overall level of resource mobilization by the four provincial governments of Pakistan from their own tax and non-tax revenue sources has fallen sharply from over 1 percent of the GDP in the early 90s to below 0.8 percent of the GDP in 2009-10. This decline can be attributed to a number of factors. The first is the relatively low revenue potential and/or low elasticity of some revenue sources due either to relatively small and/or slow growing tax bases or because of specific rates of taxes, fees and charges which have not been indexed to inflation. Second, the large transfers from the federal government, which accounted for over 80 percent of total provincial revenues in 2009-10, have created a 'dependency syndrome' whereby the provincial governments have been reluctant to incur the political costs of additional taxation, as shown by the tax-free budgets in 2010-11.

The previous section has demonstrated that there is a risk that the fiscal effort of the provincial governments will slacken even more in the presence of the large transfers following the 7th NFC Award. However, the authors of the award appear to have been cognizant of this risk and were able to get the provincial representatives in the NFC to agree to the following clause:

'The NFC recommended that the federal government and the provincial governments should streamline their taxation in order to achieve a 15 percent tax-to-GDP ratio by the terminal year, 2014-15. Provinces would initiate steps to effectively tax the agriculture and real estate sectors. Federal government and provincial governments may take necessary administrative and legislative steps accordingly'.

In addition, the 18th Amendment to the constitution has explicitly transferred the Sales Tax on services to the provincial governments. Any effort at development of this tax will involve the promulgation of provincial legislation even though the process of collection may remain centralized with the FBR or be undertaken directly by the provinces.

The objective of this section is to identify the key elements of a provincial resource mobilization strategy which can help raise the consolidated (federal + provincial) revenue to GDP ratio above the currently low level of about 14 percent. This will contribute not only to overall deficit reduction, but since the provincial governments are the prime agents for delivery of social services, (even more so after the 18th Amendment) it could also lead to higher levels of expenditure on education and health and thereby improve the prospects for attainment of the MDGs.

Projections of Own-Revenue in 2010-11

We first quantify the level of Own-Revenue[1] of each provincial government and for the four governments combined budget for 2010-11 in Table 6.8.

Table 6.8
Provincial Own Revenues

(*Rs billions*)

	Own-Tax Revenues		Own-Non Tax Revenues			Total Own-Revenues		
	2009-10 (R.E)	2010-11 (B.E)	2009-10 (R.E)	2010-11 (B.E)	Growth Rate (%)	2009-10 (R.E)	2010-11 (B.E)	Growth Rate (%)
Punjab	36.8	91.6	49.8	22.2	-55.4	86.6	113.8	31.4
Sindh	25.4	56.5	14.2	19.0	33.8	39.6	75.5	90.7
KPK	2.6	3.2	4.7	4.0	-14.9	7.3	7.2	-1.4
Balochistan	1.1	1.2	1.3	2.9	123.1	2.4	4.1	70.8
Combined	65.9	152.5	70.0	48.1	-31.3	135.9	200.6	47.6
(% of GDP)	0.4	0.9	0.5	0.3		0.9	1.1	

Source: Provincial Budget Documents
Note: Revenues from individual sources projected in 2010-11 are given in Table 6.2

Development of Taxes on Agriculture

As highlighted in Table 6.9, the provincial governments are expected to effectively tax agriculture as per the relevant clause in the 7th NFC Award. Currently, there are various levies on agriculture including land revenue (on land ownership), stamp duty and Capital Value Tax (CVT) (on land transactions), AIT and a cotton fee (in Punjab). It is difficult to allocate stamp duties to transactions in agricultural land. But it is clear that provincial taxes on agriculture today account for less than one percent of the value added by the sector in Pakistan.

The popular demand currently is for the effective imposition of the agricultural income tax, the absence of which is seen as a violation of the principle of horizontal equity in taxation. Some political parties have argued that imposition of the RGST should be preceded by development of the AIT. Therefore, one of the imperatives for development of AIT is that this has become necessary to improve the overall level of tax compliance in the country. Second, due to the jump in international commodity prices and domestic support/procurement prices, agricultural incomes have risen rapidly implying now greater ability to pay taxes.

Table 6.9
Revenues from Individual Own Sources in 2010-11

(*Rs billions*)

	Punjab	Sindh	KPK	Balochistan	Combined
Own Taxes					
Direct Taxes	**17.8**	**4.15**	**1.04**	**0.25**	**23.2**
AIT	1.2	0.22	0.02	-	1.4
UIPT	4.4	-	0.08	0.07	4.6
Land Revenues	6.9	0.25	0.76	0.10	8.0
Registration	3.3	0.90	0.07	0.08	4.4
Tax on PCT	0.5	0.28	0.11	0.001	0.9
Capital Value Tax	1.5	2.50	-	0.001	4.0
Indirect Taxes	**73.8**	**52.4**	**2.17**	**0.98**	**129.3**
GST on Services	51.2	25.0	-	-	76.2
Motor Vehicle Tax	6.5	3.8	0.98	0.37	11.6
Stamp Duties	10.2	6.6	0.55	0.16	17.5
Electricity Duty	4.0	0.6	0.34	-	4.9
Others*	1.9	16.4	0.39	0.45	19.1
Total	**91.6**	**56.5**	**3.21**	**1.23**	**152.5**

Source: Provincial Budget Documents

* Include tax on opium, provincial excise, entertainment tax, development cess on hotels and cotton fee

The first attempt to levy an AIT was made by the Caretaker Government of Mr. Moeen Qureshi in 1993 under an Ordinance. The tax was linked to the Produce Index Units (PIUs) of land and was, therefore, presumptive in nature. However, the Ordinance was not ratified by the successor elected government and lapsed after 120 days.

The legislative enactment of AIT was undertaken in 1996-97 when the provincial governments promulgated the AIT Act. A study of the Punjab version of this Act (with subsequent amendments after 1997) reveals the following:

1. Imposition of the tax is justified in the preamble on the grounds that the Constitution of Pakistan envisages the creation of an egalitarian society based on the Islamic principles of social justice.
2. The Act is in twelve sections and has two schedules.
3. 'Agricultural income' means any rent or revenue derived from any land which is used for agricultural purposes.
4. The charge of AIT is determined either on the basis of the presumed income as per the first schedule or assessed net income as per the second schedule, whichever is greater.
5. The exemption limit in the first schedule is 12.5 acres of agricultural land cultivated or 25 acres of unirrigated land. The exemption limit in the second schedule is Rs 100,000 of total income.

6. A person who has cultivated land measuring either 50 acres or more of irrigated land or one hundred or more acres of unirrigated land or irrigated and unirrigated land the aggregate area of which is equal to or more than fifty acres of irrigated land (one acre of irrigated land being reckoned as equivalent to two acres of unirrigated land) must file a return of agricultural income.
7. In computation of agricultural income, a number of allowances and deductions are admissible including labor cost, costs of inputs, hiring of equipment, costs of harvesting and marketing, payment of utility bills, mark up on loans, local taxes, cesses and rates, depreciation and capital expenditure.
8. Failure to file a return carries a maximum penalty of Rs 1,000. The penalty on concealed income is 100 percent. The penalty for default in payment is 5 percent per annum.
9. No civil court shall have the jurisdiction in any manner relating to the assessment or collection of the tax leviable under this Act.

The implications of the above provisions in the Act are as follows:

- Currently, the net income per irrigated acre of cultivated land is between Rs 25,000 to Rs 30,000. Therefore, if the principle is to apply the same exemption limit of Rs 300,000 (as in the Federal Income Tax Act) to all types of income, then the exemption limit in the first schedule looks reasonable whereas the exemption limit in the second schedule will have to be enhanced from Rs 100,000 to Rs 300,000.
- The AIT appears to be presumptive in nature for persons cultivating land equivalent to a minimum of 12.5 acres to a maximum 50 acres of irrigated land. For such persons, the first schedule applies. For persons cultivating land in excess of 50 acres of (equivalent) irrigated land, either the first or the second schedule applies, whichever implies a higher tax payment.
- The presumptive tax rates per acre in the first schedule are very low at Rs 150 to Rs 250 per acre. They are equivalent to less than one percent of the average net agricultural income per acre. They have also remained unchanged since 2003.
- There is a case for their enhancement to Rs 750 per acre upto 25 acres and to Rs 1,250 per acres beyond 25 acres, with the proviso that the tax is only applied on acreage in excess of 12.5 acres.
- The penalties are remarkably small. For example, the penalty for non-filing of a return is only up to a maximum of Rs 1,000. This needs to be substantially raised to, say, Rs 10,000 or so. Also, the penalty for default in payment should be changed at, say, 15 percent per annum. Further, the tax liability under AIT may be made chargeable as arrears of land revenue.

Overall, the AIT yields only about Rs 1 billion in Punjab and less than Rs 2 billion in the whole of Pakistan. But legislation for levy of AIT exists since 1996 and there have been a number of amendments since then. If changes of the type identified above are brought in the Acts and collection efficiency is improved, then the tax could nationally yield Rs 10 to Rs 15 billion. From the viewpoint of improving taxpayer compliance, 50 percent of the tax collected from a person could be reverted to the Zila Council of the district in which he/she is located.

Development of Taxes on Real Estate

This is the second area of taxation which the provincial governments are committed to develop as per the 7th NFC Award. Provincial taxes on real estate currently include the stamp duty, tax on transfer of property, the CVT (on property transactions) and the urban immovable property tax (on rental values). Development of taxes on real estate is likely to contribute to greater progressivity of the tax system.

Within property-related taxes, the taxes which are considered as having the maximum revenue-yielding potential are the urban immovable property tax and the capital value tax. But two basic changes are required initially. First, there is a multiplicity of taxes on property transactions. This needs to be rationalised, Second, the CVT on property currently replicates the stamp duty and needs to be replaced by a capital gains tax on property.

The CVT on immovable property was first levied by the federal government in the Finance Act of 1989. The capital value corresponded to the value in the standard valuation tables of immovable properties or the value specified by the District Collector for the purposes of stamp duty. The standard CVT rate was set at 2.5 percent. In the Finance Act of 2009 the rate was enhanced to 4 percent. Following the reallocation of fiscal powers in the 18th Amendment, the CVT on immovable properties has been transferred to the provinces and the rate brought down to 2 percent. The provinces will have to focus on the development of appropriate collection machinery for this tax.

The basic issue is, whether in the presence of multiple taxes, there is over taxation of property transactions which is likely to hinder the development of the real estate market. Currently, the incidence is as follows:

Stamp Duty	3 percent of value
CVT	2 percent of value
Registration Fee	1 percent of value
Tax on Transfer of Property (Town Tax)	1 percent of value
Total	7 percent of value

Although the incidence has been brought down from 9 to 7 percent, following the reduction in CVT rate from 4 to 2 percent, it still remains too high. There is a strong case for withdrawal of the tax on transfer of property and conversion of the registration fee into a graduated flat amount. Beyond this, the CVT needs to be converted into a Capital Gains Tax (CGT) in a manner similar to that done in the case of shares traded in the stock market.

The proposal for development of the CGT is justified on the grounds that part of the capital gains in immovable properties is due to the provision of public infrastructure and services. Therefore, there is a case for levying a tax on these gains. Consistent with this principle, only real and not nominal capital gains should be taxed. The Indian Income Tax Laws have developed a formula for computing real capital gains based on a Cost Inflation Index. The increase in nominal value is reduced by the extent to which the value would have risen due to rise in cost of construction as indicated by the index. A rate of 15 percent could be applied if the gains are over a relatively short period of three years and 10 percent on term gains in excess of three years.

Beyond the development of the tax collection machinery for the CGT on immoveable properties, there is a need for developing a mechanism for checking the substantial under-declaration of property values for tax purposes. For this purpose, the Valuation Tables (containing values specified by the District Collector) for different localities will have to be updated periodically on the basis of market surveys. These values will then represent the minimum values used for assessing both the liability of stamp duty and CGT.

The transition from CVT to CGT on immovable properties is likely to avoid distortions in the real estate market and be considered an altogether more equitable form of taxation. National revenues in 2009-10 from the CVT on properties was about Rs 3 billion. A rational and properly administered tax by the provincial governments could yield three to four times as much over the next two to three years.

Turning to the UIPT, which is a tax collected by the Provincial Excise and Taxation Department and reverted to the local governments. A case study of the tax in the province of Sindh reveals the following:

1. The Property Tax is levied and collected under the Sindh Urban Immovable Property Tax Act, 1958 and Rules framed there under.
2. The Property Tax is levied under Section 3 of the above mentioned Act, by estimating gross annual rent, which is determined under Section 6 of the act.
3. After devolution under Sindh Local Government Ordinance 2002 (3rd Amendment) every Taluka/Town shall be rating area within the meaning of Sindh Urban Immovable Property Tax Act, 1958 and shall determine the rate of assessment in an area and communicate

such rates to respective Executive District Office (Revenue), City District Government (CDG) Karachi for collection by the Excise & Taxation Department.

4. To ascertain the annual value of property, the Government of Sindh has rationalized and simplified the system by notifying a valuation table for different localities under Section 5-A of the Sindh Urban Immovable Property Tax Act, 1958. For this purpose all the cities (notified as rating areas) of the Province of Sindh have been divided into five groups and these groups are further bifurcated into four zones according to the social-economic condition of the localities.
5. The category wise different rates have been specified for each zone of every group, for the size of plot in square yard and covered area in square feet of the property unit.
6. The tax is charged and levied at 20 percent of the annual value of the lands and buildings.
7. Under Section 4 of the Sindh Urban Immovable Property Tax Act, 1958 various property units have been exempted from the Property Tax including the following:
   - Building and lands owned by federal government, provincial government and local government for public purpose.
   - A building or land, the annual value of which does not exceed eight hundred sixty four rupees.
   - Building used for residential purposes built on a plot not more than 120 sqare yards.

