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Budget Making and Intergovernmental Fiscal Relations in Pakistan

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Comparative Public Budgeting

A Global Perspective

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Contents

| | |
|---|-----|
| About the Editor | vii |
| Contributors | ix |
| Reviewers | xv |
| Chapter 1 An Introduction to Comparative Budgeting | 1 |
| Charles E. Menifield | |
| | |
| Part 1 Africa | |
| Chapter 2 The Republic of Ghana: A Success Story? | 21 |
| Craig S. Maher | |

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Part 2 Asia

- Chapter 3** Accountability Building Through Budgetary Reform: China's Experience 43
Meili Niu
- Chapter 4** Budgetary and Financial Management Reforms in Korea 59
Changhoon Jung and Cal Clark
- Chapter 5** Budgeting for Results: Enhancing the Budget Process in the Philippines
Through Reforms 77
Hazel Marie A. Sarmiento
- Chapter 6** The Limits of Budget Reform in Taiwan 91
Tsuey-ping Lee and Cal Clark
- Chapter 7** Public Budgeting and Financial Management Performance in Thailand 107
Arwiphawee Srithongrung
- Chapter 8** Budgeting in Vietnam: Decentralized Decision Making in a
Unitary Budget Environment 133
Phuong Nguyen-Hoang and Larry Schroeder

Part 3 Europe

- Chapter 9** Italian Central Government Budgeting: Future Hopes and
Past Disappointments 151
Riccardo Mussari, Pasquale Ruggiero, and Patrizio Monfardini
- Chapter 10** Public Sector Budgeting in the United Kingdom: Devolution of
Powers and Responsibilities 177
Stephen J. Bailey and William McCabe

Part 4 The Middle East

- Chapter 11** Budgeting Under Resource Abundance and Hesitant Steps to
Decentralized Investment Planning and Budgeting in Iraq 203
Ronald W. Johnson and Ricardo Silva-Morales
- Chapter 12** Budget Discipline and Undisciplined Politics: The Case of Jordan 221
Jamil E. Jreisat
- Chapter 13** Budget Making and Intergovernmental Fiscal Relations in Pakistan 237
Roy Bahl, Musharraf R. Cyan, and Sally Wallace

- Chapter 14** Budgetary Systems in Saudi Arabia: Reform Needed 257
Bassam ALBassam
- Chapter 15** Finance Reform and Performance-Based Budgeting in the
United Arab Emirates 275
Deniz Zeynep Leuenberger

Part 5 North America

- Chapter 16** Review and Reallocation in the Canadian Federal Government's
Budgetary System 289
Mike Joyce
- Chapter 17** Decentralization, Budgets, and the Challenge of Intergovernmental
Coordination: Lessons from Mexico 311
Salvador Espinosa P.
- Chapter 18** Federal Budgeting in the United States 329
Marvin Phaup and Charlotte Kirschner

Part 6 South America

- Chapter 19** Budgeting in Brazil Under the Law of Fiscal Responsibility 353
Christine R. Martell

Part 7 Conclusion

- Chapter 20** Learning from Others: Comparative Budgeting in the New Millennia 371
Charles E. Menifield and LaShonda M. Stewart
- Index 387

Budget Making and Intergovernmental Fiscal Relations in Pakistan

Roy Bahl, Musharraf R. Cyan, and Sally Wallace

Learning Objectives

- Understand the institutional makeup of budget making in Pakistan.
- Understand how institutions and policy often together define budget-making practices.
- Know and understand subnational governments and their roles in central government expenditure allocation and fulfilling national priorities.
- Know and understand provincial governments and capital budgeting.
- Know and understand transparency and intergovernmental transfers.

Introduction

Federal countries are characterized by multilevel budgeting and by the devolution of fiscal powers to lower level governments. The link between these two is the system of intergovernmental fiscal relations. An important and often missed point is that the success of this structure in achieving the objectives of fiscal decentralization depends on the incentives embodied in the intergovernmental fiscal system. This chapter is about

the experience in Pakistan.¹ We begin with a description of the multilevel budgeting system, and then turn to an analysis of why provincial governments have mobilized so few fiscal resources, rendering their budgeting dependent on central decisions and revenue performance. We conclude with some discussion of reform options and their implications for budget making.

The analysis here is best understood in the context of the wide regional disparities in economic development and socioeconomic makeup. Pakistan is a multitiered federation with four provinces, three federally administered areas, and the autonomous region of Kashmir. It has a total estimated population of about 160 million. Most of the population lives in the four provinces but there are great disparities. According to the last census held in 1998,² Punjab has a population of 73 million and the highest per capita income in the nation, Sindh has a population of 30 million and includes Pakistan's largest city, Karachi. The largest concentration of poverty is in North-West Frontier Province (NWFP) where the total population is 18 million. Baluchistan Province has a population of 7 million but a very large land area. About 5 million people live in the federally administered territories in the north, Federally Administered Tribal Areas and Islamabad Capital Territory, while Pakistani-administered Kashmir contains another 3 million.

