DEVOLUTION AND FISCAL DECENTRALISATION

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Fiscal decentralisation represents the transfer of resources from higher to lower levels of government usually accompanied by an enhancement in responsibilities and functions of sub-national governments and greater autonomy in their budget making and financial decisions. The rising demand generally for decentralisation in developing countries in recent years is a consequence of the broader processes of globalisation, liberalisation and deregulation. Political imperatives for decentralisation have been created by the urge for more effective democratisation and the need to bring governments closer to the people for greater accountability and better articulation of their needs and preferences. In a number of countries, including Pakistan, the failure of central or state/provincial governments to adequately capture local preferences and provide basic services have strengthened the case for use of local governments as delivery agents, such that the production and distribution of services is carried down to the lowest unit of government capable of capturing the associated costs and benefits.

However, there are well defined pros and cons of decentralisation. These are aptly summarised in the World Development Report [1997] as follows:

> *'Decentralisation offers the chance to match public services more closely with local demands and preferences and to build more responsive and accountable government from below. But decentralisation also has its pitfalls, including the possibility of increased disparity across regions, loss of macroeconomic stability and institutional capture by local factions, especially in highly unequal societies.'*

The objective of this paper is to identify the major issues of fiscal decentralisation which arise in the context of the devolution plan announced by the National Reconstruction Bureau (NRB). The paper is essentially exploratory and not definitive in character and seeks primarily to lay down the parameters of the agenda of the program for fiscal decentralisation which will have to be a necessary concomitant of the transfer of functions from provincial to local governments as proposed in the devolution plan.

The paper is organized as follows: Section 2 provides a conceptual framework for looking at issues related to fiscal decentralisation. Section 3 describes the broad policy statements on fiscal decentralisation contained in the devolution plan announced by NRB. Section 4 discusses the proposed allocation of functions to local governments (all tiers combined) and derives the implications for enhancement in the size of their budgets and resource requirements. Section 5 quantifies the resulting vertical imbalance among different levels of government and estimates the resource gap of local governments which will have to be filled either by enhancement in local fiscal powers or through larger transfers from higher levels of government.

Section 6 highlights the general principles for assignment of taxes to different levels of government. Key issues in tax assignment are identified and discussed and different alternatives

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suggested for allocation of fiscal powers, especially between provincial and local governments. Section 7 discusses revenue sharing arrangements between provincial and local governments and focuses on issues related to the coverage, degree of sharing and formula for allocation of revenues among local governments. Section 8 describes the pros and cons of various types of grant schemes and the different options that are available for financing of services through grants. An important issue taken up in this section is the design of fiscal equalisation transfers to compensate for the lack of taxable capacity in the relatively backward districts of the country. Section 9 deals with the issues of borrowing powers of different levels of government. Section 10 profiles the alternative schemes that are available for achieving fiscal decentralisation to local governments in Pakistan which emerge from the analysis in the earlier sections. Section 11 highlights the resulting implications for the terms of reference of the Provincial Finance Commissions. Finally, in Section 12 are presented the key conclusions.

2 FRAMEWORK FOR FISCAL DECENTRALISATION

We focus primarily on the framework for fiscal decentralisation to local governments. It is, of course, possible that the government is also contemplating devolution from the federal to provincial levels. The methodological framework for analysing this type of fiscal decentralisation is essentially the same although weights attached to different components of the program may differ.

The key parameters of fiscal decentralisation are presented in Chart I. The first decision to be taken is which additional functions are to be allocated to local governments over and above their existing functions. It appears that some of the functions proposed to be transferred to local governments in the NRB devolution plan are already contained in their list of functions, like primary education, agricultural development, rural development, social welfare and community development, etc. (see Table 1). Historically, local governments have been unable to discharge these functions primarily because of shortage of resources and lack of adequate institutional capacity. But the devolution plan goes further and allocates a large number of new functions which have hitherto been outside the domain of local governments. This includes services like information technology, commerce and industry, law and magistracy, etc.

The primary task of fiscal decentralisation is to organise the financing of the expanded list of functions. In this connection, the first decision to be taken relates to the degree of direct financing through own tax revenues and user charges levied by local governments. This is a key determinant of the extent of fiscal autonomy that local governments will enjoy in their budgeting decisions. Mobilisation of revenues through own sources will require a clear statement of what fiscal powers have been made available to local governments and the policy on the extent of cost recovery through user charges.

If local resource mobilisation turns out to be inadequate in financing target levels of expenditure (either based on existing or certain minimum standards of service provision) then a system of inter-governmental transfers will have to be put in place to support the program of fiscal decentralisation. These transfers could be in the nature of sharing in revenues of higher levels of government, grants or borrowings. A key decision is the distribution of transfers among these three types of transfers.

TABLE 1
FUNCTIONS OF LOCAL GOVERNMENT, EXISTING AND PROPOSED

EXISTING	PROPOSED[a]
Public Works[b]	Energy
Public Health[b]	Hospitals, Basic and Rural Health Units, Population Planning
Education[b]	Literacy, Vocational Education, Technical Education, Colleges and Sports
Agricultural Development[c] and Economic Welfare	Irrigation, Fisheries and Forestry
Articles of Food and Drink[b]	-
Drainage[b]	-
Public Ferries[c]	-
Livestock and Dairy Development[c]	-
Animals and Cattle[d]	-
Culture[b]	-
Public Safety[b]	-
Environmental Pollution[b]	Environmental Education and Protection
Rural Development[c]	-
Social Welfare and Community Development[b]	Labor and Social Security, Co-operatives
Town Planning[d]	-
-	Information Technology and District Data
-	Base Land Revenue; Estate; Excise and
-	Taxation Commerce and Industry
-	Legal Functions, Prosecution, Magistracy

[a]Proposed functions in the NRB devolution plan, over and above existing functions
[b]functions of both urban and rural local councils
[c]functions only of rural councils
[d]functions only of urban councils
Sources: Local Government Ordinances
NRB Report on Local Governments

3 FISCAL DECENTRALISATION IN THE DEVOLUTION PLAN

The devolution plan does include some broad statements highlighting the overall philosophy with regard to fiscal decentralisation. Perhaps, the most succinct statement is in paragraph 3.3.5.1 of the section on distribution of resources of the report on *Local Government* prepared by the NRB, as follows:

> *'Empowerment, decentralisation and deconcentration cannot be achieved without a significant redistribution of resources. Fiscal federalism must extend to the district level that will have its own taxing capacity and other independent sources of revenue, in addition to receiving funds from provincial and federal transfers and grants. The mechanisms for transfers and grants are to be approved by political authorities. They should be transparent, non-discretional and equitable. The latter includes equalisation criteria through which poorer districts receive more resources than those with greater resources.'*

Therefore, the devolution plan clearly recognises the need for a measure of fiscal autonomy of local governments through the granting and exploitation of expanded fiscal powers. However, it accepts that locally generated resources will not be adequate given the wide range of services allocated and recognises the need for transfers and grants. It is significant that the NRB plan has built in a provision for federal transfers also to local governments. Moreover, the plan emphasises the need for a system of transparent and formula-based transfers, as opposed to discretionary grants. Given one of the hazards of fiscal decentralisation of growing regional disparities, due to differences in taxable capacity, the devolution plan rightly recognises the need for establishing an explicit scheme of fiscal equalisation transfers.