It is clear from the above that the UIPT is based on presumed/assessed rental values and not on declared values. This practice has been adopted in view of low rents especially in central cities and because rental values have to be imputed in the case of owner-occupied properties.

Total collection nationally from the UIPT is less than Rs 8 billion. The revenue potential of this tax has been substantially underexploited for a number of reasons:

- Due to absence of regular reassessments, the assessed annual rental values are currently about one third or one fourth of the market rental values
- Differential treatment in favour of owner-occupied properties
- Underassessment of commercial and industrial properties
- Lack of expansion in rating areas in line with the spatial growth of metropolitan cities and lack of notification of new towns as rating areas
- Defects in the assessment formula, especially in the case of luxury properties.

In the short run there is a case for adhoc enhancement of 150 to 200 percent in the case of assessed rental values, with a bigger increase in the case of larger properties. This should then be followed by a comprehensive market survey of rents to update the assessment formula.

There is a need to emphasize the fact that in most countries the property tax is the mainstay for financing provision of local services; therefore, development of the UIPT must be given high priority for development as part of the strategy for progressive taxation of real estate.

Development of GST of Services

In accordance with the provisions of the 7th NFC Award, progress has been made to operationalize the devolution of GST on services to the provincial governments. Effort is also under way to broaden the tax base by extending the tax net to hitherto untaxed or undertaxed services. The latter is a key conditionality of the SBA signed with the IMF. One of the key structural reforms was to replace the existing GST with a comprehensive Value Added Tax (VAT) on goods and services. The VAT is expected not only to raise substantial additional revenues but also distribute the tax burden more evenly across sectors and contribute towards greater progressivity of the tax system of Pakistan. The government has preferred to refer to the VAT as RGST.

Historically, due to constitutional provisions which restrict the federal government to levy a sales tax on "the sale and purchase of goods imported, exported, produced, manufactured or consumed", the federal government had found it expedient to levy an excise duty on services, effectively in the GST mode. Federal Excise Duty (FED) was levied on TV/cable, insurance, non-fund services, air travel tax and property developers. Beyond this, sales taxable services (in FED-VAT mode) included telecommunications, facilities for travel inland and carriage of goods by air and shipping agents.

In 2000, provincial ordinances were promulgated authorizing the federal government to collect sales tax on services at the standard rate on hotels, marriage halls, lawns/clubs/caterers, advertisements on radio/TV, customs agents, ship chandlers, stevedores, shipping agents, courier services, beauty parlours, beauty clinics, slimming clinics, laundries and dry cleaners, caterers and travel agents.

Through the above, however, the government is able to mobilize only a fraction of revenues that can potentially be generated from the large and buoyant services sector. Initial estimates reveal that the services sector combined generate less than one-fourth of FBR revenues while their share in the national economy is more than half. Clearly, significant potential exists for raising more revenues from this sector. Research undertaken for the FBR (IPP, 2010) demonstrates that indeed there exists substantial untapped potential. Net revenues (net of input invoicing of output in intermediate use) from RGST (with 2010-11 tax base) are estimated to be Rs 158 billion (See Table 6.10). Revenues do not cover education and health care sectors, which as per the recommendations of the Revenue Advisory Council (RAC) are to be exempted from taxation.

Services contributed Rs 64.5 billion to the exchequer in 2009-10. These revenues are projected at Rs 76 billion in 2010-11, at a growth rate of 18 percent. As such, additional revenues from replacement of GST and an expansion of RGST to sectors not covered under the GST, regime could yield an additional Rs 82 billion, in 2010-11 equivalent to 0.5 percent of the GDP.

Table 6.10
Estimated Net Revenue from Services
(With Tax Base of 2010-11)

(*Rs billions*)

Sector/Sub-Sector	Revenue
Wholesale and Retail Trade & Hotels and Restaurants	39.7
Transport Storage and Communication	73.1
Banking, Finance and Insurance	29.4
Social Community and Personal Services	15.7
Total	**158.0**

*The following services are exempt: central monetary authority, health and education

Since GST on services is a provincial tax, revenue will not be shared between the federal and provincial governments but will be reverted back to provinces. The federal government has constituted a committee to decide on the allocation formula, as the NFC did not explicitly consider this matter in its deliberations. The Committee has identified the following three groups of services:

Group I: Stand alone services

Group-I services shall include such services that neither involve transactions across the province nor contribute a significant proportion as inputs into other supplies. These services shall be deemed to be of a 'standalone' nature and neither input/output adjustments nor refunds will be provided for such services. Services to be included in this category are to be decided by a technical committee comprising representatives of the Federal Finance Division, all the provinces and the FBR.

Group I services may be levied and collected by provincial governments, if they so desire. Conversely, any province may delegate collection of taxes under Group-I services to FBR. The proceeds of these taxes shall be credited to each province on the basis of collection from each province. In case where point collection is not clearly identifiable, these provinces will devise a distribution formula for such amounts as are not clearly identifiable.

Group II: Telecom services (origin of service clearly identifiable)

Group II shall include telecommunication services, given that the origin of these services is clearly identifiable. The proceeds of GST on telecom services shall be credited directly to the provinces on the basis of origin of service in each province.

Other services currently placed in group I but where the service constitute a significant proportion as inputs into other supplies and the origin of the services are found to be clearly identifiable for services in Group II. After mutual agreement between FBR and the provincial governments on the input/output adjustment and refunds provided, FBR will intimate Finance Division, which will deduct the specified amount from provinces' respective share of their future proceeds.

Group III: Services requiring input/ output adjustment

Group III shall include services that constitute a significant proportion as inputs into other supplies or involve transactions across provinces, shall be delegated by the province(s) to FBR for collection. Currently, these could include:

(a) Financial services, including banking, insurance, stock market operations, etc.

(b) Advertising services

(c) Construction services

(d) Franchising services

(e) Other services that constitute a significant proportion as inputs into other supplies and involve transactions across provinces

FBR will provide input/ output adjustment and refunds for services in Group III. Net tax proceeds from services in Group III will be placed in a separate fund which will be distributed among provinces, as an interim measure by accepting provisionally for one year the stated position of each province given below and the federal government picking up the differential to make up for the demand of each province, as indicated below:

Punjab	Sindh	Khyber-Pakhtunkhwa	Baluchistan	Total
60.39 percent	50.00 percent	15.62 percent	10.00 percent	136.01 percent

For FY 11-12, the federal government and the provinces would evolve a formula that is mutually acceptable to all provinces.

In summary, implementation of the above-mentioned proposals for development of provincial taxes on agriculture, real estate and services could yield additional revenue of up to 0.8 percent of the GDP, equivalent to almost Rs 126 billion on the current tax base. This will contribute not only to significant enhancement in the national tax-to-GDP ratio but also enable the provincial governments to expand the coverage and quality of basic services.

Chapter - 7

The Way Forward

Chapter - 7
The Way Forward

INSTITUTIONAL STRUCTURES

Devolution will only deliver its intended benefits if it is accompanied by appropriate institutional development. As institutional economists have emphasized, institutions are hard to create but easy to neglect and also to destroy. However, sustained economic development requires a solid institutional infrastructure that Pakistan does not have at this critical juncture in its history. The processes that have been set in place to implement the provisions of the 18th Amendment must ensure that the institutions that are working do not collapse or cause deterioration in their working. At the same time a new set of institutions will need to be established and developed that will help to achieve the immense promise of devolution and decentralization.

Pakistan's economic history is littered with examples of institutional destruction or withering away of institutions. We will note one example of institutional deterioration to underscore the important point that institutional development needs to be tended with care. This detour into history has a purpose. It underscores a number of points that are important for institutional development. The first lesson history teaches is that the creation of institutions, at any given point, reflects the needs of that time. Those needs may change but to deal with new circumstances, it is important to allow the institutions to evolve rather than let what had at one time functioned well wither away into eventual oblivion. The second lesson is that for the institutions to serve their intended purpose, they must have available to them the right kind of human and financial resources. The third lesson is that the institutions created to serve a special purpose must remain loyal to it. Further, if the purpose is to provide services to the citizenry, the created institutions must be accountable to those they are meant to serve.

The British, when they left the sub-continent in the hands of two successor states, handed over to the new states a number of well developed institutions. They were not created for the purpose of promoting economic development of the areas they controlled – no colonial power ever does that, and the British were not an exception to that general rule. Their objective in developing institutional structures was to look after their strategic interests, but the successor states could have built upon the rich institutional inheritance. To some extent that was done by India; to a considerable extent that did not happen in Pakistan.

Pakistan's railway system is an example of institutional collapse. The North Western Railways (NWR) was the crown jewel in the history of British India's institutional development. It was developed by the British for strategic reasons. They needed a well managed railway system to convey food grain surpluses as a part of deliberate public policy that were produced in the vast virgin lands of the Indus River Basin to feed the food deficit areas of northeast India. The British administration was concerned that repeated famines in Bengal, Bihar and Orissa in the second half of the 19th century – following upon the Great Mutiny of 1857 – posed a threat to their rule. Massive amounts of public investments were made to develop agriculture in Central and South Punjab and North Sindh to grow wheat and rice for the Northeast. And an elaborate railway network was laid to carry the surplus food to the deficit areas. The railway system was also needed to transport troops in the moment of need to the restive areas of the northwest.

To ensure that the NWR served its purpose, the colonial administration created a cadre of people to manage it. Most of the people engaged in relatively senior positions had to have appropriate managerial and technical skills. They were also largely recruited from the growing Anglo-Indian community that was especially loyal to the British rule. The colonial government could not afford to leave the railway system in the hands of those who could conceivably subvert it for their political ends. As we underscore in the various parts of the report, Pakistan ignored most of the lessons to be learned from the history of institutional development. The result is an institutional graveyard to which some more sites may be added if these basic lessons are lost on those who have taken upon themselves the important task of implementing the 18th Amendment. However, for the moment we return to history.

Pakistan could have built upon the NWR structure to provide long-haul transport system for its growing economy. At the time of independence – and even later, including now – the Pakistani economy was based on the movement of commodities. This is better done by railways than by road, and that was the policy pursued for a couple of decades after independence. In the 'sixties', Pakistan made significant investments in the further development of the railway system. These included double-tracking of some parts of the system and electrification of some other. However, beginning in the latter part of the decade, a number of policy decisions shifted the focus of public sector's attention towards the development of road transport. This was in part due to the rapid rise of vested interests that worked for the development of passenger and trucking systems.

The railway management system also fell victim to the afflictions that are shared by other public sector enterprises – hiring workers in numbers well beyond requirement, appointment of managers on the basis of political connections, corruption, and frequent changes in the responsibility for providing oversight. The result was the progressive deterioration of the railway system to deliver adequate service to the people or the economy. What has happened to the renamed NWR, is a fate shared by other large public enterprises that were not inherited from the British but were established by the state of Pakistan. WAPDA and PIA are two more examples of progressive institutional failure. Apart from their inability to provide appropriate service to the citizenry, these public sector enterprises are also placing an enormous financial burden on an already fiscally strained system.

Given this history, it is not unreasonable to be apprehensive that the process of devolution that is now underway may contribute to institutional deterioration and disarray. We will use another example to illustrate the dangers that lurk in the way the process of devolution is proceeding. There is intense debate in the country about the future of the HEC established by the administration of the former President Pervez Musharraf to address a deepening problem: the absence of well trained and educated work force needed by a developing and modernizing economy. The HEC operations were not free of controversy; some of the organization's critics maintained that it was spending very large amount of public resources to achieve its objectives. It was also argued that the resources put at the disposal of the Commission could have been better deployed in a sector that was long neglected by the government, and that the huge amounts of funds put at the disposal of the Commission should have been used to improve the public educational system at the primary and secondary level and to meet the MDGs to which the country is committed.

On March 29, the Implementation Commission headed by Senator Raza Rabbani[1] announced the decision that the HEC would be included in the second set of ministries and institutions that would devolve to the provinces. The decision was the subject of much speculation in the press and led to an intense debate among those who were critical of its operations as well as those who applauded its performance in promoting higher education. Why did the Implementation Commission decide to rush the HEC decision rather than spend more time on weighing the pros and cons of the move after consulting the experts involved as well as the HEC itself? The question needs an answer since it touches upon a serious matter: the impact of the process of devolution on the already weak institutional infrastructure.

One consequence of the decision to devolve HEC would be its effective break-up into four parts, two of which – those that will be transferred to the two smaller provinces – will not be viable because of their small size. This will have the perverse consequence of further retarding the process of skill formation and knowledge accumulation in the more backward areas of the country. The Implementation Commission, in making the announcement and Chairman Rabbani in addressing the press on the subject, explained that the decision was taken since education was one of the subjects that were to devolve to the provinces under the 18th Amendment. There appeared to be some logic in favour of the decision. However, it was pointed out in the numerous articles that appeared in the press following the HEC decision that some of the functions of the Commission are included in the Federal Legislative List under the 18th Amendment and should not have been devolved. These are as follows:

- Federal agencies and institutes for the following purposes, that is to say, for research, for professional or technical training, or for the promotion of special studies.
- Education as respects Pakistani students in foreign countries and foreign students in Pakistan.
- All regulatory authorities established under a federal law.
- National planning and national economic coordination including planning and coordination of scientific and technological research.
- Standards in institutions for higher education and research, scientific and technical institutions.