Pakistan has a federal structure of government. At the top two levels are the federal government and provinces. The federal government and provinces derive their functions and powers from a constitution. At the lower level, the three-tier local government is created by provincial laws and is treated as a provincial subject. For budgetary purposes, the main players are the Federal Ministry of Finance and the Planning Commission at the federal level. In the provinces, their counterparts are the finance department and planning department of the province. The National Finance Commission (NFC) is an intergovernmental body created by the president under a constitutional provision. It lays down the size of the intergovernmental transfer pool and the formula for deciding provincial shares. The budgets are prepared by the finance ministry or department and presented to the respective legislature for debate and approval. The accounts are maintained centrally. Disregarding the constitutional provisions in 2001, the federal government promulgated an ordinance to reorganize a hierarchic accounting bureaucracy with provincial accountants general directly responsible to the central controller general of accounts. The accountant general works through district level accounts offices where the control is shared between the provinces and the federal accounts bureaucracy. The accounts are audited by the auditor general of Pakistan for all levels of government except lower level local governments. The audited accounts are presented to the legislatures at each level of government.

The Structure of Budget Making

Budget making in Pakistan is a well-defined process organized through a hierarchy of laws and institutional processes and linkages. Fiscal decision-making powers are allocated to the federal government and the provincial governments, with the provinces

in turn decentralizing some authority to local governments. The provinces have a recognized status in the constitution, but the local governments have a much weaker position. Their expenditure responsibility and revenue authority has changed over time. Incremental budgeting is the norm at all levels, with some recent experimentation with performance-based budgeting.

LEGAL FOUNDATIONS

The 1973 constitution was written in the aftermath of the separation of Bangladesh from the earlier Pakistani federation. This history continues to be relevant to inter-governmental relations and to the political economy of budget making in Pakistan. In 1955, the four western provinces of Punjab, Baluchistan, Sindh, and NWFP were amalgamated into “one unit.” The separation of Bangladesh led to the recognition of provincial rights in the constitution (drafted in 1970) and to the creation of the four provinces. Important powers were decentralized to the provinces (Baxter, 1974). The provinces can make their own budgets without approval by the federal government, formulate financial management rules, and incur expenditures according to their own priorities. Provincial revenue-raising powers are assigned in the constitution.

To respond to the provincial demands for fiscal decentralization, two “legislative lists” were created in the constitution.³ These legislative lists were devised as a mechanism for expenditure and revenue assignment, and were the result of negotiation between various political parties. The legislatures, national and provincial, derive law-making powers from the legislative or expenditure lists. When subjects were assigned to the provinces through the legislative lists, the provinces automatically gained the expenditure making responsibilities for those areas. A number of subjects appear in the “federal-only” list indicating a consensus (reached in 1973) on the responsibilities of the federal government. The other legislative list is the “concurrent list,” which allows both federal and provincial governments to carry out those expenditures. Any residual functions stay with the provinces. The makers of the constitution saw the concurrent list as an interim arrangement to be abolished in due course of time, although there was no constitutional provision for this. As time has passed, the concurrent list has remained in place, and federal presence in provincial domain continues to be as strong as ever.

The clear expenditure assignments in the constitution reflected a compromise in favor of a strong role for the provinces, envisaging it as a safeguard against federal encroachment on provincial budgetary authorities. The provinces have continued to build up their role in expenditure making. They have developed elaborate manuals and processes for spending and service delivery. But similar capacity has not emerged on the revenue side (Bahl, Wallace, & Cyan, 2008). While provinces were given a less dominant role on the revenue side, they still were assigned some sources with significant revenue potential. This potential has not been realized. The lesson here is that legal clarity may be a necessary condition for optimal subnational government revenue effort, but it is not a sufficient condition.⁴ The underlying problem, as we will argue, is a system of intergovernmental fiscal relations that carries perverse incentives for revenue mobilization.

MULTITIERED BUDGETS

The constitutional scheme in Pakistan makes provision for federal and provincial level budget making. This is an important requirement for successful fiscal decentralization. For each level, legal accounting entities are defined. The most important of these are the consolidated funds, created by Articles 78 and 118 of the constitution. These funds include all revenues that accrue to a government.

The consolidated funds provide for a clear mechanism to lay down the foundation of budgetary transparency. Parallel accounts are not allowed. Once the consolidated funds are recognized as accounting entities, the budget-making processes and authorities, powers and processes to keep accounts, powers to carry out audit, and mechanisms for legislative oversight are organized around them. The annual budget statement (ABS) is prepared for all the monies in the consolidated fund. Preparation of ABS as a report on the consolidated fund is a constitutional obligation of the relevant ministry or department of finance. The ABS also allows the executive branch to lay out its expenditure program for the fiscal year and seek approval from the legislature.