The devolution plan goes on to say in paragraph 3.3.5.3:

> *'...The creation of district governments will necessitate the creation of fiscal transfer mechanisms from the provinces to the districts. This is envisaged through the creation of a Provincial Finance Commission which will create a formula based system for provincial finance awards.'*

The devolution plan envisages the setting of a Provincial Finance Commission (PFC) in each province to decide on the nature of fiscal relations between provincial and local governments. This body is expected to play a similar role as the National Finance Commission (NFC), which is constitutionally mandated (as per clause 160) to decide on the distribution of revenues between the federation and the provinces, including the distribution from net proceeds of federal taxes, the making of grants-in-aid by the federal government to the provincial governments, the exercise by the federal government and the provincial governments of the borrowing powers conferred by the constitution, and any other matter related to finance referred to the Commission by the government. It is also significant to note that the devolution plan envisages transfers from the provincial to the district governments only. Lower levels of local government like the tehsil councils and union councils will receive whatever funds are required to execute their functions from the district government and not directly from the provincial government.

With regard to the finance system, the devolution plan says in paragraph 5.1.2:

> *'Currently the provincial governments spend funds at the district level through the provincial departments. With the advent of the new local government administrative system many departments and functions previously conducted by the provincial departments will now be carried out at the district level. Therefore, funds being spent through these provincial line departments as well as those being spent at the divisional level will be transferred to the district level. The transfer and grant system has been weak. There is no formula for distribution of funds to districts and provincial budgets do not specify district expenditures.'*

This paragraph makes the important observation that the program of fiscal decentralisation to local governments will effectively not require additional resources. Provincial expenditures on services will essentially be converted into local expenditures through appropriate financing arrangements. Funds will be transferred alongwith a transfer of responsibilities. Therefore, the fiscal decentralisation program should have no immediate consequences on the fiscal deficit combined of all levels of government.

However, there is a danger that the statement made in the above paragraph by the NRB can be interpreted as being supportive of specific purpose transfers rather than general or block grants. If budgets at the district level of provincial line departments are essentially going to become budgets of the corresponding departments of the newly constituted district governments, then in the short run there will be little or no change in expenditure priorities. This will defeat one of the basic objectives of the devolution plan which is to take government nearer to the people, such that local needs and preferences can be translated into changes in expenditure priorities.

With regard to sources of finance, paragraph 5.1.6. of the devolution plan says:

> *'The three tiers of local government have a tax collection machinery at their disposal and the schedule of local taxes for union and district levels. The local governments can also charge user fees. Under the district and local government reform, access to sources of revenue will be operationalised through:*
>
> 1. *Decentralisation of provincial and divisional assets of departments*
>
> 2. *Local resource mobilisation through two sources: a) citizen community boards for their own projects and b) the incentive framework of district funds to support these projects.*
>
> 3. *To ensure district financial autonomy, a provincial fiscal transfer mechanism based on the following factors will be developed:*
>
>   - *fiscal needs judged by conditions of the area*
>   - *fiscal equalisation judged by fiscal capacity*
>   - *fiscal effort*
>   - *function specific transfers linked to minimum standards*
>
> 4. *In addition to the already provided schedule of taxes, the district assembly will also be empowered to create new taxes for specific purposes such as education and health*

5. *Eventually, there will be need for financial intermediation. The development of this system requires credit rating agencies, accounts and audit, and legal and regulatory frameworks. Achieving this is the medium term goal of the local government reform*

6. *Remunerative projects and other incomes will enhance revenues.'*

This paragraph contains a number of important provisions. First, provincial and divisional assets of line departments (performing functions that are transferred) will be decentralised (that is, handed over) to local governments enabling them to collect user charges, wherever possible, on these facilities. It is significant that only assets are being transferred and not liabilities. This implies that the debt servicing of all development loans taken earlier to finance the acquisition of these assets will continue to be the responsibility of provincial governments.

Second, innovative local financing mechanisms for projects have been proposed which include community contributions in cash or in kind organized by the citizen community boards with the possibility of some matching contribution from district governments. Third, a fiscal equalisation scheme of transfers is proposed to be put in place with the size of grants linked inversely to the fiscal capacity of an area. Fourth, as indicated earlier, there is a preference for specific transfers to ensure at least a minimum level of service provision.

Fifth, residual fiscal powers appear to have been granted to district governments, revenues from which could be earmarked for specific services. This provision runs the risk of local governments encroaching on the tax bases of higher levels of government and leading to a multiplicity of taxes. Ideally, the range of fiscal powers of local governments should be made explicit to avoid these problems. Sixth, the proposed financing mechanisms also include a provision for the more viable local governments to access to the capital markets, at least in the medium run. This is a complex issue and is discussed in a later section of the paper.

Altogether, the principles enunciated in the devolution plan on fiscal decentralisation indicate that the NRB wants to see local governments which are financially autonomous to the extent possible, with significant fiscal powers. But there is the realisation that given the large number of functions allocated to district governments involving substantial expenditure and the limited revenue generating capacity of local taxes a comprehensive and elaborate system of inter-governmental transfers will have to be put in place to bridge the resource gap. The devolution plan appears to have an implicit preference for specific transfers to ensure at least a minimal level of provision of different services. Such transfers may run counter, however, to the goal of local financial autonomy and limit the scope for change in expenditure priorities.

Further, the plan is also conscious of the danger that fiscal decentralisation will exacerbate regional disparities and, therefore, rightly proposes a system of fiscal equalisation. However, fiscal decentralisation in the devolution plan has remained essentially confined to a statement of general principles and much more work is required to operationalise this program. This paper represents the first step in this regard. It attempts to lay the groundwork of identifying issues related to implementation of the program of fiscal decentralisation which will, of course, ultimately have to be resolved by the PFCs.