The most likely reason for the move was the financial squeeze the federal government had begun to feel as it wrestled with the consequences of the 7th NFC that gave the provinces a much larger share of the divisible pool. The funding for HEC during the period of the former President Pervez Musharraf had become generous and even after major cuts were applied to it by the successor government, it remained significant. One way of dealing with the constrained financial situation under which the federation was operating was to hand over to the provinces functions of the state which were considered 'non-essential'. In other words, the 18th Amendment was being used not only to make the government more effective, and the services it delivered to the citizenry more efficient but to deal with some other problems the government faced. An institution that had played an important role in improving the quality of higher education as well as its quantity was being sacrficed in order to meet the challenges faced by a government that was finding it difficult to finance a number of important functions. Pursuit of higher education was being sacrificed on the altar of finance.

A war of words ensued between the supporters of HEC and those who were in favour of its devolution. Dr. Attaur Rahman, the founding chairman of HEC, pointed to the achievements of the Commission. "Look at the progress HEC has made", he told the press. "There has been a 600 percent increase in our publications over the last decade". He said that because of HEC more PhDs were awarded in one decade than in the previous 60 years, and a significant improvement was made in the quality of teachers available to teaching institutions operating at different levels (Khalid, 2011).

The case of HEC illustrates the problems with the process of devolution that has been put in place to implement the 18th Amendment. The Implementation Commission has preferred speed over reflection. This approach could lead to costly mistakes particularly where institutional health is concerned. The amendment focuses on the structure of government that will result after all the provisions have been met. In order not to allow the decentralization process to overwhelm the fragile institutional structure, the Implementation Commission should have settled on a number of binding principles that would be adhered to as devolution is acted upon. Four of these are particularly important.

First, implemantation of the the 18th Amendment must not be at the expense of institutional continuity. Devolution must not result in impairing the institutional functions that were being carried out reasonably well at the central level; this is the case with HEC. It is by no means certain that once HEC is transferred from federal control, all the provinces will give higher education the attention it deserves. There is a fear that some of the activities, that were being carried when the institution was under the control of the federal government, will not be continued once the provinces are in charge. To take one example: HEC has a large number of students pursuing higher education in foreign universities. Would they be allowed to continue with their studies? The assurance given by the Chairman Implementation Commission that there will be no such discontinuity is not sufficient to ensure that it would not happen.

Second, there are some regulatory functions that require national standards and enforcement. HEC, for instance, has the responsibility for developing curriculas that would be used throughout the country. In a country that is still engaged in overcoming regional tensions, leaving curriculum development to the federating units could have serious adverse consequences for nation building. HEC also used its grant-making authority as leverage to ensure minimum standards among the institutions it assisted. This ensured certain quality in all parts of the country. With the provinces operating their own higher education entities, this will not happen.

Third, if the functions being performed by the institutions while they are working at the federal level are considered to be important, there has to be some assurance that they will continue to operate at the same level of activity once they become part of the provincial structure. How this will be assured needs to be spelt out before the process of devolution, involving particular institutions, is undertaken. Had this been done, some of the controversy generated by the decision concerning HEC could have been avoided.

Fourth, as the devolution function is being currently carried out, it would be difficult to ensure consistency in the use of public funds across the country. This may result in considerable variation in behaviour on the part of the provinces. It is not clear whether the federal government will have the institutional structure to enforce some conformity.

FINANCIAL ASPECTS

The previous chapters have brought to the forefront a number of issues emerging in the process of devolution which need more or less immediate policy attention. On the financial side, these issues largely pertain to the financing of devolved subjects and the sharing of assets and liabilities. The former is largely a consequence of the wrong sequencing of the devolution process whereby financial resources were transferred prior to the decision of reallocation of functional responsibilities. As highlighted earlier in chapter five, the federal and provincial position varies on the issue. While the former argues that additional revenues transferred under the 7th NFC Award should finance the additional functions devolved through the 18th Amendment, the provincial view is that they, in effect, do not have the fiscal space to do so for the following reasons:

a) The NFC Award, though it significantly increases the share of provinces in the national resource pool, does not confer as big a bonanza of revenue transfer to provinces as claimed because of the likely shortfall in FBR tax collection in 2010-11, the first year of the Award. The budgetary magnitude of transfers is based on tax collection by FBR of Rs 1667 billion in 2010-11, increasing at a rate of 26 percent. After a lapse of eight months in the fiscal year, the revenue growth is only about 10 percent. Punjab province has received Rs 232 billion in transfers for this period, as opposed to Rs 254 billion, revealing a shortfall of Rs 22 billion. Overall, if current trends prevail, shortfall to the four provinces combined in Divisible Pool transfers could be close to Rs 75 billion in 2010-11.

b) It needs to be remembered that while the 7th NFC increases transfers from the Divisible Pool, other federal transfers, in particular grants to provinces have been discontinued.

c) The revenue gains transferred to the provinces have been significantly eroded because of the federal decision to enhance salaries and allowances of government employees by 50 percent in the Budget of 2010-11. The expenditure impact on Punjab of the salary increase is Rs 54 billion, while on Sindh, it is Rs 33 billion. Overall, the cost of salary increase is about Rs 125 to 130 billion for the four provincial governments as a whole.

d) The devastating floods, experienced in the summer of 2010, have caused heavy and widespread damages which include losses to private housing, standing crops and public infrastructure. The government provided cash assistance and support to the affectees for the first two losses while the third is the provincial government's responsibility. Punjab and Sindh governments have had to divert Rs 10 billion and Rs 20 billion respectively on this account from other budgetary heads.

e) Floods have not only led to a diversion of resources away from other expenditures but also a reduction in the flow of own revenues. According to IPP estimates, floods will result in a 2 to 2.5 percent decline in the growth rate of economy in 2010-11.

Correspondingly, growth in federal and provincial tax bases will be less than projected, leading to a likely reduction in the growth rate of revenues.

f) In the case of Punjab, an added demand on existing resources is the need to bring down the overdraft/loans acquired in previous years to improve the financial solvency of the province and also possibly to build up some surplus in case of delays in releases by the federal government.

The above factors have, as it is, led to a large reduction in the provincial ADPs in comparison to that budgeted at the beginning of 2010-11. In the case of Punjab, the budgeted ADP for 2010-11 was Rs 193 billion. The releases expected to be made in the year are Rs 128 billion, lower than last year's ADP of Rs 133 billion. In the case of Sindh also, the projected ADP is not likely to be more than two-third of the budgeted amount for 2010-11. Initial estimates indicate that the erosion of the gains in transfers following 7th NFC Award due to two factors (shortfall in FBR revenue collection and salary hike) will erode about Rs 180 billion of the Rs 222 billion revenue gain budgeted for 2010-11. This implies that additional revenue transfers due to the 7th NFC Award are not enough to finance the additional recurrent liability arising from the transfer of functions of the 18th Amendment, (see Chapter 5) leave alone the development outlays.

Clearly, the larger provinces do not have the fiscal space to take on the new responsibilities. The position with the smaller two provinces, however, is likely to be somewhat different. It appears that given the proportionately higher transfers (NFC mandated plus payment of arrears on account of hydel profits and gas) the binding constraint in their case is likely to be more institutional than financial.

The financial issues arising from the 18th Amendment are complicated and wide ranging and will require detailed workings on different issues for resolution. What perhaps is required is enunciation of some guiding principles which can be laid down to determine the nature of resolution of each issue on a case to case basis. These principles should be for the tenure of the 7th NFC Award. Some such principles are illustrated below:

1. All functions that have been devolved to the provinces following the abolition of the Concurrent Legislative List are a provincial responsibility and therefore, policy making, regulation, management and funding should be provincial responsibility.
2. The functions shifted to Part II of the Federal Legislative List and made a joint federal and provincial responsibility should continue to be financed and managed by the federal government while policy making and supervision should be jointly done through the CCI.
3. Given the overall fiscal state of governments in Pakistan, the absorption of functions devolved should be achieved in as cost effective a manner as possible, without compromising on quality of service provision. This requires an approach, already

initiated in the case of five devolved ministries, of absorption of most of the additional functions into already existing departments in the provinces. Setting up of new departments should be limited and should be based on very strong justification.

4. To the extent that there is need for an expansion in employment, first priority should be given to federal employees already working in the devolved divisions. Such federal employees should continue to be funded by the federal government. If, however, the provincial governments want to hire their own employees, the costs should be borne by the provincial government. This will provide an incentive for retaining the human capital that has been developed for the management of the devolved services.
5. A moratorium should be placed on new federal recruitment in order to absorb the federal staff dislocated due to the devolution of the 18 Divisions/Ministries.
6. Throw-forward of on-going projects/programs devolved to the province should be financed by the federal government upto to the end of the tenure of the present NFC Award. For new schemes or for recent vintage of projects/programs the choice to carry-on should be with the provincial government. For such schemes, the provincial government should demonstrate some ownership and commitment and finance 50 percent of the cost while the remaining should be financed by the federal government.
7. Provinces have under exploited tax bases in their fiscal jurisdiction as demonstrated in Chapter Five. There is need for provinces to exploit their revenue potential and also to avoid profligacy in unproductive spending. The standing committee of the NFC should decide on an incentive scheme, such as matching federal grant for higher resource mobilization or higher self-financing ratio, to motivate the provinces to have greater ability over time to finance the expansion of devolved services.
8. The 18th Amendment, while devolving ministries/divisions to the provinces, has also in effect devolved the assets and liabilities of the Ministries/Divisions. This implies devolution of income from sources like WWF, Workers Profit Participation Fund (WPPF) to the provinces following the transfer of labour-related functions. Likewise Article 172 (3), while providing for equal ownership of federal and provincial governments of minerals, also implies sharing of incomes from these natural resources on a 50:50 basis. Essentially, non-tax receipts of dividends, profits etc. of corporations like OGDC operating in the field of natural resources will thus be shared by the federal and provincial governments. If a decision on the sharing formula is agreed upon, then the additional funding requirements of the 18th Amendment can be financed partially through these non-tax revenue sources. The initial estimates indicate that such funding can contribute about Rs 36 billion annual to the four provincial exchequers combined. This, alongwith higher federal and provincial tax mobilization, can finance the additional resource requirements of the provincial government to manage the devolved functions.

DEEPENING AND SUSTAINING THE PROCESS OF DECENTRALISATION

The transfer of a large number of functions from the federal government to the provincial governments following the 18th Amendment has naturally led to the expectation that the process of decentralization will be deepened further by the process of strengthening of local governments (which fall within the ambit of provincial governments), both functionally and financially, and with greater autonomy in their operations.

However, following the induction of elected governments in the provinces there has been a fundamental re-examination of the Devolution Plan of 2001, introduced by the military government. Given the history of local governments in Pakistan being promoted primarily by military dictators as a way of developing an alternative constituency of support, the return to democracy was likely to be followed by an assessment of the extent to which too many powers had been granted to District Governments, especially in areas of law and order and revenue record related functions.

The consequence has been a dissolution of the local councils pending the next round of elections and drafting of new Local Government Laws. Elected heads of local governments have temporarily been replaced by provincial bureaucrats. The resulting 'institutional vacuum' has been vividly highlighted by the recent devastating floods, when local elected representatives were not available to organize communities for relief and rehabilitation work.

As local government legislation has now fully reverted to provincial assemblies, there is likely to be a difference in the posture towards decentralization among the four provinces, depending upon the particular history, experience and political configuration. For example, local governments are likely to retain substantial powers in Sindh given the role of Muttahida Quami Movement (MQM), a party with pre-dominant vote bank in the cities. The commitment to strengthening local government is likely to be less in the other provinces, especially in Punjab, where the government appears to think that the process of devolution had been taken too far in 2001.

The subsequent sections of this chapter are focused primarily on Punjab, where an assertive provincial government has already begun to displace local governments. Therefore, there is a real danger that the gains in decentralization arising from the 18th Amendment may be at least partially nullified by the impending Local Government Laws, which are likely to reduce the powers, functions and resources of the lowest tier of government in Pakistan, especially in Punjab. It must be remembered that local governments, in particular, are important in strengthening democracy through participation of the people at the 'grass roots' level in the provision and access to basic services which have a vital bearing on the quality of life of citizens.

We proceed now to a comparison of the key provisions in the LGO of 2001 and the draft Local Government Act (LGA) of 2010 in Punjab. The latter is yet be passed by the provincial assembly, although some provisions have been made operative through cabinet approval.

Structure of Local Government

The Devolution Plan of 2001 had led to a radical change in the structure of local governments as compared to the LGO of 1979. At the highest level, district governments were put in place covering both the urban and rural areas of a district. In LGO of 1979, there was a clear separation between urban and rural jurisdictions. Depending upon the size of an urban settlement, it was granted the status of a metropolitan corporation/municipal committee/town committee.

The consolidation into district governments was a step forward in terms of enhancement in capacity and the resulting ability to take on more functions. However, this move was rendered controversial by the replacement of the Deputy Commissioner, who reported to the provincial government, by a District Coordination Officer (DCO) within the local administration and by the local assignment of law and order functions.

The proposed LGA of Punjab essentially reverts to the local government structure as per LGO 1979. The only difference is that the special status of Metropolis will be awarded to Lahore. Zila Councils will cover only the rural areas of a district. The lowest tier of local government in the form of Union Councils remains unchanged. In addition, it is not clear at this stage if the position of District Commissioner will be restored and with what kind of powers.

Allocation of Functions

The basic municipal functions of water supply, sanitation, local roads and garbage disposal will continue to be performed by local governments. Some of the additional functions passed on to local governments in LGO 2001 will be retained. This includes agriculture, community development, public health, rural health centres and basic health units, population welfare, literacy and primary education. However, a number of important functions have been taken back by the provincial government including civil defense, labor, sports and culture, secondary and technical education, colleges, special education, district and tehsil HQ hospitals, information technology, revenue, works and services. Recently, the local Executive District Officer (EDO) for revenue has been designated as Assistant Commissioner (AC) and brought under the provincial government; however, the powers to be vested with him/her are not clear.