The ABS defines expenditures from the consolidated fund and lays down parameters for budget execution from this account. The financial rules are also formulated under the constitutional provisions. The accountants general, at different levels of government, federal and provincial, are mandated to prepare a statement of accounts for all budgetary transactions, leaving a clear trail of expenditures (Government of Pakistan, 2001b). The auditor general, as the supreme audit institution, lays down the principles, forms, and methods of accounting and also carries out audit at all levels of government (Government of Pakistan, 2001a). The only departure from this rule is at the two lower tiers of government where special arrangements have been made. Together, the constitutional provisions relating to finance and the subordinate legislation carried out under them, define a codified system of budget making, expenditure tracking, and preparation of accounts and audit.

At the federal level, all revenues collected by the federal agencies go into the Federal Consolidated Fund, with two important exceptions. The first exception is the public account where monies are held in trust. For example, court deposits are placed in the public account.

The second exception to the consolidated fund principle laid down in the constitution is given in Article 160, subarticle 4, which pertains to the NFC. The NFC sits after an interval of no more than 5 years. It makes recommendations on the vertical and horizontal sharing of tax revenue between the federal government and provinces and among the provinces. The decisions of the NFC are given effect by a statutory order promulgated by the president. The latter has no authority to amend the commission's recommendations. The effect of Article 160 is that it automatically removes the provincial shares of central taxes from the Federal Consolidated Fund and takes them directly to the Provincial Consolidated Funds. In this manner, Parliament does not have any authority over determination of the provincial shares. This has important implications for the Pakistani budget making. By definition, it means that the federal government and its Ministry of Finance get no powers to attach any conditions to the provincial revenue shares. No wonder that some provinces, in their

budget documents, describe the share of revenues received under the NFC formula as their own source revenues.⁵

Another important feature of the NFC award is that the provinces take these revenues as an entitlement, and would not countenance any conditions attached to these grants. They would expect the transfers to flow to them without hindrance and without any conditions. The provincial shares have indeed been transferred to the provinces without fail, in time and with no conditions attached (Ahmad & Wasti, 2003).

Due to provincial dependence on the federal budgetary decisions, the budget calendars are organized so that the provincial budgets follow the federal budget in June, the last month of the fiscal year. Several important committees meet in the preceding months to indicate resources available to the provinces, allowing them a planning figure for their budgets. Three of these important committees are: (1) the Annual Plan Coordination Committee (APCC), which is chaired by the Planning Commission, has provincial membership, and recommends capital investments and decides on the capital grants to provinces; (2) the Appropriations Committee, chaired by the federal finance division finalizes the recommendations of the APCC and indicates the size of transfers during the following fiscal year to the provinces; and (3) National Economic Council (NEC), which is chaired by the prime minister (PM) and its members include the provincial chief ministers along with important federal ministers. It derives its mandate from the constitution. This body coordinates budget making at the highest level and meets at the beginning of June every year. The NEC forum also takes up any further intergovernmental coordination that may be required.

SUBNATIONAL GOVERNMENT BUDGET AUTONOMY

The constitution was written against the backdrop of dissolving the one unit government system. The dissolution of one unit and the recreation of four provinces was hailed as a fulfillment for the demand for decentralization. The makers of the constitution wanted to give clear revenue assignments to the provinces to make them less dependent on federal transfers. This resulted in the insertion of two types of provisions in the constitution. First, certain taxing powers were delegated to the provincial governments. For instance, the tax on professions was recorded as a provincial tax.⁶ Second, the legislative lists mechanism and enumerates the tax bases that are either awarded to the federal governments or shared between the federal government and the provinces. The constitutional assignment of taxes is described in Table 13-1. The award to the federal government is exclusive and provinces do not have the right to tax those bases. Similarly, if a tax base is not mentioned in either of the lists, it falls to the provincial domain. The federal government in these cases has no right to tax the base.

The mismatch between the relatively heavy assignment of expenditures to provinces and their weaker revenue assignment is resolved by the NFC awards. In this case, federal taxes are shared, but defining the base and setting rates and administration of these taxes is exclusively a federal authority. These taxes include personal income tax (except agriculture income), corporate income tax, customs, sales tax on goods, excise duty (except on alcohol and narcotics), and capital value tax. Most of the national