4 ALLOCATION OF FUNCTIONS

The devolution plan proposes (in paragraph 4.2.5.2.2) that the district administration will consist of 13 departments as follows:

1. *Finance, Planning and Budget*

2. *Public works:* housing and urban development, rural development, water supply and sanitation, energy, roads and other infrastrcture

3. *Health:* standards and programs, public health, basic and rural health units, hospitals, child health and the women's health sub-department (additionally responsible for population planning)

4. *Literacy:* literacy campaigns, continuing education and vocational education

5. *Social Development:* institutional development, community resource development, labor and social security, social welfare, culture and co-operatives

6. *Information Technology:* information technology and district data base

7. *Revenue:* land revenue, estate, excise and taxation

8. *Agriculture:* food, agriculture, livestock, irrigation and drainage, fisheries and forests

9. *Education:* elementary education, secondary education (boys), secondary education (girls), technical education, colleges and sports

10. *Commerce and Industry:* investment, commerce and industry

11. *Law:* prosecution, legal functions and legislation

12. *Environment:* environmental education, environmental protection

13. *Magistracy:* land revenue, estate, excise and taxation

The list of sub-departments is generic in nature and will vary in accordance with the nature of each district.

Therefore, virtually all social services and a major component of economic and community services, which are currently the responsibility of provincial governments, are proposed to be transferred to district governments. In addition, new functions are being created related to literacy, social development, information technology and environment, for which full-fledged departments do not currently exist at the provincial level. Therefore, as highlighted earlier, what we are witnessing in Pakistan is a massive program of fiscal decentralisation to the local level. This is unprecedented in the history of Pakistan and most other developing countries.

What implication does this program have on the size of local budgets? Currently, a ball park estimate is that local governments in Pakistan, which include the urban local councils (metropolitan corporations, municipal corporations, municipal committees and town committees) and their rural counterparts (district councils) and union councils, collectively are responsible for expenditure (both current and development) of about Rs 40 billion. The corresponding budget of the four provincial governments combined is about Rs 225 billion. Therefore, in the present dispensation, local governments are small (about one fifths) in size in relation to provincial governments.

Following the transfer of functions to local governments, as envisaged in the devolution plan, local governments will expand considerably while the direct expenditure responsibilities of provincial governments will contract significantly. As shown in Table 2, it is likely that approximately 40 per cent of provincial budgets (both current and development) will stand transferred to local governments. This, of course, depends upon the nature of financing arrangements, especially with regard to which level of government picks up the salary and allowances of district and lower level staff of provincial line departments, responsibilities of which are transferred to local governments. Ideally, district and lower level personnel should be paid out of local budgets. If close to 40 per cent of the existing provincial budgets is transferred to local governments following the implementation of the devolution plan then expenditures of provincial governments will become restricted to costs of general administration, law and order, debt servicing, budgets of provincial line departments like works, irrigation, etc, which remain in existence with the responsibility of managing and developing trunk (inter-district) infrastructure, budgets of regulatory entities (like education boards) and the legislative and judicial components.

40 per cent of provincial budgets is about Rs 90 billion. Therefore, with the additional functions, local budgets will increase to about Rs 130 billion from the present level of approximately Rs 40 billion. On top of this, budgets for new departments of literacy, social development, information technology and environment and costs of the legislative component of local governments will have to be provided for. A subsequent paper in the seminar by Shahrukh Rafi Khan attempts a quantification of the costs of devolution. Further, it is proposed by NRB that specialised agencies like the WASAs and the development authorities will be merged into district governments in the large cities. Altogether, it would not be surprising if, after the full-scale implementation of the devolution plan, we have local governments which are almost four times larger in terms of the size of their budgets than at present. Clearly, this has major implications not only on the required financial resources but also on the institutional capacity of local governments. This will imply, in particular, the need for strengthening of budgeting and accounting systems and audit procedures and enhancement in the technical capacity to design and execute projects.

With about 40 per cent contraction in expenditures, the combined budget of provincial budgets (in terms of direct expenditures) will reduce to about Rs 135 billion. This, of course, does not incorporate the increase in expenditure if there is also a devolution of functions from the federal to provincial level. All in all, it can be concluded at this stage that the devolution plan will change dramatically the relative size of provincial and local governments. From being about one fifths the size of provincial governments, local governments are likely to become almost equal or somewhat larger in size, following the execution of the devolution plan. Given this radical change, it is clear that the process of transition will have to be carefully managed.

A variant on the NRB allocation of functions has been presented by Kaiser Bengali in the previous paper presented at the seminar. On the basis of the application of criteria of externality,

TABLE 2
SHARE OF PROVINCIAL EXPENDITURE AT DISTRICT LEVEL OR BELOW
(Four provinces combined; current plus development expenditure)
1997-98

(Rs in Billion)

	Service	Expenditure	% Expenditure at District Level or Below on Functions to be Transferred	Expenditure at District Level or Below on Functions to be Transferred
A.	General Administration	18.9	20	3.8
B.	Law and Order	15.0	-	-
C.	Social Services	57.4	71	40.8
	Education	43.3	76	32.8
	Primary	23.4	80	18.7
	Secondary	11.6	75	8.7
	Higher	8.3	65	5.4
	Health	11.5	58	6.7
	Curative	9.4	60	5.6
	Other	2.1	50	1.1
	Others	2.6	50	1.3
D.	Economic Services	18.3	64	11.7
	Agriculture	7.2	50	4.3
	Irrigation	8.2	70	5.7
	Others	2.9	60	1.7
E.	Community Services	19.0	57	10.9
	Highways, Road, etc.	10.4	50	5.2
	Public Health Engg	3.5	75	2.6
	Others	5.1	60	3.1
F	Subsidies	2.8	-	-
G	Interest Payments	33.3	-	-
H	Others	2.0	-	-
	TOTAL	166.7	40	67.2

Sources: Provincial Budget Documents.

chargeability and technicity he proposes a somewhat truncated number of functions for local governments. As such he keeps the responsibilities for higher education, food and agriculture, forestry and fisheries, preventive health, industries, labor welfare and social security and industries with provincial governments. This would, therefore, imply less fiscal decentralisation. In the Kaiser Bengali proposal the total budget transferred to local governments would be about Rs 65 billion as opposed to Rs 90 billion in the NRB plan. Therefore, even the truncated proposal involves substantial decentralisation of expenditures.

The basic difference between the NRB and the Kaiser Bengali proposals is that the former envisages local governments not only as the primary delivery agent for services but also as key players in the regional development process, while the latter essentially allocates only the first role to local governments and leaves the second role largely with provincial governments. In both proposals, for a large number of functions, the role of provincial governments will be transformed from one of direct provision to that of regulation, financing and monitoring.

5 VERTICAL IMBALANCE

Given the present allocation of taxes and the proposed allocation of expenditure functions (alongwith the associated non-tax revenues) by NRB, as discussed in the previous section, we are now in a position to quantify the extent of vertical imbalance between revenues and current expenditures of the federal, provincial and local governments. This indicates the magnitude of transfers required from one level of government to the other in order to balance budgets. Table 3 indicates that the allocation of taxes is such that the federal government will continue to enjoy a sizeable surplus while both provincial and local governments will carry large deficits.