An evaluation of the outcomes from the devolution process after 2001 by Social Policy and Development Centre (SPDC), 2008 reveals that many of the social indicators showed a faster rate of improvement after the Devolution Plan was implemented. It may be argued that this was due more to enhanced availability of fiscal resources up to 2006-07, during a period of relatively fast growth, and less due to a reallocation of functions. However, the justification for taking back functions like secondary education and hospitals from local governments is not clear. The prospects for public accountability in the provision of such services are undoubtedly greater at the local level.

Fiscal Powers and Transfers

No material changes in fiscal powers of local governments are proposed in the LGA 2010. These governments will continue to rely heavily on provincial transfers to finance their Operation and Maintenance (O&M) costs and development expenditure. The source of concern now is the greater uncertainty about the magnitude of provincial transfers to local governments. Following the abolition of Octroi and Zila tax in 1997, a decision was taken that one-sixths of the federal GST on goods would be transferred to local governments in the form of the District Support Grants. The Provincial Finance Commissions (PFCs) ensured the sharing of these transfers on the basis of a formula of distribution among district governments.

The 7th NFC Award has avoided explicit mention of the transfers in lieu of Octroi/Zila tax, which are to be routed to local governments via the provincial governments. There is now the danger that the transfers legitimately due to local governments may not reach them. This is an anamoly in the NFC award which needs to be corrected on a priority basis; otherwise, there may be demands for a return of Octroi in the fiscal powers of urban local governments, as has already been voiced in Sindh. It must be remembered that Octroi was abolished because it had become a very oppressive and regressive form of taxation.

Finances of Local Governments

The following comments can be made on sections of LGA 2010 relating to the finances and the process of financial management of local bodies:

Section 177 on Application of Funds

The specification of budgetary ratios would impinge on the autonomy of local councils to decide on their budgetary priorities. Also, the ratio of development works to the total budgetary expenditures will depend upon the financial strength of a particular council. We recommend that this clause be dropped, subject to the constraint that local councils cannot borrow as specified in Section 183. The earmarking of transfers between development and current transfers ensures a minimum level of development expenditure.

Section 182 on Audit

Instead of constitution of Local Council Accounts Committees to examine audit reports of Local Councils, this function may be performed by the Provincial Local Government Commission, which has the right to initiate a special audit as one of its functions in Section 211.

Section 189 on the Local Rate

The Local Rate is a revenue source for the District Council and/or Union Council in rural jurisdictions. However, the fifth schedule in the draft Act does not mention the local rate as a tax either of Union Council or District Council.

Since the Local Rate is essentially a surcharge on land revenue and 'piggy backs' this tax, there should be some flexibility to the Local Council to vary the rate of surcharge, rather than be notified by the provincial government. The Local Rate can then act as a budget-balancing device. This is similar to the powers granted for setting of the rate of UIPT by Urban Local Councils, as specified in Section 190, sub-section (2).

Section 191 on Enforcement of Taxes

There should be a clear statement as to which sources of revenue will be collected by the local council and which by the provincial government or some other agency. The issue in particular of who collects the UIPT, especially in the Metropolitan Corporations, needs to be clarified.

This section allows a council to increase, reduce, suspend or abolish tax, provided that the provincial government shall vet the proposal prior to the approval by the concerned council. This provision safeguards against unhealthy 'tax competition' among jurisdictions to bring down tax rates to attract economic activity. However, if a Council wants to increase or levy a tax, it should have the freedom to do so without reference to the provincial government, subject of course, to passage in the council. It is important to provide all possible incentives to local councils to generate more revenues from their own sources.

Section 197 on Taxation Rules

This section allows for 'leasing' of collection of particular taxes, whereby tax collection could be privatized by appointment of contractors. The past experience of leasing of Octroi collection by local councils was unsatisfactory, and this was one of the reasons why the tax was abolished. The scope for leasing should be restricted to some minor non-tax revenue sources only, like parking fees or tolls on roads.

Taxation rules should ideally be standardized for all local councils within the province and be subject to once-and-for-all approval by the provincial government.

Section 199 on Local Grants Committee

It is not clear why the name, Provincial Finance Commission (PFC), has been changed to Local Council Grants Committee. From 'commission' to 'committee' sounds like a downgrading of the status of this institution.

Section 200 on Composition of Local Grants Committee

The total number of members, including the Chairman, adds up to 13, not 10 as stated. The composition of the Local Council Grants Committee has been changed in favour of representatives from the provincial tier by inclusion of Minister of Local Government and two members of the provincial assembly. Only three members are from local government.

Overall, the above changes impinge on the financial autonomy of local governments and need to be reviewed before the Act is passed by the provincial assembly.

Lessons from PFC Awards

The PFCs have been making awards every three years or so on the total quantum of transfers and their sharing among local governments. The lessons from the PFC Awards of Punjab which should be kept in mind in the design of future transfers after promulgation of the new Local Government Act are as follows:

- A fairly complex system of transfers has been evolved by the PFC of Punjab with four types of grants: general purpose, equalization, development and tied with primarily two beneficiaries - district governments and Tehsil municipal administrations. Therefore, there is a need to specify eight shares from the total transfer and the horizontal criteria for distribution of each type of grant to each local entity. This needs to be simplified.
- The horizontal criteria are primarily population and level of development (in the case of development and tied grants). This formula is less complex than that used in Sindh which has five criteria. In the case of Khyber-Pakhtunkhwa current transfers are broken up into salary and non-salary transfers.
- The practice of earmarking transfers into current and development transfers ensures a balance in the priority towards O&M of existing services versus expansion in service coverage. Within each category of transfer, local governments should have full autonomy in allocation of expenditures; however, the share of development grants is relatively small and needs to be enhanced.
- Conditional grants specifying the target service are observed only in the case of tied grants, which are variable and account for only a small portion of the transfers.
- The fact that generally over 90 percnet of expenditure is financed by transfers and there is no criterion reflecting local fiscal effort, as in the case of Sindh, has created a culture of dependency in local governments. Some incentive should be provided for greater local fiscal effort.
- There is no explicit consideration of fiscal equalization in current transfers, unlike Sindh and Kyber-Pakhtunkhwa. Any equalization (large per capita allocation to more backward districts) is purely incidental. It should be made explicit.

- The so-called equalization grants component in current transfers is actually not aimed at fiscal equalization but is more in the nature of 'deficit' grants to finance benchmark levels of expenditure. It could create the perverse incentive between awards for local governments to raise their current expenditures in the hope of establishing a higher benchmark. Therefore, benchmarking has to be done carefully on the basis of some objective criteria.
- The presence of 'expected shortfall' in determining the net proceeds from the Provincial Consolidation Fund reduces the degree of predictability in local transfers, especially in view of the failure of FBR to achieve revenue targets. As such, a margin of 5 to 10 percent may be set initially and local transfers ensured after this provision.
- The lump sum grant to Union Administrations is too small and makes them largely ineffective in performing functions at the grass roots level. Consideration may be given to raising the share of Union Council from 3.69 percent to at least 7.5 percent.

Pakistan is making a great leap forward following the 18th Amendment in empowering the provinces through transfer of more resources and functions to them. Logically, this should have been accompanied by a deepening of the process of decentralization by strengthening of local governments, but the opposite is happening, especially in Punjab. This could defeat the objective of bringing government nearer to the people and thereby leading to a more effective functioning of democracy. The draft local government laws need to be reviewed on the basis of an evaluation of the past experience so as to withdraw or modify some of the provisions which limit the functions, resources and autonomy of local governments.

PROMOTING PARTICIPATORY DEVELOPMENT[2]

The term Participatory Development has been given a specific meaning in dicussing the theory and practice of poverty reduction over the last three decades by a group of scholars from South Asia[3]. Participatory Development is a process which involves the participation of the poor at the village/mohalla level to build their human, natural and economic resource base for breaking out of the poverty nexus. It specifically aims at achieving a localized capital accumulation process based on the progressive development of group identity, skill development and local resource generation.

The Concept of Participatory Development

At this level of generalization the concept has three key elements:

(i) *Process:* It is a process whose moving force is the growth of consciousness, of group identity and the realization in practice of the creative potential of the poor.

(ii) *Empowerment:* The process of reconstructing a group identity, of raising consciousness, of acquiring new skills and of upgrading their knowledge base progressively imparts to the poor a new power over the economic and social forces that fashion their daily lives.

It is through this ‘power’ that the poor shift out of the perception of being passive ‘victims’ of the process that accentuates their poverty. They become the vital subjects in initiating interventions that progressively improve their economic and social condition and overcome poverty.

(iii) *Participation:* The acquisition of the power to break the vicious circle of poverty is based on participation within an organization in a series of projects. This participation is not through `representatives' who act on others' behalf but through the actual involvement of each member of the organization in project identification, formulation, implementation and evaluation. It is in open meetings of ordinary members at the village/mohalla level organization that decisions are collectively taken and work responsibilities assigned on issues such as income generation projects, savings funds, conservation practices in land use, infrastructure construction and asset creation.

The Dynamics of Participatory Development

The process of participatory development proceeds through a dynamic interaction between the achievement of specific objectives for improving the resource position of the local community and the sense of community identity. Collective actions for specific objectives (such as a small irrigation project, fertilizer manufacture through organic waste, clean drinking water provision) or production activities (such as fruit processing) can be an entry point for a localized capital accumulation process, leading to group saving schemes, reinvestment and asset creation. The dynamics of participatory development are based on the possibility that with the achievement of such specific objectives for an improved resource position, the community would acquire greater self confidence and strengthen its group identity.

The Necessary Conditions for Initiating and Sustaining the Process

Participatory development in most cases cannot begin spontaneously, given the deep rooted dependency relations of the poor on both local elites as well as the government officials. Two pre-conditions are necessary (though not sufficient):

(i) A catalyst is needed to initiate the process. A catalyst or initiator is a new type of activist who is committed and will work with the poor. He helps the community through a series of dialogues to articulate their felt needs and to initially persuade an atomized set of people to constitute themselves into an organization. The animators help in pinpointing bottlenecks and calling in expertise from outside as well as help forge links with formal credit institutions.

(ii) A support system at the macro level is necessary for training the cadres of `animators' for providing the initial financial support to help begin income generation/infrastructure projects of the community and to provide technical expertise for overcoming bottlenecks in project implementation.

Employment Generation and Poverty Alleviation through Non-Governmental Organizations (NGOs)

Over the last three decades a variety of NGOs have established support programmes aimed at developing community organizations at the village level, building institution, providing training and accessing credit and technical support.

The question that arises is whether these alternative institutional forms can achieve sufficient coverage of the poor population and cost effectiveness to become a credible framework for achieving a significant impact on the overall employment and poverty problem in the country. In addressing this question, it may be useful to examine broadly the different types of Participatory Development NGOs and their antecedents and then to identify the conditions under which NGOs can be: (a) effective, (b) reach scale both in terms of population and geographic area covered and (c) achieve and maintain cost effectiveness. An examination of these issues would provide the basis for proposing national level apex organizations and a broad policy environment within which the replication and up-scaling of NGOs can be facilitated.

Types of Development NGOs and their Advantages Compared to Government

Development NGOs operating in rural areas may be classified into three broad groups by scale of operation:

(i) The Rural Support Programmes (RSPs), instituted by government are multi-functional and also have a wide area of operation at a national level National Rural Support Programme (NRSP) or at a provincial level Sarhad Rural Support Corporation (SRSC) and Punjab Rural Support Programme (PRSP). The RSPs start functioning on a large scale and in a wide geographic area by simultaneously establishing regional offices in a number of districts.

(ii) Smaller NGOs, such as SUNGI and Pakistan Institute for Environment-Development Action Research (PIEDAR), which are independently created and are multi-functional[4] start operating on a small scale and in a single location. They gradually increase their scale of operations in terms of both population covered and geographic area; nevertheless, they remain much smaller than RSPs.

(iii) CBOs which operate on a local scale either at the village level or a cluster village level, and which are supported not by NGOs of types (i) and (ii) above but directly by donors, such as the Aga Khan Foundation (as distinct from the Aga Khan Rural Support Programme).

Development NGOs using the participatory method have four main advantages over government in fostering rural development through the participation of village communities: (a) penetration, (b) targeting, (c) cost-sharing and sustainability of development initiatives, (d) human resource development, consciousness and empowerment. Let us briefly consider each of these features:

Penetration: Despite the supposed universal availability of services provided by government, its actual coverage of the population is generally very low. In fact, the RSPs were set up on the premise (accepted by government) that the federal and provincial governments do not have the organizational reach to bring a range of development activities to the majority of the nation's rural population and that even if it were possible, the recurring budget for the development activities would be beyond the financial capacity of the government. There is also a tendency on the part of government to make intended beneficiaries come to a service provider often over a considerable distance, rather than to bring the service to the community. This attitude emanates from a concept of power endemic to governance in Pakistan, whereby service provision is regarded as a means of perpetuating dependency relations. Thus, the provision of services through government functionaries becomes an instrument of bringing those dependent on such services into their domain of power. NGOs by contrast are able to penetrate to the level of village, hamlet or community. This is integral to their approach (counter-posed to that of government), which is to enable the poor to empower themselves and become both subjects and the objects of development effort.

Targeting: Most government programmes work on a scale and through an administrative approach that encourages provision of resources and services to be misdirected beyond the target group, reach high levels of leakage and sometimes get misappropriated by government functionaries and local power brokers such as landlords, influential traders and politicians. For example, according to the field visit report of the Swiss Development Corporation, "at most five to fifteen percent of the target group of small farmers benefit directly from research, extension, credit and seed supply service in Pakistan" (Government of NWFP and Swiss Development Corporation, 1990). NGOs by contrast are able to target disadvantaged regions, communities, groups and even individuals more precisely. This arises out of their institutional orientation, greater understanding of the complexity of the social and economic process within which they are intervening and finally, their operating methodology. The latter, in some cases, includes compiling and updating community data bases such as village profiles, which include both physical and social geography, community histories, land ownership and irrigation patterns, crop, livestock, village trade and production and basic consumption and income data.