Table 13-1

| Constitutional Assignment of Revenues | |
|--|--|
| Revenue assignment/tax | Legal provision |
| Federal revenues | |
| 1. Personal income tax (except agricultural income) | Federal List (subject 47) |
| 2. Corporate income tax | Federal List (subject 48) |
| 3. Customs | Federal List (subject 43) |
| 4. Sales tax on goods | Federal List (subject 48) |
| 5. Excise duty (except on alcohol, narcotics) | Federal List (subject 44) |
| 6. Capital value tax | Federal List (subject 50) |
| 7. Estate duty | Federal List (subjects 45, 46) |
| 8. Mineral oil, minerals, natural gas | Federal List (subject 51) |
| 9. Tax on production capacity | Federal List (subject 52) |
| 10. Terminal taxes on goods and passenger transportation | Federal List (subject 53) |
| 11. User charges on federal subjects | Federal List (subject 54) |
| Provincial revenues | |
| 12. Excise duty on alcohol, liquor, narcotics | Assigned to province by bar on the federation in the Federal List (subject 44) |
| 13. Sales tax on services | Residuary assignment |
| 14. Tax on professions | Article 163 of the constitution |
| 15. Motor vehicle tax | Residuary assignment |
| 16. Property tax | Residuary, but there is bar in the Federal List (subject 51) |
| 17. Capital gains | Assigned through bar on the federation in the Federal List (subject 50) |
| 18. Agriculture income tax | Through bar on the federation in the Federal List (subject 47) |
| 19. Stamp duty | Residuary assignment |
| 20. Registration fee | Residuary assignment |
| 21. Mutation fee | Residuary assignment |
| 22. Natural gas excise duty | Article 161 of the constitution |
| 23. Net hydro profits | Article 161 of the constitution |
| 24. Electricity duty | Article 157(2)(b) of the constitution |
| 25. User charges | Residuary assignment |
| <i>Note: Taxes at number 1 to 6 in the table are shared revenues under the NFC clauses of the constitution. The base and rate are set by the federation.</i> | |

revenue is collected from these taxes. Table 13-2 shows a detail of revenue structure. Provinces, even when claiming these as “shared taxes,” abdicate all responsibility for taxation to the federal government. Due to the provincial claim on the revenue from these taxes, they do not have further right to impose another tax on the same base. Provincial governments simply budget their entitlements from federal taxes.

Table 13-2

Revenue Structure of Federal Government, Fiscal Year 2008/2009

| Revenue items | Amount | Percent of total |
|--------------------------------------|------------------|------------------|
| Total tax | 1,180,462 | 66.2 |
| Direct taxes | 461,000 | 25.8 |
| Income tax | 443,341 | 24.9 |
| Worker participation tax | 11,618 | 0.7 |
| Capital value tax | 6,041 | 0.3 |
| Indirect taxes | 719,462 | 40.3 |
| Customs | 145,000 | 8.1 |
| Sales tax | 457,000 | 25.6 |
| Federal excise | 116,000 | 6.5 |
| Other taxes | 1,402 | 0.1 |
| Airport tax | 60 | 0.0 |
| Nontax revenue | 603,140 | 33.8 |
| Income from property and enterprises | 107,807 | 6.0 |
| Receipts from civil administration | 236,915 | 13.3 |
| Miscellaneous receipts | 258,418 | 14.5 |
| Total revenue | 1,783,602 | 100.0 |

Source: *Budget in Brief, 2009–2010*, Tables 9 and 10, Ministry of Finance, Government of Pakistan.

Note: Amounts given in millions of rupees (Rs) and based on revised estimates of collection for fiscal year ending June 30, 2009.

From one perspective, it can be argued that separation of bases, as in Pakistan, allows for clear revenue assignment and prevents any tax competition. This system would appear to give subnational governments considerable autonomy in determining the size of the budget envelope. In practice, however, it has resulted in unintended consequences. Most of the revenue productive bases are assigned to the federal level, and NFC awards to the provinces have been generous. As a result, there has been very little tax effort at the subnational government level. As the NFC awards have grown and grants have flowed in, there has been further dampening of provincial revenue efforts.

INTERGOVERNMENTAL INFLUENCES

In the hierarchic system, grants link budget making at all levels. Grants are an expenditure in the federal budget and a revenue in the provincial budget, and define the amount of direct expenditures that can be budgeted at either level. There are five types of federal grants offered to the provinces in Pakistan. The federal government cannot make a direct grant to a three-tier local government unless it is for a specific purpose.⁷

The five types of federal transfers are: (1) shared tax revenues; (2) mandated pass-through grants for local government; (3) subventions; (4) natural resource royalties; and (5) discretionary federal grants. The first three grants are created by the NFC, which lays down their size and distribution formulas. The third is also decided by the NFC and lump sum amounts are announced each year. The system of transfers to provinces in Pakistan is quite transparent by comparison with many developing countries. The structure of this system raises no problems with respect to certainly in budgeting.