TABLE 3
VERTICAL IMBALANCE AMONG DIFFERENT LEVELS OF GOVERNMENT FOLLOWING TRANSFER OF FUNCTIONS TO LOCAL GOVERNMENTS AS PER DEVOLUTION PLAN

(%)

Level of Government	Share in Revenues	Share in Current Expenditure	Surplus (+) / Deficit (-)
Federal	88	70	+18
Provincial	6	15	-9
Local	6	15	-9
All levels	**100**	**100**	**0**

Source: Estimated by authors.

The fundamental implication of the likely vertical imbalance is that either there is a massive realignment of fiscal powers or there will continue to be a need for large transfers from federal to provincial governments (as per NFC provisions) and, in addition, a new system of substantial inter-governmental transfers to local governments will need to be put in place. The issue is whether there should be direct transfers from the federal to local governments or whether the transfers should be routed through provincial governments. Our preference is for the latter which is likely to be more consistent with the constitutional provisions and enable provincial governments to play the necessary role of regulating and monitoring the behaviour of local governments.

Therefore, in an inter-governmental regime where transfers from a higher level of government are only to the next lower level of government, federal transfers to provincial governments will not only have to cover up the resource gap of the latter but also of the local governments. Provincial transfers will then finance the resource gap of local governments. In effect, the federal government will indirectly be transferring resources to the local government via provincial governments.

Table 3 also gives an indication of the required magnitude of transfers. Federal transfers to provincial governments will have to be over 20 per cent of revenues (tax and non-tax) collected by the federal government. Provincial transfers to local governments will constitute almost 40 per cent of provincial own revenues and federal transfers to provinces. On this basis it is possible to quantify the extent of dependence of subnational governments on transfers. It appears that over 60 per cent of the current expenditure by provincial and local governments will have to be financed by transfers. If the objective is to eliminate borrowing by subnational governments then transfers will have to be even larger to generate sufficiently big revenue surpluses to finance the development programs of provincial and local governments.

We turn now to the issues of, first, whether a better strategy is to remove the vertical imbalance by realigning substantially the fiscal powers and, in particular, increasing the tax assignments to sub-national governments or to bridge the resource gap through transfers and, second, what form the transfers should take, with the options being revenue sharing or various forms of grants.

6 TAX ASSIGNMENTS

The extent of self-reliance of local governments on own sources crucially depends on the allocation of fiscal powers. In addition, there are other benefits from enhancement in local fiscal powers. It becomes possible, in particular, to establish a much closer link in the minds of citizens between taxes paid and benefits received. This is likely to encourage greater tax payer compliance and promote the development of a tax culture. Further greater self-financing of services essentially makes local governments more accountable. At the margin, if a local government wants to provide more or better services than it has to convince local residents to pay more for this improvement. However, decentralisation of the tax system has the negative implication of increasing the differences in the financial resources among local jurisdictions on the basis of divergence in taxable capacity.

The division of revenue sources among different levels of government constitutes the tax assignment problem. We start by first laying down the principles of tax assignment and based on these discuss the resulting allocation of taxes between different tiers of government. Two considerations are important in determining the extent to which fiscal powers should be decentralised. First, there has to be a link between expenditure and tax assignments so as to match expenditure needs with revenue means at different levels of government. Second, there are efficiency considerations with regard to the appropriate level of government for collecting a particular tax. The general principle is that taxes on relatively immobile tax bases should be levied by local authorities so as to minimise the excess burden associated with taxation. The objective is to ensure that the costs of provision of local public goods are financed primarily by taxes the incidence of which falls on local residents.

Beyond this, taxes on mobile factors of production should be centralised in order to maintain uniform tax rates across jurisdictions and prevent distortions in the location of economic activity. Further, progressive redistributive taxes and taxes suitable for economic stabilisation should be centralised. As far as user charges are concerned these can be levied appropriately by all levels of government.

By and large, efficiency considerations appear more important in assignment of taxes among different levels of government in developing countries. This is reinforced by the need for centralized tax administration which can effectively collect revenues and avoid fragmentation of the resource mobilisation effort.

Based on the above principles, the major potential local taxes are presented in Table 4. These include taxes on property, transport, sales, entry / exit, entertainment, resources, production, transaction and sumptuary taxes. Taxes on real estate have valorisation characteristics and can recover costs of public service provision based on the increment in property values. Since road street maintenance is generally a local responsibility, transport / motor vehicle taxes are suitable for assignment to local governments subject to the condition that the particular vehicles taxed essentially ply within a jurisdiction. If the tax rate is harmonised, single-stage sales tax can be levied by any level of government and can provide a broad-based buoyant source of revenue for local governments also. However, the point of taxation should be at the retail level to prevent possibilities of 'tax exporting'. Taxes on resources and entertainment are good local government instruments because of the immobile nature of the tax base. Income tax (both personal and corporate) is a tax on mobile factors and is partially levied for redistributive reasons. Therefore, it is more suitable for assignment to the central government.

A number of issues arise in the context of assignment of taxes. First, *overlapping tax bases or tax base sharing* between different levels of government increases tax payers' compliance costs and leads to spatial variation in effective tax rates, with associated distortions. For example, in Pakistan, a stamp duty is charged by provincial governments on property transactions. In addition, local governments levy a tax on transfer of property. The consequence is that the overall incidence of taxes on property transactions is quite high, retarding the development of the property market and leading to a large-scale underdeclaration of property values for tax purposes. This multiplicity of collection agencies belonging to different levels of government has also increased compliance costs for tax payers. A better arrangement is for establishment of revenue-sharing in one tax imposed on property transactions.

Second, in the case of subnational taxes levied on mobile tax bases problems arise due to *tax rate competition* among different jurisdictions. Clearly, there has to be some degree of autonomy in the fixation of tax rates so that the subnational governments can select the optimal level of taxation in line with the preferences of their residents. However, there is the danger that subnational governments may opt for too low a tax rate to attract economic activity within their respective jurisdictions. This problem has been resolved at the provincial level in Pakistan by harmonisation of tax rates although it mitigates against fiscal autonomy.

Third, in countries like Pakistan characterised by large variations in the level of regional development there is the danger of *tax exporting*. Given regional disparities, especially in industrialisation, relatively advanced regions (where industry is concentrated) can export their taxes to residents of consuming states, assuming that the burden of the taxes is borne by the consumers. There was evidence of this in the context octroi and zila taxes, which now stand abolished at the local level. The likelihood of tax exporting is one of the justifications for not assigning taxes on natural resources to subnational governments.

TABLE 4
POTENTIAL LOCAL TAXES AND EXISTING LOCAL TAXES IN PAKISTAN

Property Related Taxes
Tax on Annual Rental Values[?]