- *Cost-sharing and sustainability of development initiatives:* Rural development NGOs seek to organize communities into basic participatory organizations variously called village organizations, self-help organizations, community organizations and community based organizations. These village level organizations which are based on decision making by the general body of their membership rather than by the elected office bearers, identify projects and activities that are of priority to the villagers and which they are willing to help sustain from their own resources. Such projects, whether income generating or social sector are prioritized and selected through an intensive, interactive process involving the whole membership of a community organization. Since members agree to contribute labour materials or money to their building and upkeep, they reflect the community's greatest needs. The community will, therefore, continue the maintenance and upkeep of the project even if the NGO no longer operates there. This is in sharp contrast to government aided projects that are 'orphaned' at birth because government itself seldom has funds for O&M, and villagers who are not consulted during project selection, identification of sites, technology choice and construction, will not assume responsibility for O&M.

- Human resource development, consciousness and empowerment: The NGO development intervention does not merely aim to provide service delivery or other tangible benefits at a point in time as the government does. It is a process of empowerment. By raising consciousness; acquiring new skills; increasing productivity, incomes, savings and investment, the poor community acquires a new power over the economic and social forces that fashion their daily lives. Thus, the tangible benefits acquired by the community are part of a process in which the community begins to take initiatives for its own material welfare and develops its human, natural and economic resource base to sustain it.

Strategic Issues in taking Development NGOs to Scale

The question of how NGOs are to achieve scale in both their demographic and geographic coverage, focuses attention on six inter-related issues: (a) The only large NGOs, which start by operating in a number of different districts and provinces simultaneously, are RSPs which have been established by the government. The issue here is whether these RSPs can remain participatory development organizations autonomous of government, and whether they can achieve adequate coverage of the poor population in Pakistan, cost effectively and within a credible time frame. (b) How can a small NGO which has achieved success in Participatory Development in a few villages, upscale its coverage without losing the key features which defined its character and determined its earlier success? These are institutional autonomy, participatory decision making (both within the NGO as well as in its relations with village communities), innovativeness and cost effectiveness. (c) How can small but successful NGOs be multiplied quickly in a large number at different locations to achieve a much larger coverage and yet maintain cost-effectiveness? (d) What are the conditions under which NGOs, as they enlarge geographic coverage, divest themselves of village level community organizations which have achieved maturity and which can develop their own organization clusters and support systems? (e) What are the strategic macro level constraints in terms of training of personnel, financial resources and geographically diversified monitoring and impact assessment capabilities? (f) An enabling policy environment at the national level.

Participatory Development through Rural Support Programmes

The Question of Time and Money

The raison d'etre of RSPs, such as the NRSP, is the assumption that they can achieve coverage of the entire poor population in the foreseeable future, provided resources are made available to them by government and donors. In this regard, earlier studies have raised questions about the pace of the poor population coverage and resource cost. After three decades of operations, about five percent of the poor population appears to have been covered within Community Organizations (CO) of NRSP. Even if it is assumed that as soon as an individual becomes a member of a CO he/she permanently shifts out of poverty, the cost per person of 'shifting out' of poverty has been estimated at Rs 33,777 (at 1997 prices). At this rate, it will cost Rs 1,925 billion to shift out of poverty the population that lives below the poverty line currently. In terms of the average pace of coverage of NRSP so far, it would take about six hundred years to achieve this objective.

Structural Weaknesses of the RSP Model

1. The administrative structure of the RSPs is designed to provide a permanent support infrastructure without any provision for encouraging cluster formation amongst COs let alone devolving organizational responsibilities to such apex formations at the local level. Instead there is a tendency to set up more and more offices and a growing cadre of management staff at the central, regional and field unit levels. Consequently, RSPs are characterized by high and growing overheads as their operations expand. The financial implications of this aspect of the RSPs organizational structure have been discussed in earlier Section 5(i).
2. The sustainability of maintaining its management structure becomes problematic as operations expand in widely dispersed geographic locations. The heavy reliance on RSPs staff in mobilizing communities and building community organizations could be both costly and counter-productive in terms of the objective of empowering village communities. This approach can be contrasted with relying on a process of identifying, training and supporting village activists to perform these services for their communities with long term recurring costs borne by the communities themselves. This internal dynamic within communities reduces dependence and is more likely to produce a self-sustaining community organization capable of taking charge of its own development. At the regional level also, instead of maintaining and continuously enlarging regional offices, it may be more cost-effective to encourage formation of sub-regional apex organizations of autonomous CO clusters. These could provide a more decentralized and self-financing support system at the regional level.
3. The linkage of RSPs with provincial governments has produced another set of problems. There is no clear recognition within government of the independent role

of an RSP. On the contrary, there is a tendency to regard the RSP as a slightly different version of a government department with much higher salaries, and which could be used to provide relatively high wage employment to civil servants, politicians and their clients. At best, RSPs are seen by the government as vehicles for attracting donor funding and taking on many of the development responsibilities of government departments while still being subject to institutionalized control by senior civil servants and politicians. There is a tendency for RSPs to fall in with government demands in terms of staff appointments, allocation of funds to particular sub-regions or taking on (in a top-down fashion) government designed projects in the social sector, such as health and education. This tendency is facilitated by the presence of ex-officio and other serving government officers on the boards and in management of the RSPs.

4. A problem not unique to RSPs but exaggerated by their large scale is the handling of credit operations. As large multi-sectoral development organizations, they view credit as an integral part of their other interventions such as social mobilization, training and institutional capacity building of RSPs themselves. Therefore, RSPs in their accounting systems tend to avoid separating costs specific to the credit program. This alters the perception of their credit program at the policy level: they seek subsidized credit for on-lending at market rates to the poor, using the resultant spread as a means of facilitating their overall multi-sectoral program. At the same time, it becomes difficult for them to calculate cost recovery and break-even points for the credit operations.

Taking Small NGOs to Scale: Some Necessary Conditions for Success

Perhaps the single most important factor in their success is the quality of leadership. The successful NGO leader creates the team synergy to develop innovative responses to each new problem on the ground.

The second factor in the success of small NGOs is the identification, training and fostering of village level activists who gradually begin to manage existing COs, thereby, enabling NGO staff to give more time to develop new COs. This process of devolution of management responsibility from NGO staff to village level activists is a crucial factor in the enlargement of NGO coverage in a situation where funds are limited and rapid expansion of staff, financially unfeasible.

The third factor in the success of small NGOs, which have reached significant scale, is the development of second level management and the ability of top level leadership to devolve responsibility.

The fourth factor in the success of small NGOs in reaching significant scale is the development of credible accounting procedures, and a regular monitoring and evaluation exercise on the basis of which donor funding can be sought when it is required.

Taking Participatory Development NGOs to Scale

For a direct attack on the poverty problem, it is proposed that Participatory Development be taken to national scale. This is a process of empowerment of the poor through social mobilization at the village level, development of group identity, and initiating a localized capital accumulation process at the village and cluster level. Experience of development NGOs during the last three decades has shown that this process can be initiated and sustained by building a network of support institutions at the village and regional levels.

In order to take development NGOs to scale and replicate them rapidly to achieve national coverage, the following enabling policy framework is proposed:

(i) Enable the Pakistan Poverty Alleivation Fund (PPAF) to engage in capacity building so that it can fulfill its mandate of becoming an apex organization for fostering the rapid growth of Participatory Development NGOs. This capacity building would involve the development of five dimensions of its organization: (a) coordinating rigorous evaluation and impact assessment of the work of partner organizations, (b) coordinating large scale training of village activists, social mobilizers and management professionals for NGOs going to scale, (c) coordinating management support for NGOs (e.g., MIS, customized software programs and management systems), which are in the process of up-scaling, (d) providing a forum for NGOs to learn from each other's experience, (e) providing a forum for policy dialogue between NGOs, governments, donors and the private sector.

(ii) Establish a national facility for training village activists in a variety of skills. It should be a lean organization with a mandate to network with all NGOs, identify their training needs and then coordinate with different training sources, develop courses and ensure that high training standards are established. The sources would include Vocational Training Institutes (VTIs); training facilities in provincial government line departments, such as Agriculture, Forestry, Livestock and Irrigation departments; and the private sector, such as Sustainable Development Policy Institute (SDPI), Human Development Centre (HDC), Lahore University of Management Sciences (LUMS).

(iii) Establish a national Monitoring, Evaluation and Participatory Poverty Assessment Institute (MEPPAI) in the private sector, supported by donors and government, which has the professional expertise to undertake rigorous monitoring, evaluation, and impact assessment exercises for the PPAF and NGOs on demand. Such an institute would network national data collection and research institutions (such as the Federal Bureau of Statistics (FBS), Pakistan Institute of Development Economics (PIDE), LUMS) to bring their expertise together for particular impact assessment exercises. The Participatory Poverty Assessment (PPA), currently initiated by Department for International Development (DFID), could be institutionalized into a permanent feature within the Monitoring, Evaluation and Participatory Poverty Assessment Institute (MEPPAI).

Participatory Development and Local Government

Under the devolution programme, a new structure of local governments at the district level is emerging within which elected representatives will be expected to undertake (amongst other functions) poverty alleviation at different tiers of local government (district, tehsil, union council and village levels).

Within this structure, NGOs could play an important role by facilitating the formation of autonomous organizations of the poor. An institutionalized relationship could be created between such organizations of the poor and every tier of local government (from the union council to the district level). Such a relationship would enable the poor to participate in the identification and implementation of development projects as well as in decisions related with access over markets and access over public services. It could also help broaden the social base of power, authority and the allocation and use of public resources[5].

Annexure

Annexure 1:
Fourth Schedule of The Constitution of Pakistan
Concurrent Legislative List

1. Criminal law, including all matters included in the Pakistan Penal Code on the commencing day, but excluding offences against laws with respect to any of the matters specified in the Federal Legislative List and excluding the use of naval, military and air forces in aid of civil power.
2. Criminal procedure, including all matters included in the Code of Criminal Procedure, on the commencing day.
3. Civil procedure, including the law of limitation and all matters included in the Code of Civil Procedure on the commencing day; the recovery in a province or the federal capital of claims in respect of taxes and other public demands, including arrears of land revenue and sums recoverable as such, arising outside that province.
4. Evidence and oath, recognition of laws, public acts and records of judicial proceedings.
5. Marriage and divorce, infants and minors, adoption.
6. Wills, intestacy and succession, save as regards agricultural land.
7. Bankruptcy and insolvency, administrators-general and official trustees.
8. Arbitration.
9. Contracts, including partnership, agency, contracts of carriage, and other special forms of contracts, but not including contracts relating to agricultural land.
10. Trust and trustees.
11. Transfer of property other than agricultural land, registration of deeds and documents.
12. Actionable wrongs, save in so far as included in laws with respect to any of the matters specified in the Federal Legislative List.
13. Removal of prisoners and accused person from one province to another province.
14. Preventive detention for reasons connected with the maintenance of public order, or the maintenance of supplies and services essential to the community, persons subjected to such detention.
15. Persons subjected to preventive detention under federal authority.
16. Measures to combat certain offences committed in connection with matters concerning the federal and provincial government and the establishment of a police force for that purpose.
17. Arms, fire-arms and ammunition.
18. Explosives.
19. Opium, so far as regards cultivation and manufacture.
20. Drugs and medicines.
21. Poisons and dangerous drugs.
22. Prevention of the extension from one province to another of infectious or contagious diseases or pests affecting men, animals or plants.
23. Mental illness and mental retardation, including places for the reception or treatment of the mentally retarded.
24. Environmental pollution and ecology.
25. Population planning and social welfare.
26. Welfare of labour, conditions of labour, provident funds, employees liability and workmen's compensation heath insurance including invalidity pensions, old age pensions.

27. Trade unions, industrial and labour disputes.
28. The setting up and carrying on of labour exchanges, employment information bureaus and training establishments.
29. Boilers.
30. Regulation of labour of safety in mines, factories and oil-fields.
31. Unemployment insurance.
32. Shipping and navigation on inland waterways as regards mechanically propelled vessels, and the rule of the road on such waterways, carriage of passengers and goods on inland waterways.
33. Mechanically propelled vehicles.
34. Electricity.
35. Newspapers, books and printing presses.
36. Evacuee property.
37. Ancient and historical monuments, archaeological sites and remains.
38. Curriculum, syllabus, planning, policy, centers of excellence and standards of education.
39. Islamic education.
40. Zakat.
41. Production, censorship and exhibition and cinematograph films.
42. Tourism.
43. Legal, medical and other professions.
44. Auqaf
45. Fees in respect of any of the matters in this list, but not including fees taken in any court.
46. Inquiries and statistics for the purpose of any of the matters in this list.
47. Offences against laws with respect to any of the matters in this list; jurisdiction and powers of all courts except the Supreme Court, with respect to any of the matters in this list.
48. Matters incidental or ancillary to any matter enumerated in this list.