The NFC award, comprising the first three transfers, is by far the largest of the grants in the system. The NFC is charged with making a decision every 5th year on the size of the sharing pool and on the distribution of this amount among the four provinces.⁸ It has a major influence on budget making at all levels. The NFC itself is composed of two representatives each from the federal and from the four provincial governments. The finance minister and one other technical representative from each of the five governments meet for several months or longer to reach a consensus on the sharing formula. The recommendations of the NFC are governed by a powerful constitutional provision: The president is obliged to promulgate the recommendations as a statutory order without making any changes to them. Once promulgated, the NFC formula regulates the vertical and horizontal sharing of important taxes between the federal government and the provinces (the vertical share) and among the provinces (the horizontal share) until the next NFC makes its recommendations.

The provincial share of the NFC award was set as 41.5% of the shared federal taxes in 2006 and is scheduled to increase by 1% per year, up to 46.5% by 2011 (Government of Pakistan, 2006). According to the structure of the NFC grant program, the only revenue growth for a province during an award period comes from increases in federal government tax revenues. So, there is stability in the distribution system that helps long-term fiscal planning at both levels of government.

Federal grants are the main sources of revenue in the provincial budgets, accounting for more than 80% of provincial revenue. The local governments, in turn, depend on the provinces for their revenue. On average, district and lower level governments derive between 70 and 97% of their revenue from the provinces (Asian Development Bank, Department for International Development, & The World Bank, 2004). An important federal grant was created in 2002 as a compensation for an abolished local government sales tax.⁹ This pass-through grant transfers one sixth of the value-added tax revenue collected by the federal government to the provinces for further allotment to local governments. Some local governments are heavily dependent on this grant to a major extent.

CAPITAL FACILITY BUDGETS

Pakistan appears to be transitioning away from central planning. The Ninth Plan, 1998–2003 initiated a switch toward “indicative planning” (Pasha et. al., 1996). The Planning Commission prepares planning documents with the participation of different government and nongovernmental entities. For the period between 1996 and 2001,

the provincial governments were dependent on federal funds for capital investments. Most of the dependence arose out of the unrealistic revenue projections, which formed the basis of the 1996 NFC. The provinces did not have the revenue to carry out planned capital investment after meeting their recurrent expenditures. The federal government gave them loans for capital investment purposes, albeit at very high interest rates (17 to 18%). After 2002, the fiscal situation improved and the provinces did not need further loans. The result was that provinces began deciding investment priorities on their own.

The Planning Commission tracks provincial capital investments. Project appraisal and approval powers were given to various authorities by the federal government on the advice of the Planning Commission. When some federal funding is involved, all projects with a total cost above a specified threshold level must be approved by the Planning Commission. The project approval requires that provincial projects be prepared in a format provided by the federal government, and that they meet the appraisal criteria set by the commission.

The provinces are allowed to borrow for capital investment and commodity operations. For the former, borrowing is only allowed from the federal government, an overdraft facility with the State Bank, or from multilateral agencies. In the last case, the operations are supervised by the federal government. Foreign loans to the provinces are processed by the federal government. The Federal Ministry of Finance oversees such loans and their project implementation by the provinces.

MULTILEVEL BUDGETS AND DECENTRALIZATION

In principle, there is no inconsistency between multilevel budgets and fiscal decentralization. Each level of government has revenue and expenditure assignments, their expenditure level is set by a combination of own source revenue mobilization and intergovernmental transfers, and each has substantial budget autonomy. So long as there is a hard budget constraint for the subnational governments, there is no compelling reason to have a consolidated budget for all levels of government. This is true for both industrialized and developing countries.

A problem arises in coupling multilevel budgets with fiscal decentralization. The goal of decentralization is to provide some degree of fiscal autonomy at the subnational government level, so that voter preferences can be matched by expenditure and revenue outcomes. On the revenue side, voters need to be able to have a say not only about the amount of revenues that will be raised locally, but about how this revenue will be raised. Revenue mobilization at the provincial level is a key to making provincial officials accountable for the quality of services delivered. In Pakistan, as in many developing countries, the incentives embodied in the intergovernmental fiscal system are perverse with respect to stimulating tax reform that will match fiscal decentralization goals. Multilevel budgeting works in that a hard budget constraint is imposed at the subnational government level, and there is provincial discretion about how to obey this constraint, but the revenue mobilization dimension of fiscal decentralization has failed.

BUDGET MAKING IN RECENT YEARS

Budget preparation follows incremental approach. Each year, finance departments issue a budget call letter at the end of September, which coincides with the end of the first quarter of the fiscal year. The call letter lays out various stages of submission of expenditure estimates. Generally, it allows an incremental increase in the sector's share based on the revenue projections and policy targets of the government. Pay raises and other recurrent expenditures are deemed to be protected unless specifically indicated. Departments are allowed to carry out intrasector changes. Designated budget execution authorities are well specified within each department with clear powers under the rules. They are called the drawing and disbursing officers (DDOs). Each DDO prepares a budget on the given format following the general instructions and protecting the previous expenditures and adding incremental changes, like salary raises. For the latter, the DDOs follow the centrally laid down schedule of salary raises. Any new positions or expenditures for replacement of equipment are submitted separately using the forms for the Schedule of New Expenditures (SNEs). Both the recurrent expenditure estimates and SNEs are processed in the department and then submitted to the finance department by the end of the third quarter of the fiscal year. At that stage, the finance department holds a series of meetings with line departments to go over the submitted proposals for expenditures. Once agreed, the proposals are included in the budget estimates and presented to the assembly as the ABS.