Tax on Capital Values

Tax on Transfer of Property[?]

Transport Taxes
Registration and Annual Tax on Non-Mechanised Transport[?]

Registration and Annual Tax on Motor Vehicles[?]

Taxes on Motor Fuels

Congestion Tolls

Taxes on Sales
Single-Stage Retail Sales Tax

Entry / Exit Taxes
Octroi[??]

Export Tax[??]

Sumptuary Taxes
Betting and Gambling Tax

Tax on Lotteries

Tax on Race Tracks

Tax on Alcohol

Entertainment Taxes
Tax on Cinemas[?]

Tax on Dramatic and Theatrical[?] Shows

Tax on Feasts[?]

Tax on Advertisements[?]

Head Taxes
Tax on Professions, Trades[?]

Tax on Hearths[?]

Tax on Births and Marriages[?]

Poll Tax

Resource Taxes
Royalties

Conservation Charges

Taxes on 'Bads'
Taxes on Motor Fuels

Effluent Charges

Congestion Tolls

Taxes on Animals
Slaughter Tax[?]

Livestock Trading Tax[?]

Surcharges
Personal Income Tax

Sales Tax

State / Provincial Taxes[?]

[?] existing local taxes in Pakistan as per the Local Government Ordinances
[??] included in local fiscal powers, but octroi and zila tax have been abolished in 1998
Sources: Local Government Ordinances
Pasha and Ghaus [1995]

The key questions that arise in the context of local tax assignments in Pakistan include the following: What is the current allocation of local taxes in the country? Do these conform to the principles enunciated above?

Local government's fiscal powers in Pakistan are explicitly mentioned in the Local Government Ordinances, promulgated by the four provincial governments in the country. By and large, taxes included in the fiscal powers of local councils in Pakistan are in line with the potential local taxes presented in Table 4. The key exclusions are a single-stage retail sales tax and surcharges on personal income tax and sales tax. The former remains underdeveloped in Pakistan. Likewise, piggy backing on mobile tax bases like the income tax opens the possibility for shifting income to low tax rate jurisdictions away from smaller towns / cities, where the disincentive created due to the relatively higher incidence of the tax is not outweighed by the large city benefits. As such, there is limited scope of any meaningful reassignment of taxes to the local governments in the country.

With the abolition of octroi/zila tax in 1998 whatever revenue mobilisation capacity existed at the local level has been largely eroded. As such local governments now have to almost totally rely on transfers from higher tiers of government not only to finance their development activities but also the operations and maintenance of existing facilities. Given the limited scope for reassignment of fiscal powers it appears that transfers will increasingly be the backbone of the local government finances in the country. This will tantamount to a big change in local fiscal structure. Traditionally, prior to the abolition of octroi / zila tax, local governments in Pakistan had largely been self-financing entities. The challenge then is how can funds be transferred to local governments without compromising on local autonomy? This issue is discussed in subsequent sections.

Another issue is the commonality in the provincial and local tax bases. Five potentially key taxes, this is, urban immovable property tax; tax on vehicles; tax on transfer of properties; tax on professions; trades and callings; and entertainment tax can essentially be levied by both provincial as well as the local governments. To avoid multiplicity of taxation and its concomitant problems discussed earlier, it is important that either a tax is handed over exclusively to one level of government or one tier of government collects it, subsequently sharing the revenue proceeds with the other tier on the basis of some predetermined, transparent revenue-sharing formula. A strong case exists for the handing over of urban immovable property tax to local governments, since the tax is levied to finance the provision of local services. The handing over of property tax to local governments will at least partly compensate for the loss of fiscal autonomy due to the withdrawal of the powers to levy octroi / zila tax in 1998, it will also augment the local fiscal base and the tax can, in effect, be developed as a budget-balancing devise. Currently, provincial governments are able to extract only about one thirds of the revenue potential of the tax at existing statutory rates due primarily to low valuation of annual rental values. Since 85 per cent of the proceeds of the tax have to be transferred to local governments, provincial governments have had little incentive to incur the high political costs involved in development of the tax. The other common tax bases can form part of the divisible pool of taxes to be shared between the provincial and the local governments.

The next issue relates to the reintroduction of octroi and zila tax since these were the largest sources of local revenue. Their abolition and substitution by grants can be considered a major blow to local fiscal autonomy. However, the abolition of both these taxes can be supported on the grounds that they had become a major impediment to the development of a national common market and the flow of goods within the country. They were generally regressive in character and imposed higher costs of collection and compliance. Moreover, the appointment of private contractors for tax collection had led to high levels of corruption. Also, both taxes had the problem of being at least partly exported to other local jurisdictions. As such, their reintroduction cannot be justifiably argued for. However, from the viewpoint of preserving local fiscal autonomy, the revenue foregone should be substituted by a mechanism which ensures buoyancy, sustainability, fairness and transparency. Therefore, the grant system for substituting revenue from octroi / zila tax should have the following features: one, explicit earmarking of a revenue source for financing the grant to establish viability and sustainability; and, two, a clear cut formula for determination of the size of the grant to each local council to ensure transparency and fairness. The original proposal for the abolition of octroi / zila tax (prepared by the Multiplicity of Taxes Committee) incorporated these features. It was suggested that the standard GST rate on goods be enhanced by an amount adequate to cover the total cost of octroi / zila tax grants to local governments. GST was chosen for earmarking because of the similarity of the octroi, in particular, to a local sales tax. Given the projected GST revenue, this required an increase in the standard rate of 2.5 percentage points.

In the area of tax assignment, another issue is the intra-district sharing of fiscal powers among the district, tehsil and union councils. Currently in the Local Government Ordinances there is a considerable overlap in the fiscal powers of union councils and district/urban local councils. As such, it is proposed that fiscal powers of tehsil and union councils should primarily consist of the ability to levy surcharges on taxes of district governments. This will avoid a multiplicity of small taxes and obviate the need for establishment of an elaborate tax collection machinery at the lower levels of local government.

Finally, an issue is one of the degree of regulation of the local tax systems by provincial governments. The current practice is that any change in local tax rates has to based on prior approval from provincial governments. Clearly, this represents a major violation of the principle of local fiscal autonomy and will have to be abandoned. But, in view of the possibility of capture of local governments by vested interest groups and the resulting granting of concessions in local taxes, a floor / minimum may be prescribed by provincial governments on local tax rates / per capita tax collections. This will also avoid unhealthy tax competition among local jurisdictions to attract economic activity. Further, appropriate incentive mechanisms may need to be put in place by provincial governments in the design of grant schemes to reward extra fiscal effort or improved expenditure management by particular local governments.