Annexure - 2
Key Indicators

Table A-1
Level and Pattern of Growth

	GDP Growth Rate (%)	Incremental Capital Output Ratio	Volatility of Growth[a] (%)	Extent of Balanced Growth[b]	Relative Growth Rate of Labor Intensive Sectors[c]
2000-01	2.0	9.05	-2.2	7.18	0.78
2001-02	3.1	5.59	-0.2	4.79	1.01
2002-03	4.7	3.72	1.2	4.04	1.68
2003-04	7.5	2.10	3.9	13.27	0.16
2004-05	9.0	1.86	4.8	9.09	0.72
2005-06	5.8	3.15	0.5	11.83	0.72
2006-07	6.8	2.94	0.8	4.85	0.82
2007-08	3.7	5.38	-3.1	4.40	1.22
2008-09	1.2	13.98	-5.4	4.55	n.c
2009-10	4.1	4.00	-1.2	4.07	2.12
Average	**4.8**	**5.18**	**-0.5**	**6.81**	**1.03**

n.c. = not computed

Source: Pakistan Economic Survey (various issues)

[a] Difference in the growth rate of GDP during a year minus the trend growth rate (as approximated by the average growth rate during the previous five years)

[b] Computed as the weighted (share of value added in 1999-2000) standard deviation of the growth rates of individual sectors during a particular year. The larger the magnitude of this indicator the less the extent of balanced growth

[c] Labor-intensive sectors of the economy are identified as agriculture, small scale manufacturing, construction, whole sale and retail trade, public administration and defence and social services

Table A-2
Level and Pattern of Investment

	Gross Domestic Capital Formation (% of GDP)	National Savings as % of Investment (%)	Private Investment as % of Total Fixed Investment (%)	Share of Private Investment in Labor Intensive Sectors (%)
1999-2000	17.4	91.0	65.0	40.3
2000-01	17.2	95.8	64.0	37.5
2001-02	16.8	110.7	72.7	33.7
2002-03	16.9	123.1	73.8	31.6
2003-04	16.6	108.0	72.4	34.4
2004-05	19.1	91.5	74.3	36.0
2005-06	22.1	82.3	75.6	30.5
2006-07	22.5	77.7	72.0	31.4
2007-08	22.1	61.5	73.2	36.0
2008-09	19.0	70.0	73.0	33.9
2009-10	16.6	83.1	71.3	40.5
Average	**18.8**	**90.4**	**72.0**	**35.9**

Source: Pakistan Economic Survey (various issues)

Table A-3
Agricultural Growth and Profitability

	Growth Rate (%)	Share of Growth in Crop Sector (%)	Volatility in Agriculture Growth[a] (%)	Change in Ratio of Output Prices to Fertilizer Prices (%)	Change in Agriculture Terms of Trade with Manufacturing (%)
1999-2000	n.a.	n.a.	1.1	6.6	n.a.
2000-01	-2.2	n.c.	-7.1	-3.1	4.6
2001-02	0.1	n.c.	-2.0	-5.4	0.0
2002-03	4.1	60.8	2.0	-0.7	-0.8
2003-04	2.4	44.6	0.4	0.4	0.2
2004-05	6.5	95.7	4.4	-4.5	-2.1
2005-06	6.3	n.c.	4.1	-4.9	-8.0
2006-07	4.1	61.0	0.2	13.7	6.4
2007-08	1.0	n.c.	-3.7	-18.8	-0.2
2008-09	4.0	54.2	-0.1	-7.0	14.0
2009-10	2.0	n.c	-2.4	19.9	4.6
Average	**2.8**	**n.c**	**0.0**	**0.3**	**0.9**

n.c. = not computed, n.a. = not available

Source: Pakistan Economic Survey (various issues)

[a]The difference in the growth rate of agriculture during a year minus the trend growth rate (as approximated by the average growth rate during the previous five years)

Table A-4
Level and Pattern of Manufacturing Growth

	Growth Rate (%)	Growth Rate of Export Oriented Industries (%)	Growth Rate of Import Substituting Industries (%)	Share of Growth in Large-Scale Manufacturing (%)	Growth Rate of Manufactured Exports (%)
1999-2000	1.5				
2000-01	9.3	27.6	4.6	76.3	6.2
2001-02	4.5	9.7	3.1	52.0	1.5
2002-03	6.9	4.3	7.6	68.2	22.2
2003-04	14.0	8.0	15.5	84.6	11.6
2004-05	15.5	26.5	12.7	87.0	15.6
2005-06	8.7	5.9	11.1	75.2	14.4
2006-07	8.3	9.9	7.5	74.3	3.4
2007-08	4.8	12.8	2.3	58.9	12.2
2008-09	-3.7	4.3	-2.4	n.c.	3.3
2009-10	5.2	6.0	14.8	56.1	0.4
Average	**6.8**	**11.5**	**7.7**	**70.3**	**9.1**

n.c. = not computed

Source: Pakistan Economic Survey (various issues)
SBP, Annual Report (various issues)

Table A-5
Growth in Employment by Sector

	Employment (000)					2001-02 to 2009-10		
	2001-02	2005-06	2006-07	2007-08	2009-10	Employment Growth Rate (%)	Value Added Growth Rate (%)	Employment Elasticity
Agriculture	20474	19075	20775	21894	2342	1.7	3.8	0.45
Manufacturing and Mining	4982	5421	6433	6382	6857	4.1	7.8	0.53
Electricity and Gas	299	296	n.a	n.a	n.a	-0.3	3.9	-0.07
Construction	2757	3579	3145	3093	3475	2.9	4.8	0.60
Wholesale and Retail Trade	5090	6635	6862	7167	8455	6.5	4.8	1.35
Transport and Communication	2216	2452	2573	2700	2697	2.5	3.9	0.64
Finance and Insurance	247	491	n.a	n.a	n.a	18.7	17.9	1.05
Public Administration and Community Services	7151	8405	6862	6725	5809	-2.6	6.7	-0.39
Total	**43286**	**46365**	**47650**	**49090**	**5187**	**2.3**	**5.5**	**0.42**

Source: Labour Force Surve, FBS
Pakistan Economic Survey

Table A-6
Inflationary Trends

	Rate of Inflation (Consumer Prices) (%)	Rate of Inflation (Food Prices) (%)	Core Rate of Inflation (Non-Food Non-energy) (%)	Rate of Inflation in Import Prices (%)	Rate of Monetary Expansion less GDP Growth (%)
1999-2000	3.6	-	n.a	16.0	5.5
2000-01	4.4	3.6	n.a	15.2	7.2
2001-02	2.5	2.5	n.a	0.0	12.3
2002-03	3.1	2.8	n.a	3.7	13.3
2003-04	4.6	6.0	3.9	14.8	12.1
2004-05	9.3	12.5	8.8	10.4	10.1
2005-06	7.9	6.9	7.0	17.3	9.3
2006-07	7.8	10.3	6.9	7.6	12.5
2007-08	12.0	17.6	10.2	27.7	11.4
2008-09	20.8	23.7	19.2	25.1	8.4
2009-10	11.7	12.5	11.6	10.5	8.4
Average	**8.0**	**9.8**	**9.7**	**13.5**	**10.0**

Source: Pakistan Economic Survey
SBP, Annual Report
IMF

Table A-7
Fiscal Policy

(*percentage of GDP*)

	Revenues[a]	Expenditure[b]	Non-Interest Current Expenditure[c]	Budget Balance[d]	Revenue Deficit/Surplus[e]
1999-2000	13.4	18.5	9.5	-4.6	-3.0
2000-01	13.1	17.1	9.4	-4.3	-2.2
2001-02	14.0	18.6	9.6	-5.5	-1.7
2002-03	14.8	18.4	11.4	-3.8	-1.5
2003-04	14.1	16.9	9.5	-2.3	0.3
2004-05	13.8	17.2	9.9	-3.3	0.5
2005-06	14.1	18.4	10.2	-4.3	0.5
2006-07	14.9	19.3	11.3	-4.3	-0.9
2007-08	14.6	22.2	13.1	-7.6	-3.5
2008-09	14.5	19.9	10.9	-5.3	-1.5
2009-10	14.2	20.5	11.7	-6.3	-1.9
Average	**14.1**	**18.8**	**10.6**	**-4.7**	**-1.4**

Source: Pakistan Economic Survey
SBP, Annual Reports
Ministry of Finance, Fiscal Operations

[a] Total revenues of federal and provincial governments
[b] Revenue and development expenditure of federal and provincial governments
[c] Current expenditure minus interest payments
[d] Total revenue minus total expenditure
[e] Revenue receipts minus current expenditure of federal and provincial governments

Table A-8
Fiscal Policy

	Primary Balance[a] (% of GDP)	Total Government Debt[b] (% of GDP)	Effective Interest Rate on Domestic Debt[c] (%)	% of Deficit Financed by Bank Borrowing (%)
1999-2000	na	83.7	14.1	19.3
2000-01	1.3	88.8	11.3	-18.4
2001-02	0.1	81.4	12.4	7.4
2002-03	0.4	74.5	10.2	-30.5
2003-04	1.2	67.8	9.4	47.4
2004-05	0.0	62.9	8.5	27.7
2005-06	-1.2	57.3	10.2	21.8
2006-07	-0.1	55.4	13.8	37.5
2007-08	-2.6	59.0	13.7	80.5
2008-09	-0.2	59.9	12.9	54.2
2009-10	-2.0	60.0	12.4	32.8
Average	**-0.3**	**68.3**	**11.7**	**25.4**

Source: Pakistan Economic Survey
SBP, Annual Reports
Ministry of Finance, Fiscal Operations

[a] Estimated as revenue receipts minus total expenditure net of interest payments
[b] Includes domestic and external debt
[c] Defined as the ratio of domestic interest payment to outstanding domestic debt

Table A-9
Effective Tax Rates
(Tax Revenues as percentage of Tax Base[a])

	Income Tax (%)	Customs Duty (%)	Excise Duty (%)	Sales Tax (%)	Total FBR Taxes (%)
1999-2000	4.3	19.1	6.4	11.6	9.1
2000-01	4.2	17.8	4.7	13.1	9.3
2001-02	4.5	12.0	4.3	14.1	9.1
2002-03	4.4	14.8	3.6	14.8	9.4
2003-04	4.0	14.3	3.1	12.7	9.2
2004-05	3.8	11.2	2.9	10.0	9.1
2005-06	3.9	12.1	2.4	10.3	9.4
2006-07	5.0	10.5	2.7	9.9	9.7
2007-08	4.9	7.6	2.9	10.0	9.8
2008-09	4.7	6.0	5.7	9.9	9.1
2009-10	4.9	6.2	5.1	10.4	9.1
Average	**4.4**	**11.0**	**4.0**	**11.5**	**9.3**

Source: Pakistan Economic Survey (various issues)
FBR

[a] Tax bases for various taxes are as follows:
Income tax: Non-agricultural GDP
Custom Duty: Value of imports
Excise Duty: Value of manufacturing
Sales Tax: Value of Imports plus value of manufacturing

Table A-10
Monetary Policy

	Net Foreign Assets (% Change of broad money)	Net Domestic Assets (% Change of broad money)	Private Credit Growth (%)	Interest Rate on Six Month Treasury Bill (%)	Broad Money Growth (%)	Interest Rate Spread[a] (%)
1999-2000	2.0	7.4	1.4	8.8	9.4	8.0
2000-01	5.1	3.9	4.0	10.4	9.0	8.3
2001-02	13.4	2.0	4.8	8.2	15.4	9.6
2002-03	17.5	0.5	18.9	4.1	18.0	7.8
2003-04	2.1	17.5	29.8	1.7	19.6	6.3
2004-05	2.2	17.1	33.2	4.7	19.3	7.4
2005-06	2.5	12.4	23.2	8.5	14.9	8.7
2006-07	8.1	11.3	17.2	8.9	19.3	9.0
2007-08	-7.8	23.2	16.4	11.47	15.3	8.4
2008-09	-3.2	12.8	0.7	12.0	9.6	9.8
2009-10	-6.9	0.8	3.9	12.3	12.5	9.3
Average	**3.2**	**9.9**	**14.0**	**8.3**	**14.8**	**8.4**

Source: State Bank of Pakistan, Annual Report
IMF Article 4 Consultation's Press Releases
[a]Difference between the interest rate on advances and deposits

Table A-11
Level and Pattern of Trade

	Merchandise Export Growth (US $; %)	Extent of Product Diversification of Exports[a]	Extent of Market Diversification of Exports[a]	Merchandise Import Growth (US $; %)
1999-2000	11.2	0.801	0.230	13.1
2000-01	12.5	0.798	0.221	14.3
2001-02	2.3	0.786	0.221	-7.5
2002-03	20.1	0.791	0.223	20.1
2003-04	13.5	0.782	0.232	21.2
2004-05	16.2	0.778	0.218	38.3
2005-06	14.3	0.769	0.229	31.7
2006-07	3.2	0.737	0.230	8.0
2007-08	16.5	0.722	0.190	31.2
2008-09	-6.4	0.709	0.160	-10.3
2009-10	2.9	n.a	n.a	-1.7
Average	**9.7**	**0.767**	**0.215**	**14.4**

Source: Pakistan Economic Survey
IMF
United Nations Conference on Trade and Development

[a]This is estimated by UNCTAD as the Herfindahl Index, which ranges from a value of 0 to 1. The greater the extent of diversification the lower the value of the index

Table A-11 (Contd.)
Level and Pattern of Trade

	Change in Terms of Trade (%)	Share of Essential Imports[a] (%)
1999-2000	-15.3	39.3
2000-01	-7.1	39.3
2001-02	-0.2	36.7
2002-03	-9.6	35.0
2003-04	-4.1	28.8
2004-05	-6.5	25.0
2005-06	-11.7	30.7
2006-07	-3.7	29.1
2007-08	-11.5	38.9
2008-09	2.8	41.9
2009-10	5.8	42.3
Average	**-5.5**	**33.0**

Source: Pakistan Economic Survey (various issues)
State Bank of Pakistan, Annual Report (various issues)

[a] Essential imports are of wheat, edible oil, fertilizers, medicines and POL products