In recent years, despite the overall integration of planning and budgeting or the capital and recurrent budgets, the process of budget making both at the federal and provincial levels takes place as two separate streams (Gable & LaPorte, 1983). Planning or capital budgeting begins with the Planning Commission-led periodic development plans setting priorities for sectors and projects. At the provincial level, the same mandate is exercised by the planning departments. Ministries and departments initiate projects rather than sectoral capital investment plans. The latter, if they are developed for a sector, have remained as guiding principles rather than operational plans. For example, the multiyear expenditure frameworks developed by the federal government and Punjab do not specify strict sectoral planning figures but only indicative figures. The budget-making cycle culminates each year with approval of a number of new and ongoing projects. Mostly new projects, unless already appraised and given technical approval by planning agencies, receive indicative financing only. Ongoing projects are allocated funds according to their stage of completion to be achieved in the following fiscal year. Ordinarily, ongoing projects are not dropped from the projects. Over the past two decades, change of government has been followed by review of ongoing projects, sometimes resulting in closure of ongoing projects that did not find favor with the incoming political government.

The projects are the main agency for accessing capital investment in a sector. Individual projects are reviewed by planning departments and approved by committees chaired by them. Only in case of small projects, the line departments are allowed to approve projects on their own. For the federal agencies, the upper limit has been

specified at Rs 40 million (US\$0.5 million). Projects costing more than this are submitted for appraisal and approval to the planning commission (Government of Pakistan, 2008). The provincial planning departments can approve projects costing Rs 5 billion (US\$62.5 million) or less. Projects with a higher cost are submitted for appraisal and approval to the planning commission at the federal level.

Appraised and approved projects are combined to formulate each sector's capital budget. This methodology has certain strengths and weaknesses. On the positive side, it has allowed the line departments to carry out project identification and selection at their level, using their better information bases and understanding of the sector. It has, in practice, become a fairly decentralized system catering to departmental initiatives even in the presence of central planning agencies at the two levels of government. Within a loose sectoral planning figure, departments are able to generate capital investment proposals and implement them after approval. On the other side, the system suffers from important weaknesses. Responding to demands for development, departments keep on adding projects to the portfolio within the existing sector share of the capital budget. Each year, new projects are added at the time of budget preparation. The inclusions carry token allocations to keep the overall sector share within the allocation made by the planning agency. As a result of this mechanism of budgeting, the portfolio of projects has often swelled to several times the capital budget of the government, requiring periodic pruning, which sunk costs of ongoing projects. The individual projects and sector objectives are often not reconciled correctly. Project appraisal looks at matches between project objectives and sector objectives. But where sector objectives are not clearly defined, most projects pass the muster if they are aiming to contribute in any way to development goals of the sector. This mechanism does not cater to selection of the highest value projects.

Despite the centralized project appraisal and approval, projection identification, preparation, and implementation is with the concerned line ministries. There is one exception to this rule. The capital funds are controlled by the planning departments. For most of the projects, planning departments authorize funds on a quarterly basis often after ascertaining amounts that had been authorized earlier. This mechanism allows a central capital budget programming. This is important at the provincial level because provinces depend on federal transfers and can only operate within overdraft limits specified by the State Bank of Pakistan. Planning departments at the provincial level authorize funds to individual projects of the line departments, keeping in view the financial situation intimated by the finance department.

Subnational Government Revenue Mobilization

Provincial governments do have access to some revenue sources that are potentially revenue productive (see Table 13-1). To demonstrate the success with revenue raising in Pakistan, we use data from two of the four provinces: Punjab (the largest) and the NWFP (the poorest).¹⁰ Together, these provinces account for about 60% of the national population.

Table 13-3

Revenue Mobilization in Punjab and NWFP, Fiscal Years 2002–2006

| Revenue source | Punjab | | NWFP | |
|---------------------|-----------|-----------|-----------|-----------|
| | 2001–2002 | 2005–2006 | 2001–2002 | 2005–2006 |
| Urban property tax | 0.001 | 0.026 | 0.039 | 0.041 |
| Excise duty | 0.021 | 0.019 | 0.005 | 0.004 |
| Land taxes | 0.086 | 0.077 | 0.049 | 0.045 |
| Motor vehicle taxes | 0.064 | 0.094 | 0.110 | 0.093 |
| Professions tax | 0.007 | 0.005 | 0.010 | 0.010 |
| Other taxes | 0.000 | 0.001 | 0.014 | 0.005 |
| Fees and charges | 0.196 | 0.135 | 0.255 | 0.209 |
| Total | 0.375 | 0.358 | 0.482 | 0.424 |

Source: *Provincial Revenue Time Series Data, 2001–2006*, The World Bank, Islamabad.