7 REVENUE SHARING ARRANGEMENTS

We have concluded in the previous section that the scope for reassignment of taxes to enhance fiscal powers and the resulting autonomy of local government is constrained by the limited revenue-raising capacity of potentially ‘local taxes’ and, therefore, reliance will have to be placed on transfers to finance the process of fiscal decentralisation to local governments. This, of course, has the consequential implication that the goal of financial autonomy of local governments, as reflected in the ability to self-finance expenditure, will largely not be realised. The question then arises: As emphasised by the NRB how far do we go for the second best option of building local fiscal autonomy by establishing revenue sharing arrangements which are transparent, formula-driven and fixed for a period of time (say, five years like the NFC) by the PFCs (which should ideally be granted constitutional status like the NFC)? The answer to this question is in some sense of fundamental importance in determining whether the process of devolution provides a better mechanism for articulation of local needs or preferences or not.

The single most important issue in the context of revenue-sharing arrangements is the extent to which such transfers should finance the process of fiscal decentralisation to local governments. At one extreme, if the objective is to maximise local autonomy in the absence of local revenue generation of a large enough magnitude then the preference is for general transfers, either through revenue sharing or block grants. At the other extreme, if the process of fiscal decentralisation is to be regulated and restrictions placed on the behaviour of local governments then the PFCs could opt for specific purpose transfers which ensure that expenditure priorities do not change dramatically in the short run.

We highlight the implications of each alternative. If bulk of the transfers are to be in the nature of revenue sharing transfers then the divisible pool of taxes to be shared and the share of local governments in this pool will have to be kept sufficiently large. This can only be achieved by the inclusion of transfers to provinces from the federal-provincial divisible pool in the provincial-local divisible pool alongwith the revenue collected from provincial taxes. As highlighted in the earlier section on vertical imbalance, this would be the way to indirectly route through federal support to local governments. In 1999-2000, the former are estimated at Rs 123 billion for the four provinces combined as compared to about Rs 22 billion generated from provincial taxes (which could contract in size somewhat if as described in the previous section some provincial taxes are assigned to district governments). Therefore, if revenue sharing transfers to local governments are to be the principal transfer mechanism then the share of such governments in the expanded provincial divisible pool, consisting both of revenues from provincial taxes plus federal NFC transfers to provinces, would approach 40 to 45 per cent.

If, however, the revenue sharing by local governments with provincial governments is to remain restricted, then the divisible pool will consist of only some or all provincial taxes and the job of the PFCs (like the NFC) would be to specify which provincial taxes should form part of the divisible pool and what the collective share of local governments ought to be in this pool. Given the fact that in this situation the maximum size of the divisible pool will be about Rs 22 billion it is clear that the process of fiscal decentralisation would then have to be largely financed by various grants.

Beyond the issue of the size of the divisible pool, we have the issue of what formula should be used to allocate funds to individual district governments. This is also likely to be a somewhat contentious issue (as is the case for the NFC with regard to the distribution of revenues to individual provinces) and will ultimately have to be resolved by the PFCs. Presently, the NFC has incorporated explicitly only one criterion, that is, population, in the revenue sharing formula and proposed special grants to the two relatively backward provinces, Balochistan and NWFP, as a measure of fiscal equalisation. The question is whether the PFCs can evolve a more complex formula for distribution of revenues to districts based on the use of multiple criteria? If so, what are the potential candidates for use as criteria?

The present revenue sharing between the provinces and local councils is restricted only to the urban immovable property tax with shares of 15 and 85 per cent respectively. Government of Balochistan had proposed a 50 : 50 share in the motor vehicles tax which has probably not yet been implemented. The basis for sharing is *collection or the origin of revenues.* Therefore, this is one valid criterion which can be used in future revenue sharing arrangements, especially if the divisible pool remains restricted only to provincial taxes. However, if the divisible pool is to be extended to include federal divisible pool transfers to the provinces then the allocation of funds to districts on the basis of collection of federal taxes could become an extremely complicated exercise. This is partly the reason why this criterion has not been used for allocating funds to provinces from the federal divisible pool. Perhaps, the recently reconstituted NFC will begin deliberating on the feasibility of including this criterion in the revenue sharing formula for some or all the taxes in the federal divisible pool.

Why is the inclusion of the criterion of collection either at the provincial or local level so difficult, even if it is accepted as a legitimate criterion? The problem is essentially one of <u>apportionment</u>. This is particularly manifest in the case of federal taxes which are levied at the import stage like customs duties, general sales tax and presumptive income tax on imports. In such cases while collection is largely from Karachi port and the dry ports the effective burden of these taxes falls on all jurisdictions where imported goods are consumed. Therefore, sharing on the basis of collection in such cases would lead to a very skewed distribution of the transfers. The apportionment problem also arises in the context of the income tax collected from corporate entities. Collections accrue from head offices of companies which are concentrated in a few locations in the country while profits are effectively realised from sales all over the country. Here again, revenue transfers on the basis of collection would lead to biased allocations. The only taxes which can possibly be shared on the basis of collection are personal income tax, general sales tax on domestic production of goods and services and excise duties. In the case of sales tax excise duties, there could be some concern about the tax exporting of the burden to other jurisdictions. If the criterion of collection is to be used for allocation to districts then it would be necessary to ensure that CBR is able to provide information on collections at the district level. This would require that there be a mapping of the CBR circle, commissionerate and collectorate boundaries to district jurisdictions.

Beyond population, the other criterion that could be used for allocation of revenues to districts from the provincial divisible pool is *pre-devolution expenditure on transferred services.* This would have to be based on the aggregation of district level budgets of provincial line departments performing functions which will be transferred to local governments as part of the devolution plan (see the earlier section on allocation of functions). The merit of inclusion of this criterion is that it will at least partly ensure that districtwise presence of facilities like schools, hospitals, roads, etc., is reflected in funds transferred so that there continues to be the ability to finance the operation of these facilities. Of course, it is likely that this criterion is likely to confer some differential advantage to the more developed districts which are endowed with more public infrastructure and facilities.

Another criterion which ought to be included because it enables a degree of fiscal equalisation is the *extent of backwardness.* The NRB devolution plan has rightly emphasised the need for such transfers in order to reflect the relatively limited fiscal capacity for own revenue generation in the less developed areas. The issues then will be of how fiscal capacity or the level of backwardness is to be measured and how funds for fiscal equalisation should be allocated. There is no tradition in Pakistan of measuring districtwise value added in key sectors like agriculture or manufacturing and available socioeconomic indicators at the district level are few in number and generally out of date. Fortunately, the population census has been conducted recently and a composite indicator of backwardness of districts can be constructed from the census and other data which could include measures like the extent of urbanisation, literacy rate, coverage of potable drinking water, school enrollment rates, etc. As far as allocation of fiscal equalisation funds is concerned, the Indonesian approach, which is simple, may be adopted. Districts within a province which are declared 'backward', on the basis of some criteria, could become eligible for a special grant linked to the size of population.