Table A-12
Balance of Payments

	Current Account Balance (% of GDP)	External Debt as a % of Exports of Goods and Services	Net Reserves (US $ Million)	Gross Reserves (In months of next years imports of goods and services)	Change in Value of Pakistani Rupee per US $ (%)	Change in Real Effective Exchange Rate (%)
1999-2000	-1.6	322.1	908	0.9	3.0	-0.6
2000-01	-2.7	309.4	1679	1.7	12.8	-2.5
2001-02	3.9	282.0	4337	3.7	5.1	-2.6
2002-03	4.9	229.0	9529	6.5	-4.7	-0.1
2003-04	1.8	209.5	10564	5.0	-1.5	-1.8
2004-05	-1.4	183.7	9805	3.5	3.1	0.3
2005-06	-3.9	167.2	10760	3.7	0.8	5.3
2006-07	-4.9	169.2	13345	4.5	1.3	0.5
2007-08	-8.4	169.7	8577	2.7	3.2	-1.12
2008-09	-5.7	212.9	9118	2.8	25.5	-1.0
2009-10	-2.3	218.9	12958	3.9	6.8	1.0
Average	**-1.8**	**224.9**	**8325**	**3.5**	**5.0**	**-0.2**

Source: State Bank of Pakistan, Annual Report
IMF Article 4 Consultation's Press Releases

Table A-13
Trend in Income Inequality
Growth in Real Household Income by Quintile

(*Annual Growth Rate, percent*)

	Total	QUINTILE 1st	2nd	3rd	4th	5th
2001-02 to 2005-06						
Pakistan	**7.8**	**4.8**	**6.0**	**6.7**	**7.7**	**9.6**
Urban	4.4	0.5	1.7	3.0	2.1	5.0
Rural	9.3	5.7	7.2	8.0	10.6	14.2
2005-06 to 2007-08						
Pakistan	**-1.4**	**-1.9**	**-1.1**	**-2.8**	**-2.4**	**-0.9**
Urban	-0.3	5.6	3.2	-1.4	1.0	-0.6
Rural	-2.2	-3.3	-2.5	-3.4	-4.2	-1.0
2001-02 to 2007-08						
Pakistan	**4.7**	**2.5**	**3.6**	**3.4**	**4.2**	**5.9**
Urban	2.8	2.2	2.2	1.5	1.7	3.1
Rural	5.3	2.6	3.9	4.1	5.4	8.9

Source: Household Integrated Expenditure Survey, FBS

Table A-14
Trend in Regional Inequality
Growth in Employment by Province

	Number of Employed (000)					Annual Growth Rate 2001-02 to 2009-10
	2001-02	2005-06	2006-07	2007-08	2009-10	(%)
Punjab	25224	27292	29130	28970	31150	2.7
Sindh	10819	11043	11300	12260	12900	2.2
Khyber-Pakhtunkhwa	5208	5881	5080	5730	5710	1.2
Balochistan	1931	1988	2140	2130	2110	1.1
Pakistan	**43286**	**46365**	**47650**	**49090**	**51870**	**2.3**

Source: Labor Force Survey, FBS

Table A-15
Trend in Regional Inequality
Growth in Real Household Income by Province

	(Annual Growth Rate, Percent)								
	2001-02 to 2005-06			2005-06 to 2007-08			2001-02 to 2007-08		
	Urban	Rural	Total	Urban	Rural	Total	Urban	Rural	Total
Punjab	5.9	10.5	9.1	-1.3	-0.6	-0.9	3.4	6.7	5.6
Sindh	1.9	8.9	6.1	2.2	-9.6	-2.9	2.0	2.3	3.0
Khyber-Pakhtunkhwa	9.0	8.8	9.1	-7.3	-1.5	-2.7	3.3	5.3	5.0
Balochistan	-3.0	-3.0	-2.5	8.1	-1.6	3.2	0.5	-2.5	-0.6
Pakistan	4.4	9.3	7.8	-0.3	-2.2	-1.4	2.8	5.3	4.7

Source: Household Integratd Economic Survey, FBS

Table A-16
Trend in Regional Inequality
Coverage of Education and Health Services

	1998-99	2001-02	2006-07	2007-08	2009-10
Gross Primary Enrolment Rate					
Punjab	75	76	100	97	97
Sindh	64	63	79	80	84
Khyber-Pakhtunkhwa	70	77	82	83	87
Balochistan	64	62	72	75	75
Max/Min Ratio	**1.172**	**1.242**	**1.389**	**1.293**	**1.293**
Net Primary Enrolment Rate					
Punjab	44	45	62	61	62
Sindh	41	40	50	51	54
Khyber-Pakhtunkhwa	39	41	49	49	52
Balochistan	36	32	41	41	44
Max/Min Ratio	**1.222**	**1.406**	**1.512**	**1.488**	**1.409**
Gross Middle Enrolment Rate					
Punjab	43	45	55	59	57
Sindh	38	34	43	46	49
Khyber-Pakhtunkhwa	37	38	53	52	54
Balochistan	29	33	34	35	36
Max/Min Ratio	**1.483**	**1.364**	**1.618**	**1.686**	**1.583**
Net Middle Enrolment Rate					
Punjab	19	18	20	19	22
Sindh	17	14	17	18	18
Khyber-Pakhtunkhwa	11	12	16	14	17
Balochistan	9	8	9	12	11
Max/Min Ratio	**2.111**	**2.250**	**2.222**	**1.583**	**2.000**

Source: Pakistan Social and Living Standard Measurement Survey, FBS

Table A-16 (CONTD.)
Trend in Regional Inequality
Coverage of Education and Health Services

	1998-99	2001-02	2006-07	2007-08	2009-10
Gross Matric Enrolment Rate					
Punjab	37	44	51	54	57
Sindh	51	42	45	44	50
Khyber-Pakhtunkhwa	36	41	45	48	51
Balochistan	41	29	33	34	34
Max/Min Ratio	**1.244**	**1.517**	**1.545**	**1.588**	**1.676**
Net Matric Enrolment Rate					
Punjab	12	12	11	13	13
Sindh	10	13	10	11	11
Khyber-Pakhtunkhwa	6	10	6	6	8
Balochistan	3	6	5	5	5
Max/Min Ratio	**4.000**	**2.000**	**2.200**	**2.600**	**2.600**
Literacy Rate (10 +)					
Punjab	46	47	58	59	59
Sindh	51	46	55	56	59
Khyber-Pakhtunkhwa	37	38	47	49	50
Balochistan	36	36	42	46	45
Max/Min Ratio	**1.417**	**1.306**	**1.381**	**1.283**	**1.311**
Full Immunisation					
Punjab	55	57	83	76	85
Sindh	38	45	65	67	69
Khyber-Pakhtunkhwa	54	57	76	74	73
Balochistan	34	24	54	57	43
Max/Min Ratio	**1.618**	**2.375**	**1.537**	**1.333**	**1.977**

Source: Pakistan Living Standard Measurement Survey, FBS

Table A-17
Trend in Pakistan's Ranking in Different Governance Indicators

Source	Type	INDICATORS: EARLIEST YEAR[a] Year	EARLIEST YEAR[a] Number of Countires	EARLIEST YEAR[a] Ranking[d] (Quintile)[c]	LATEST YEAR[b] Year	LATEST YEAR[b] Number of Countries	LATEST YEAR[b] Ranking[d] (Quintile)[c]	Trend
1 Transparency International (TI)	Corruption Perception Index (CPI)	1995	41	39 (1st)	2010	178	143 (1st)	
2 Freedom House (Freedom in the World)	Political Rights Score	2002	151	131 (1st)	2011	193	146 (1st)	↗
	Civil Liberties Score	2002	151	135 (1st)	2011	193	165 (1st)	↘
	Status	2002	Not Free	-	2011	Partly Free	-	↘
3 Freedom House (Countries at the Crossroads)	Civil Liberties	2004	30	28 (1st)	2006	30	30 (1st)	↘
	Rule of Law	2004	30	27 (1st)	2006	30	29 (1st)	↘
	Anticorruption and Transparency	2004	30	22 (1st)	2006	30	24 (1st)	↘
	Accountability and Public Voice	2004	30	27 (1st)	2006	30	28 (1st)	↘
4 Freedom House (Countries at the Crossroads)	Voice & Accountability	1996	191	123 (1st)	2008	197	138 (1st)	↘
5 Freedom House (Press Freedom Survey)	Status	2002	Not Free	-	2009	Not Free	-	No Change
	Legal Environment	2002	187	172 (1st)	2009	195	174 (1st)	↘
	Political Environment	2002	187	177 (1st)	2009	195	178 (1st)	↘
	Economic Environment	2002	187	176 (1st)	2009	195	172 (1st)	↗
	Total Score	2002	187	172 (1st)	2009	195	175 (1st)	↘
6 World Bank Institute (Governance Matters)	Voice & Accountability	1996	194	139 (1st)	2009	212	174 (1st)	↘
	Political Stability and Absence of Violence	1996	180	162 (1st)	2009	212	211 (1st)	↘
	Government Effectiveness	1996	182	120 (2nd)	2009	212	162 (1st)	↘
	Regulatory Quality	1996	183	130 (2nd)	2009	212	145 (1st)	↘
	Rule of Law	1996	171	105 (2nd)	2009	212	176 (1st)	↘
	Control of Corruption	1996	154	127 (1st)	2009	212	167 (1st)	↘
7 World Bank - World Development Indicators [Country Policy and Institutional Assessment (CPIA)	CPIA Building Human Resources Rating	2005	76	46 (1st)	2006	78	47 (1st)	↘
	CPIA Business Regulatory Environment Rating	2005	76	15 (4th)	2006	78	12 (4th)	↗
	CPIA Debt Policy Rating	2005	76	12 (4th)	2006	78	12 (4th)	↘
	CPIA Economic Management Cluster Average	2005	76	15 (4th)	2006	78	28 (3rd)	↘
	CPIA Efficiency of Revenue Mobilization Rating	2005	76	40 (2nd)	2006	78	40 (1st)	↗
	CPIA Equity of Public Resource Use Rating	2005	76	38 (2nd)	2006	78	37 ((1st)	↗
	CPIA Financial Sector Rating	2005	76	1 (5th)	2006	78	1 (5th)	↗
	CPIA Fiscal Policy Rating	2005	76	41 (2nd)	2006	78	40 (2nd)	↗
	CPIA Gender Equality Rating	2005	76	75 (1st)	2006	78	77 (1st)	↘
	CPIA Macroeconomic Management Rating	2005	76	17 (4th)	2006	78	39 (2nd)	↘
	CPIA Policies for Social Inclusion/Equity Cluster Average	2005	76	54 (1st)	2006	78	52 (1st)	↗
	CPIA Policy and Institutions For Environmental Sustainability Rating	2005	76	22 (4th)	2006	78	24 (3rd)	↘
	CPIA Property Rights and Rule-Based Governance Rating	2005	76	41 (2nd)	2006	78	42 (2nd)	↘
	CPIA Public Sector Management and Institutions Cluster Average	2005	76	39 (2nd)	2006	78	39 (2nd)	↗
	CPIA Quality of Budgetary and Financial Management Rating	2005	76	34 (3rd)	2006	78	32 (3rd)	↗
	CPIA Quality of Public Administration Rating	2005	76	19 (4th)	2006	78	17 (4th)	↗
	CPIA Social Protection Rating	2005	76	55 (1st)	2006	78	53 (1st)	↗
	CPIA Structural Policies Cluster Average	2005	76	2 (5th)	2006	78	7 (5th)	↘
	CPIA Trade Rating	2005	76	37 (3rd)	2006	78	36 (3rd)	↗
	CPIA Transparency, Accountability, and Corruption In The Public Sector Rating	2005	76	63 (1st)	2006	78	64 (1st)	↘

Table A-17 (Contd.)
Trend in Pakistan's Ranking in Different Governance Indicators