Note: The revenues are listed as a percentage of gross domestic product (GDP).

The time frame of revenue mobilization for the two provinces, by major revenue source, is described in Table 13-3. The results for both provinces show little change in the rate of revenue mobilization (relative to gross domestic product [GDP]) over the 2002–2006 period. In fact, the overall level has declined between 2002 and 2006 in both provinces (bottom row of Table 13-3). Various analysts have offered several reasons to explain this weak revenue–GDP elasticity (buoyancy).¹¹

First, provincial taxable capacity is low and the tax base is hard to reach. NWFP is the poorest province in Pakistan and has a high concentration of poverty, leading provincial officials to argue that it is tough to expect to get much more out of the system. A similar argument is made in Punjab. Per capita GDP is higher, but there also is a high concentration of poverty and large informal sector. Even so, many would argue that the economic base is strong enough to give up more in provincial government tax revenues than the 0.36% and 0.42% of GDP that were collected in Punjab and NWFP, respectively, in fiscal year 2005/2006. Moreover, both provinces have shown significant growth in GDP in recent years. The “low taxable capacity” argument for low revenue buoyancy is not persuasive.

Second, the tax administration machinery has not been effective in either province.¹² Both provinces are plagued by incomplete and out of date records, suggesting that there is not a good sense of the true tax base. Moreover, most tax subjects (e.g., professions tax, land taxes) have not been recently surveyed, hence tax bases are understated. Most of the recordkeeping in both provinces is manual.

Particularly in NWFP, there are serious constraints on assessment and collection. Revenue collections, except for some excises, take place only in urban areas. For example, there are 24 districts in NWFP but 70% of all property tax collections are from Peshawar (the capital city). More than 50% of excises come from seven districts.

In fact, some districts in NWFP are all but excluded from the tax system. About one third of the NWFP is made up of Provincially Administered Tribal Areas (PATA). Only a few taxes are collected in these districts (e.g., tax on the transfer of property, stamp duty, and the local rate). Urban immovable property tax (UIPT) is collected in only 16 of 24 districts. While there is no question about NWFP facing a challenging environment for tax collection, the situation is by no means hopeless. A thorough review and analysis of the tax administration system in NWFP points out numerous approaches to overcoming some of these obstacles (Khan, 2004).

In Punjab, the tax administration does not appear to be effectively mining the significant taxable capacity in urban areas. Property values have grown but property tax collections have not, the number of motor vehicles has grown but motor vehicle tax (MVT) revenues have not kept pace, and so on. Part of the problem is that the province has given away much of its tax base in the form of preferential treatment, but another part of the problem is that underassessment is considerable and collection rates are low. With respect to rural areas in Punjab, the story of underassessment and low collection rates is much the same.

The two provinces have a common administrative problem of not being able to effectively reach the agricultural sector. Neither of the provinces do a particularly good job with collection of agricultural income tax or with property transfer taxes. Certainly part of the problem is with the structure of these taxes, but there are also major administrative failings. These include poor recordkeeping and surveillance, exclusion of part of the tax base, and a failure to update valuation information.

Third, the structure of taxes is such that significant increases in revenue relative to GDP should not be expected. One reason for this is that the tax structure is partly based on specific rates. Another is that land is being acquired by government and nonprofits, thereby taking it off the tax rolls. It is also the case that provincial governments are not taking discretionary action to increase the effective rate of tax collection, such as revaluation of property or increases in nominal rates. Finally, the growth in tax revenues might have been slowed because some faster growing components of the tax base are not taxed, are given exemption, or preferential treatment (e.g., owner-occupied property, industrial property and vacant land, and the consumption of services).

All of these factors no doubt contribute to the weak revenue mobilization by provincial governments. But perhaps the dominant explanation is the perverse incentives that are embedded in the system of intergovernmental fiscal relations. Increases in intergovernmental transfers from the center have been large enough to allow a slowing of the effort exerted to collect provincial taxes. The increase in central government assistance has been significant in both provinces while the growth in own source revenues has been nearly flat. This pattern should come as no surprise. There is no incentive built into the transfer formula that would reward provinces for increasing their tax effort, or penalize them for not doing so.