In summary, the issue of the extent and nature of revenue sharing transfers to finance the fiscal decentralisation to local governments remains a complex issue which will have to be grappled with by the PFCs. Fundamental decisions will have to be taken with regard to, first, whether the divisible pool should remain restricted only to some or all provincial taxes or be extended to include NFC mandated transfers from the federal level to the provinces, second, what the combined share of the district governments should be in this divisible pool, and, third, whether the allocation should be simple and linked only to population or also include other criteria like collection, pre-devolution expenditures on transferred services, level of backwardness, etc. If, in fact, the PFCs opt for a restricted divisible pool consisting only of some or all provincial taxes then grants will have to act as the major mechanism for financing the devolution of functions to local governments. We turn to the issues related to the design of grants in the next section.

8 GRANTS

In the devolution plan the underlying thinking of NRB appears to be somewhat tilted in favour of grants. The question then arises as to which type of grant schemes should be established. Broadly speaking, grants can be classified into three key categories. The first is a *selective or specific grant*. This type of grant is given for a particular purpose or to be spent on a specific service. It is best suited for subsidizing activities considered high priority by the higher level of government but low priority by local governments. However, it has the disadvantage of limiting local autonomy by not allowing the money to be spent according to local preferences. It can also lead to overexpenditure (in relation to local preferences or needs) on subsidized services. The second type of grant is an *unconditional or general grant.* This is like a block transfer to be spent according to local preferences, allowing maximum flexibility to the recipient government. Because it augments local resource availability, this type of grant is like general revenue-sharing transfers. The danger here is that such a transfer induces local governments to underutilise their own tax bases. The third type is a *matching grant* which can be either specific or general purpose and requires local governments to match the funds to some degree. Though this type of grant encourages local resource mobilisation, its biggest disadvantage is that given the greater ability to generate funds, it favours richer jurisdictions and tends to exacerbate prevailing inequities across regions.

A number of criteria have been identified for evaluation of inter-governmental transfers based largely on grants. The first criteria is that of *autonomy*. Ideally, transfers should honor the independence of recepient governments in setting their own priorities. The second criterion is one of *revenue adequacy*. Transfers should be adequate to the extent possible to cover both vertical and horizontal imbalances of local governments. *Equity* is the third criterion, whereby grants should vary directly with fiscal need and inversely with the taxable capacity of a local jurisdiction. The fourth criterion is one of *predictability*. Local governments should be able to forecast the quantum of inflow of funds with reasonable accuracy so that they can plan with some degree at certainty. According to the fifth criterion of *simplicity*, a subnational government's allocation should be based on objective factors over which individual units have little control. In other words, 'grantsmanship' must be discouraged. A grants scheme linked, for example, to the size of revenue deficits runs the risk of creating perverse incentives for raising expenditures and reducing own revenues in order to qualify for larger grants. Therefore, we have the final criterion of *appropriate incentives*, whereby transfers should promote sound fiscal management.

Indonesia represents a useful case study, with regard to the design of grant schemes. In Indonesia, local governments receive *general purpose transfers* which are formula based. District development grants have two components: a minimum grant for each government and a per capita grant. Village development grants of an equal amount are given to each village, while villages in less developed areas get an additional per capita grant. The second type of transfers in Indonesia is *specific purpose transfers* of the non-matching variety. Such grants to local governments are meant to cover establishment costs, road improvement, expenditures on primary schools and health services. Each type of grant is formula based. For example, road improvement grants are linked to length and condition of roads, road density and unit costs.

It appears that Indonesia has developed a simple, transparent and formula-driven grants system which ensures minimum standards of provision at all locations by the incorporation of fiscal equalization criteria. This system can perhaps be replicated in countries like Pakistan where responsibilities are being transferred to local governments. The PFC may develop suitable formulae for specific transfers to defray the operations and maintenance costs of the major services transferred to local governments. Key decisions with regard to the design of such transfers will relate to the desired service standards and the target for local cost recovery from user charges.

The simplest way to build in fiscal equalisation in this regime will be to specify minimum standards of service provision. Local governments in regions which are underserviced can thereby get additional development grants for expansion of such services. Also, as emphasised earlier, it is important that grants to local governments are routed through provincial governments. The only exception, with direct funding by federal government to local governments, could be in the case of special programs like the Prime Minister's / Chief Executive's Mass Literacy Program.

9 BORROWING POWERS

The degree of access to borrowings by subnational governments is one of the key issues in the context of fiscal decentralization. This depends on whether such governments should face a relatively 'hard' budget constraint or not. It is important also in determining whether the process of decentralization is likely to preserve macroeconomic instability or not, depending upon the magnitude of unregulated borrowings by local governments which can hinder the operation, in particular, of monetary policy. The NRB devolution plan has essentially precluded market borrowing in the short run by local governments.

Internationally, local governments generally have limited access to borrowings. In India, for example, state and local governments face a relatively hard budget constraint with severe limitations on direct access to capital markets, both domestic and external. This has spared the country from moral hazard and macroeconomic crisis witnessed in some federated states of Latin America, many of which were triggered by excessive state and local borrowings with implicit central government guarantees.

In Pakistan, provincial governments essentially borrow on a long-term basis, at near market rates, from the federal government and float only limited market loans. Local governments have seldom accessed the capital market in Pakistan. In practice, governments have recourse to running overdraft facilities with the State Bank of Pakistan. While there are well-defined limits imposed on the use of cash balances with the central bank these are frequently violated. The central bank has found it difficult to dishonor cheques issued by subnational governments, which generally involve payment of salaries of government employees, due to the fear of agitation by a large number of people employed by such governments. The prospect of an inevitable *'bail out'* has created a kind of moral hazard problem.

It, therefore, appears that in the interest of preserving macroeconomic stability borrowing powers of the local governments will have to be severely restricted. While access to capital markets is ruled out in the short run, use of overdraft facilities with the banking system should also be tightly regulated. However, a window may be opened for financing remunerative projects at the local level by the establishment of a Municipal Development Fund by provincial governments with near-market rates of interest.

10 ALTERNATIVE SCHEMES OF FISCAL DECENTRALISATION

We are finally in a position to identify on the basis of the discussion in the previous sections different approaches to fiscal decentralisation that can be adopted to finance the functions allocated to local governments in the NRB or Kaiser Bengali devolution plan. It appears that there are basically two approaches which have fundamentally different implications for the financial autonomy of local governments. The first approach is one which maximises local autonomy by reassigning taxes to the extent possible (in terms of whether the tax base is mobile or not) to local governments including possibly some powers to levy surcharges on taxes of higher levels of government and combines this with revenue sharing transfers or block grants which do not impose any conditionalities on the type and level of expenditures by local governments. If revenue sharing transfers is the preferred financing mechanism in this approach then the provincial divisible pool to be shared with district governments will not only have to include most, if not all, provincial taxes but also the funds received as federal transfers to the provinces from the federal divisible pool. A likely ranking of the size of different financing mechanisms in this approach is given in Table 5.