Source	Type	INDICATORS: EARLIEST YEAR[a] Year	Number of Countires	Ranking[d] (Quintile)[c]	LATEST YEAR[b] Year	Number of Countries	Ranking[d] (Quintile)[c]	Trend
8 UNDP Human Development Report	Gender Empowerment Measure	1996	104	101 (1st)	2007	109	99 (1st)	↗
9 Overseas Development Institute (World Governance Assessment)	Civil Society	1996	16	15(1st)	2000	16	16 (1st)	↘
	Political Society	1996	16	16 (1st)	2000	16	16 (1st)	No Change.
	Government	1996	16	15 (1st)	2000	16	16 (1st)	↘
	Bureaucracy	1996	16	14 (1st)	2000	16	12 (1st)	↗
	Economic Society	1996	16	15 (1st)	2000	16	13 (1st)	↗
	Judiciary	1996	16	16 (1st)	2000	16	16 (1st)	No Change.
	Total	1996	16	15 (1st)	2000	16	15 (1st)	No Change.
10 Human Rights Commitment (Danish Centre for Human Rights)	CPR Violations	2000	72	30 (3rd)	na			
	Formal Commitment	2000	72	15 (4th)	na			
	Social Commitment	2000	72	41 (2nd)	na			
	Gender Commitment	2000	72	42 (2nd)	na			
11 Data on Governance Indicators (IADB/DIFID)	Freedom of the Press	1993	92	80 (1st)	2008	211	180 (1st)	↘
	Political Rights	1993	92	85 (1st)	2008	211	162 (1st)	↘
	Political Stability and Absence of Violence	1993	92	72 (1st)	2008	211	195 (1st)	↘
	Voice and Accountability	1993	92	60 (1st)	2008	211	185 (1st)	↘
12 Center for Global Development	Commitment to Development Index	na	na	na	na	na	na	na
13 Democracy Index Economist Intelligence Unit (EIU)	Overall Score	2006	167	113 (2nd)	2008	167	108 (2nd)	↗
	Electoral Process and Pluralism	2006			2008			
	Functioning of Government	2006			2008			
	Political Participation	2006			2008			
	Political Culture	2006			2008			
	Civil Liberties	2006			2008			
14 Polity IV Country Reports (University of Maryland - Center for International Development and Conflict Management)	Polity	1972	154	112 (1st)	2007	163	145 (1st)	↘
	Democracy	1972	154	121 (1st)	2007	163	129 (1st)	↘
	Autocracy	1972	154	110 (1st)	2007	163	134 (1st)	↘
	Durable	1972	154	135 (1st)	2007	163	148 (1st)	↘
	Tentative	1972	Not	-	2007	Yes	-	↘
15 Business Environment Risk Intelligence (BERI)	Political Stability and Absence of Violence	1996	101	47 (3rd)	2008	101	92 (1st)	↘
	Government Effectiveness	1996	101	84 (1st)	2008	119	87 (1st)	↘
	Rule of Law	1996	119	87 (1st)	2008	119	52 (3rd)	↗
	Control of Corruption	1996	119	59 (3rd)	2008	119	57 (3rd)	↗
16 Gallup International (Gallup World Poll)	Voice & Accountability	2006	122	80 (2nd)	2008	143	102 (1st)	
	Government Effectiveness	2006	122	61 (2nd)	2008	143	53 (3rd)	↘
	Rule of Law	2006	122	62 (2nd)	2008	143	94 (2nd)	↗
	Control of Corruption	2006	122	75 (2nd)	2008	143	62 (3rd)	↘
17 Index of Economic Freedom (Heritage Foundation and Wall Street Journal)	Business Freedom	1995	101	88 (1st)	2009	183	65 (3rd)	↗
	Trade Freedom	1995	101	87 (1st)	2009	183	140 (1st)	↗
	Fiscal Freedom	1995	101	63 (2nd)	2009	183	72 (3rd)	↘
	Government Size	1995	101	35 (3rd)	2009	183	23 (4th)	↗
	Monetary Freedom	1995	101	48 (3rd)	2009	183	125 (2nd)	↗
	Investment Freedom	1995	101	33 (3rd)	2009	183	118 (2nd)	↘
	Financial Freedom	1995	101	21 (4th)	2009	183	128 (2nd)	↘
	Property Rights	1995	101	32 (3rd)	2009	183	131 (1st)	↘
	Freedom from Corruption	1995	101	90 (1st)	2009	183	146 (1st)	↘
	Labor Freedom	1995	155	88 (2nd)	2009	183	122 (2nd)	↘
	Overall Index	1995	101	52 (2rd)	2009	182	102 (2nd)	↘

Table A-17 (Contd.)
Trend in Pakistan's Ranking in Different Governance Indicators

Source	Type	INDICATORS: EARLIEST YEAR[a] Year	Number of Countires	Ranking[d] (Quintile)[c]	LATEST YEAR[b] Year	Number of Countries	Ranking[d] (Quintile)[c]	Trend
18 Voter Turnout: Global Report	Vote to Registration Ratio, Parliamentary Elections	1945-2004	169	164 (1st)				
19 Inter-Parliamentary Union (Women in National Parliaments -Statistical Archive)	Lower or single House Upper House or Senate (Women's weight)	1997	102	95 (1st)	2008	136	46 (3rd)	↗
	Lower or single House Upper House or Senate (Women's weight)	1997	102	95 (1st)	2008	136	46 (3rd)	↗
20 The Opacity Index (Price Waterhouse Coopers)	Corruption	2004	48	42 (1st)				
	Efficacy of the Legal System	2004	48	36 (1st)				
	Deleterious Economic Policy	2004	48	44 (1st)				
	Inadequate Accounting and Governance Practices	2004	48	29 (2nd)				
	Detrimental Regulatory Structures	2004	48	19 (2nd)				
	The Opacity Index	2004	48	28 (2nd)				
21 Reporters without Borders (Press Freedom Barometer)	Press Freedom Index	2002	139	119 (1st)	2009	175	159 (1st)	↘
22 University of California Santa Barbara (Stohl)	Political Terror Scale Amnesty International	1977	101	89 (1st)	1977	152		↘
	US State Department	2008	111	96 (1st)	2008	179		↘
23 Governance-III (USAID)	Voice & Accountability	1996	192	151 (1st)	2002	199	168 (1st)	↘
	Political Stability and Absence of Violence	1996	186	165 (1st)	2002	186	157(1st)	↘
	Government Effectiveness	1996	180	108 (1st)	2002	195	123 (1st)	↘
	Regulatory Quality	1996	182	138 (1st)	2002	195	151 (1st)	↘
	Rule of Law	1996	167	104 (2nd)	2002	195	140 (1st)	↘
	Control of Corruption	1996	151	127 (1st)	2002	195	140 (1st)	↘
24 Bertelsmann Transformation Index (Bertelsmann Stiftung)	Voice & Accountability	2002	116	85 (1st)	2008	125	93 (1st)	↘
	Government Effectiveness	2002	116	53 (3rd)	2008	125	81 (1st)	↘
	Regulatory Quality	2002	116	61 (2nd)	2008	125	78 (1st)	↘
	Rule of Law	2002	116	80 (1st)	2008	125	97(1st)	↘
	Control of Corruption	2002	119	63 (2nd)	2008	125	86 (1st)	↘
25 Cingranelli-Richards (CIRI) Human Rights Database (CIRI Human Rights Data Project)	Voice & Accountability	1996	159	136 (1st)	2008	192	156 (1st)	↘
	Political Stability and Absence of Violence	1996	174	152 (1st)	2008	192	186 (1st)	↘
	Rule of Law	1996	159	109 (2nd)	2008	192	176 (1st)	↘
26 International Fund for Agricultural Development (IFAD Rural Sector Performance Assessments)	Voice & Accountability	2004	124	21 (1st)	2008	90	59 (1st)	↘
	Government Effectiveness	2004	124	27 (1st)	2008	90	68 (1st)	↘
	Regulatory Quality	2004	124	71 (2nd)	2008	90	28 (3rd)	↘
	Rule of Law	2004	124	106 (1st)	2008	90	62 (1st)	↘
	Control of Corruption	2004	124	45 (2nd)	2008	90	59 (2nd)	↘
27 Institutional Profiles (Institutional Profiles Database)	Voice & Accountability	2006	85	63 (1st)	2008	85	63 (1st)	No change.
	Political Stability and Absence of Violence	2006	85	81 (1st)	2008	85	81 (1st)	No change.
	Government Effectiveness	2006	85	75 (1st)	2008	85	75 (1st)	
	Regulatory Quality	2006	85	59 (2nd)	2008	85	59 (2nd)	No change.
	Rule of Law	2006	85	69 (1st)	2008	85	69 (1st)	No change.
	Control of Corruption	2006	85	49 (2nd)	2008	85	49 (2nd)	No change.
28 International Budget Project Open Budget Index	Voice & Accountability	2005	59	19 (3rd)	2008	85	47 (2nd)	No change.
29 Global Insight Business Conditions and Risk Indicators	Voice & Accountability	1998	181	127 (1st)	2008	203	170 (1st)	↘
	Political Stability and Absence of Violence	1998	181	142 (1st)	2008	203	194 (1st)	↘

Table A-17 (Contd.)
Trend in Pakistan's Ranking in Different Governance Indicators

		INDICATORS						
		EARLIEST YEAR[a]			LATEST YEAR[b]			
Source	Type	Year	Number of Countires	Ranking[d] (Quintile)[c]	Year	Number of Countries	Ranking[d] (Quintile)[c]	Trend
	Government Effectiveness	1998	181	157 (1st)	2008	203	176 (1st)	↘
	Regulatory Quality	1998	181	159 (1st)	2008	203	199 (1st)	↘
	Rule of Law	1998	181	133 (2nd)	2008	203	185 (1st)	↘
	Control of Corruption	1998	181	150 (1st)	2008	203	179 (1st)	↘
30 Country Security Risk Ratings (IJET Country Security Risk Ratings)	Political Stability and Absence of Violence	2004	167	149 (1st)	2008	185	183 (1st)	↘
31 Cerberus Corporate Intelligence Gray Area Dynamics [Merchant International Group (MIG)]	Political Stability and Absence of Violence	2002	118	118 (1st)	2008	164	162 (1st)	↘
	Government Effectiveness	2002	118	118 (1st)	2008	164	145 (1st)	↘
	Regulatory Quality	2002	118	107 (1st)	2008	164	57 (3rd)	↗
	Rule of Law	2002	118	113 (1st)	2008	164	87 (2nd)	↗
	Control of Corruption	2002	118	118 (1st)	2008	164	148 (1st)	↘
32 Country Policy and Institutional Assessments (Asian Development Bank)	Government Effectiveness	2005	25	6 (4th)	2008	28	12 (3rd)	↘
	Regulatory Quality	2005	25	6 (4th)	2008	28	7 (4th)	↘
	Rule of Law	2005	25	16 (2nd)	2008	28	19 (2nd)	↘
	Control of Corruption	2005	25	19 (1st)	2008	28	16 (2nd)	↗
33 Brown University's Center for Public Policy	Government Effectiveness	2002	194	127 (2nd)	2008	196	109 (2nd)	↗
34 Trafficking in People Report (United States Department of State)	Rule of Law	2000	82	74 (1st)	2008	153	76 (3rd)	
35 World Economic Forum	Global Competitiveness Scale	2008	131	92 (1st)	2010	133	101 (1st)	↗

[a] The earliest year denotes the year for which the data of the indicator is available

[b] The latest year is the most recent year for which the data of the indicator is available

[c] Note that the Pakistan's ranking is divided into quintiles. These are given in the braces against each indicator and measures the indicators performance as follows:

- the 1st quintile is the lowest quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the lowest 20% of the countries
- the 2nd quintile is the second lowest quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the 21-40% of the countries
- the 3rd quintile is the middle quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the 41-60% of the countries
- the 4th quintile is the second highest quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the 61-80% of the countries
- the 5th quintile is the highest quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the 81-100% of the countries

[d] The most we are away on the most bad in terms of performance in that indicator

Source: IPP estimates from the various sources of governance indicators mentioned in Table 3.1 of Chapter 3 of this Report

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Notes:

EXECUTIVE SUMMARY

1. Raymond Davis, a CIA operative, killed two young men on a busy Lahore street in late January fearing that they were going to use the weapons they were carrying to rob him. Davis was arrested, charged with murder and held in prison to be released after compensation amounting to Rs 200 million was made to the members of the deceased under Islamic law.
2. See the Chapter that follows.
3. These developments were described in some detail in two chapters in IPP's third annual report. See Institute of Public Policy, *State of the Economy; Pulling Back from the Abyss*, Lahore, 2010, Chapters 6 and 7.
4. Ibid.
5. Parvez Hasan, having worked in a number of senior positions at the World Bank which meant studying as well as guiding some of the miracle economies of East Asia laments the fact that he did not succeed in persuading the policymakers in Pakistan to put emphasis on export promotion. "Looking back, one of the biggest disappointments of my career has been the failure to persuade Pakistan policymakers regarding the importance of learning from the East Asian experience, especially in exports, despite frequent attempts over a thirty year period." Parvez Hasan, *My Life, My Country: Memoirs of a Pakistani Economist*, Lahore, Ferozezons, 2011(P. 398).

CHAPTER 1

1. The ratios are higher when calculated in current prices because the prices of capital goods have risen at a faster pace than the general price level. But the real trends in constant prices are more relevant.

CHAPTER 3

1. Preamble to the Constitution of the Islamic Republic of Pakistan. The edition used in this work is by M. Rafiq Butt, Manssor Book House, 2010.
2. The Commission's report can be found at *www.ncgr.gov.pk*.
3. For an analysis of the historical significance of the "Twenty-Two families speech see Shahid Javed Burki, *Historical Dictionary of Pakistan*, Oxford, The Scarecrow Press, 2006, pp. 501-503.
4. Mahbubul Haq, Karachi, *The Strategy of Economic Planning: A Case Study of Pakistan*, Oxford University Press, 1965.

CHAPTER 4

1. This was the theme of IPP's third annual report, see Institute of Public Policy Lahore, 2010 *State of the Economy: Pulling Back from the Abyss* .

CHAPTER 6

1. Include tax on opium, provincial excise, entertainment tax, development cress on hotels and cotton fee.

CHAPTER 7

1. Mr. Rabbani joined the federal government in January 2010 as Minister in charge of Interprovincial Coordination.

2. The group of scholars who developed the theory and practice of Participatory Development in South Asia include Dr. Ponna Wignaraja, Dr. Akmal Hussain, Mr. Susil Sirivardana and Mr. Harsh Sethi. They undertook Participatory Development initiatives through social mobilization at a number of locations in various South Asian countries, and produced a number of books based on their practice on the ground. These include: (i) Ponna Wignaraja, Susil Sirivardana, Akmal Hussain, (eds.), Economic Democracy through Pro Poor Growth, SAGE Publications, New Delhi, London, New York, 2009. (ii) Ponna Wignaraja, Susil Sirivardana (eds.) Pro-Poor Growth and Governance in South Asia: Decentralization and Participatory Development, SAGE Publications, New Delhi, London, New York, 2004. (iii) Ponna Wignaraja, Akmal Hussain, Harsh Sethi, Ganeshan Wignaraja, (Co-authors), Participatory Development: Learning from South Asia, United Nations University Press and Oxford University Press, 1991.

3. Certain NGOs such as SUNGI combined their development work with active advocacy on issues of both public and local interest. Other NGOs such as PIEDAR engage in policy dialogue at the national and also South Asian level. While these dimensions may be important in the overall development context, they are beyond the scope of this study.

4. Government of N.W.F.P. and Swiss Development Corporation: Report of the Project Preparation Mission, January 1990.

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