It is also the case that the central government has encroached enough on provincial tax bases that potential revenue growth has been dampened. The provincial government has been limited by the federal government in terms of the fiscal space it has been given. Some of these limits stem from the constitution, but there also are limits

imposed by federal government policy. Four examples, regularly mentioned by provincial officials, include the following:

- The only tax, which provinces alone are specifically empowered to levy, is the tax on professions, trades, and callings. The fact that more revenue-productive taxes are not assigned exclusively to the subnational governments is a limiting factor on revenue growth.
- The UIPT is a provincial government tax, but most of the revenue collected is assigned to local governments.¹³
- Motor vehicle registration and licensing taxes (MVT) belong to the provincial governments. The collection rate is only about 70%. Some argue that the collection rate is this low because there is mandatory collection of the (federal) presumptive income tax at the time of vehicle registration. This additional tax payment stiffens resistance to payment of MVTs and reinforces opposition to any proposed increase in the provincial levy on MVTs. It is in this sense that the federal government is seen as encroaching on the provincial tax base.
- The federal government imposes a 2% capital value tax on property transfers, raising the total rate on each transfer and arguably reducing the rate of compliance with provincial stamp duty and registration taxes.

The result plays to the motives of elected local officials who are hesitant to increase tax effort for fear of losing political support. There have been no increases in tax rates or expansions in tax bases for 8 years in NWFP and 5 years in Punjab. The provincial government in Punjab postponed the introduction of the new property tax valuation roll, due in 2007, in part because of upcoming elections. Enforcement is lax in both provinces. Politics has been perhaps the major reason why provincial tax structures have not developed. Clearly, politicians have felt pressure from strong interest groups (agriculture, property owners) to hold off on increasing taxes, and in a sense they have been “protected” by increased intergovernmental transfers under the NFC. In NWFP, political leadership has not insisted on an aggressive administration in regions of civil unrest.

Intergovernmental Transfers

The system of (three) NFC transfers to provinces in Pakistan is quite transparent. In practice, the NFC awards have not been so simple to execute. In the last iteration, the NFC was not able to reach agreement on the sharing formula. The NFC distribution formula decided in 1996, initially valid for 5 years, was continued through 2005. The 7th NFC Award was finalized only in January 2006 after the NFC could not reach a consensus on the sharing arrangement despite 11 meetings after July 2000.¹⁴

The fundamental issue with the NFC award is that the constitution mandates that the four provinces must agree on the proposed formula. Given the great differences in wealth, needs, and demographic conditions in the four provinces, agreement is quite

unlikely. This consensus requirement has held up the final decision of the NFC. In January 2006, the president announced a formula for sharing of resources, which is technically not an NFC award.¹⁵

At present, the provincial pool for the NFC award is 41.5% of the federal divisible pool and is scheduled to increase by 1% per year up to 46.25% by 2011. The distribution of this pool among provinces is by population shares: NWFP receives 13.82% and Punjab receives 52%. The pattern of distribution of intergovernmental transfers to the two provinces is described in Table 13-4. From the data presented here, we can see that the shares of Punjab and NWFP have remained approximately constant since 1999. According to the structure of the NFC grant program, the only revenue growth for a province during an award period comes from increases in the rupee amount of the vertical share. This in turn depends on the growth in federal government tax revenues. So, there is stability in the distribution system that helps long-term fiscal planning.

The largest increases in the real per capita amounts received came at the time of the formation of the new award, in fiscal year 2004/2005, because of the increased vertical share for provincial governments. We might look back at the 2000–2006 period

Table 13-4

| The Growth in Federal Transfers | | | | | | |
|---------------------------------|---|------|--|------|--|------|
| Fiscal year | Transfers received as percent of provincial GDP | | Transfers received as percent of total expenditure | | Transfers received as percent of total federal transfers | |
| | Punjab | NWFP | Punjab | NWFP | Punjab | NWFP |
| 2000–2001 | 3 | 5 | – | – | 52 | 12 |
| 2001–2002 | 3 | 5 | – | – | 51 | 12 |
| 2002–2003 | 3 | 5 | 68 | – | 52 | 12 |
| 2003–2004 | 3 | 5 | 58 | – | 51 | 13 |
| 2004–2005 | 3 | 5 | 50 | 58 | 53 | 13 |
| 2005–2006 | 3 | 5 | 46 | 40 | 52 | 13 |
| Fiscal year | Total federal transfers as percent of GDP | | Total federal expenditures as percent of GDP | | Federal transfers as percent of federal expenditures | |
| 2000–2001 | 3.64 | | – | | – | |
| 2001–2002 | 3.60 | | – | | – | |
| 2002–2003 | 3.74 | | – | | – | |
| 2003–2004 | 3.28 | | 10.33 | | 31.77 | |
| 2004–2005 | 3.62 | | 10.46 | | 34.63 | |
| 2005–2006 | 3.53 | | 10.26 | | 34.38 | |

Sources: For federal expenditures, we used Table 5.10 in *Economic Survey: 2006–2007* (Government of Pakistan, 2007); for transfers we have relied on the provincial time series data provided by The World Bank, Islamabad, 2001–2006.

Notes: Transfers include only shared taxes.