TABLE 5
RANKING[?] OF DIFFERENT TYPES OF FINANCING MECHANISMS[? ?] IN ALTERNATIVE SCHEMES FOR FISCAL DECENTRALISATION

Alternative I *(with greater local fiscal autonomy)*	**Alternative II** *(with less fiscal autonomy)*
1. General Revenue-Sharing Transfers (including fiscal equalisation transfers)	1. Specific Transfers
2. Non-Tax Revenues from Transferred Services	2. Specific Development Grants (including fiscal equalisation transfers)
3. Tax Revenues from Reassigned Taxes	3. Non-Tax Revenues from Transferred Services
	4. General Revenue-Sharing Transfers
	5. Tax Revenues from Reassigned Taxes

? in terms of size
? ? existing tax and non-tax revenues + octroi / zila tax grants are to be used for the O&M and development of existing services

It needs to be recognised, however, that given the unprecedented magnitude of fiscal decentralisation to local governments that is proposed in the devolution plan, which in rupee terms amounts to almost Rs 90 billion, there may be need to properly manage the process of transition to avoid large-scale disruptions in the provision of basic services.

If transfers for increasing the availability of funds with local governments are general in character than it is possible that the pattern of expenditures undertaken by local governments could differ widely from the existing priorities of provincial governments. This is clearly one of the benefits of devolution in that the changed priorities may more accurately reflect the needs and preferences at the local level. But it creates the hazard that there may be expenditure cutbacks in the financing of operations and maintenance of existing facilities and the savings diverted to financing development in areas having higher priority. For example, a city government may decide to reduce allocations for public schools, given the presence of a strong private sector, and use the funds saved for development of trunk infrastructure for, say, water supply and urban transport. This will imply closing down of a number of existing government primary and secondary schools and lead to redundencies in employment. Are we prepared in the short run to let this happen and honor fully the different expenditure preferences of locally elected representatives?

The other diametrically opposed approach to fiscal decentralisation is one which minimises the problems of transition and as indicated in the NRB plan creates financing mechanisms whereby the present district budgets of provincial line departments become, more or less, the budgets of the corresponding departments of local governments following implementation of the devolution plan. This implies that greatest reliance will be placed on specific transfers to finance both current and development expenditures. The consequence will be that in the short run there will be minimal change in expenditure priorities, which will largely ensure that there are no dislocations in the provision of services by the existing infrastructure and facilities. However, it needs to be recognised that this approach essentially preserves the status quo and restricts the flexibility of the newly constituted district governments in influencing the process of economic and social development in their respective jurisdictions.

On the balance, we are inclined to prefer the first approach of ensuring that the nature of fiscal decentralisation is such as to preserve the maximum financial autonomy of local governments. Pakistan is about to embark on a major social and political experiment of carrying decision making and provision of services to the grass roots level through implementation of the bold and ambitious devolution plan. As such, institutional and financial arrangements must be consistent with the enabling the third tier of government to truly manifest itself in terms of catering to the needs of the people and organising the provision of services in a more cost effective and sustainable manner.

11 TERMS OF REFERENCE OF PROVINCIAL FINANCE COMMISSIONS

To ensure financial sustainability and effective operations of local governments in the country following the implementation of the devolution plan, the PFCs will have to study and make recommendations on the following:

(1) Which taxes, that are currently being levied and collected by provincial governments, should be handed over local governments?
(2) Which taxes should be shared between the provincial and the local governments? Specifically, whether the divisible pool should remain restricted only to some or all provincial taxes or be extended to include NFC mandated transfers from the federal government to the provinces?
(3) What should be the respective shares of the provincial and local governments in the divisible pool?
(4) What should be the criteria for distribution of revenues among local governments? Should the allocation be simple and linked only to population or also include other criteria like collection, pre-devolution expenditures on transferred services, level of backwardness, etc.?
(5) To what extent should grants-in-aid be used to finance local expenditures? What type of a grants scheme should be established? Which functions should be financed by grants? What should be the target levels of local cost recovery in different services?
(6) What should be the mechanism of intra-district fiscal transfers?

The PFCs should ideally be staffed by retired members of the higher judiciary, public finance experts and representatives from civil society. In order to avoid any political victimisation of particular local governments through withholding of grants, the Secretariat of the PFCs should be charged with the task of routinely distributing grants on the basis of the prescribed formula to all the district governments within a province. The provincial governments should remit the overall grant in advance on a quarterly basis to the PFCs for onward distribution.

Also, the PFCs will require a districtwise database on which to base their awards. For example, data will be required for each district on local revenues and expenditures, presence of facilities (like schools, RHCs, hospitals, roads, etc), collection of provincial taxes, provincial line department expenditures and non-tax revenues. In addition, to determine the need for fiscal equalisation , other indicators of social and economic development will need to be constructed at the district level.

Compilation of this data should commence on a priority basis as work preparatory to the constitution of the PFCs.

12 CONCLUSIONS

The NRB Devolution Plan involves substantial fiscal decentralisation to local governments, which is unprecedented in the history of Pakistan. Almost Rs 90 billion (equivalent to almost three per cent of GDP) of expenditure will to transferred from provincial to local budgets making them comparable in size and increasing the outlays by local governments to almost four times their present level. This devolution will see the transformation of provincial governments from the role of direct provision to that of financing, regulation and monitoring and the emergence of local governments as the prime delivery agents of services and a key player in the process of regional development. Institutional capacity of local governments will have to be enhanced to perform these functions adequately.

Given the magnitude of fiscal decentralisation, relatively complex financial arrangements will have to be put in place to finance this process. Enhancement of local fiscal powers is expected to make only a minor contribution. The rest of the finances will have to be organised through a system of inter-governmental transfers, ranging from general revenue-sharing mechanisms to specific purpose and fiscal equalisation grants. The mix of these transfers, which will be decided by the PFCs, will depend upon the extent it is proposed to grant local fiscal autonomy. The paper recommends resort to general, unconditional and formula-driven transfers to the extent possible to give the newly formed district governments an opportunity to prove their ability to reflect local needs and preferences better and organise the provision of services in a more cost effective and sustainable manner.

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DEVOLUTION AND FISCAL DECENTRALISATION[?]

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SUMMARY

The NRB Devolution Plan involves substantial fiscal decentralisation to local