

**BUDGETS AND
FISCAL DECENTRALIZATION:
A CASE STUDY OF SINDH**

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1 INTRODUCTION

Government of Sindh (GoS), under the guidance of National Reconstruction Bureau, embarked upon an ambitious programme of fiscal decentralization. The effort has its genesis in the Sindh Local Government Ordinance (SLGO) 2001 and formation of Provincial Finance Commission (PFC). Till June 2002, the SLGO amended three times and as result of these amendments first PFC Award (Interim) has announced in the history of Pakistan. This award has formulated a divisible pool for distribution of resources between the provinces and the districts, prepared benchmarks of revenue and expenditures for the tiers of the governments that are consistent with their respective mandates, determined provincial retained and allocable amounts, developed a fiscal distribution criteria, minimizing inter-regional disparities by means of equalization grants from provincial government to economically weaker districts and to suggest parameters for achieving fiscal discipline.

The process of fiscal decentralization is considered as one of the possible ways to ensure a more efficient and effective public service delivery mechanism. However, welfare gains of decentralization cannot be achieved without proper distribution of revenue and expenditure assignments. Because residents of different districts can choose the mix of public goods and taxes that best conforms to their preferences.

The purpose of this paper is to discuss some basic issues related to fiscal decentralization in Sindh. The paper is essentially exploratory and not definitive in character and seeks primarily to lay down the parameters for the stronger local government role. Possible options for reform of the current design and rigidities of the government are highlighted. Along the way, some of the empirical analyses are presented to illustrate various points. After the introduction, the paper presents an overview of fiscal position of the province in the absence of devolution. The paper then briefly outlines the objectives of decentralization and presents the status of fiscal

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decentralization in Sindh. The paper concludes with some brief closing remarks about the enormity of the task ahead.

2 FISCAL POSITION OF THE PROVINCE

In general, fiscal position of any government can be analyzed through the different indicators in comparison with gross domestic product. However, in Pakistan no data on the provincial gross domestic product is compiled. Therefore, it is not possible to develop a relationship between public revenue and expenditure and the provincial gross domestic product. However based on the crude estimates, Sindh contributes one-third of the national gross domestic product. Its contribution in large-scale manufacturing is 43 percent. Its share in oil production is 62 percent, in production of gas 48 percent, in coal 31 percent and in generation of electricity 39 percent. Most importantly, its contribution to the federal divisible pool of tax revenue is 64 percent.

2.1 Where Does the Money Come From?

Sindh is the highest revenue collecting province of Pakistan. However, most of the buoyant taxes are collected by the federal government and distributed through the 1997 National Finance Commission (NFC) Award. NFC Award (1997-2002), which regulates the allocation of resources between federal and provincial governments, was significant in two ways. It changed the distribution formula from 80/20 to 37.5/62.5 in favor of federal government while at the same time expanding the tax base. It also inflated the projected tax collections and arbitrarily curtailed the provincial expenditures. None of the federal taxes could achieve their targeted growth during the period. The overall shortfall during the period is estimated to be Rs. 1082 billion. Provinces thus received Rs. 379 billion less than the projected revenue during the period. For Sindh, the award was particularly harsh as selection of a low expenditure benchmark impacted the province negatively. Sindh's current expenditure; was subjected to an economy cut of Rs. 5 billion as against an economy cut of Rs. 1.5 billion for Punjab, which is the biggest province of Pakistan. This had a negative impact of Rs. 28 billion on Sindh provincial receipts. The fiscal year 2001-02 was the last year of the award, and the Federal Government constituted the National Finance Commission for fiscal years 2003-07, which failed to make any recommendations and rectify the prevailing position.

The provincial resource picture contains revenues from federal government in the form of federal tax assignment based on 1997 NFC Award, and federal grants of 2.5 percent from the 15 percent GST as compensation for the abolition of O & Z tax. In the coming fiscal year 2002-03, Sindh government expects 11 percent growth in own tax revenues, 20 percent growth in district tax revenues and 11 percent growth in non-tax revenues. In addition, it expects to receive six billion rupees from the World Bank in the form of an IDA loan. The total expected resources for fiscal year 2002-03 is estimated to Rs. 85.9 billion.

Table 1 presents the summary of provincial resources for the year 2002-03 according to the budget estimates. The receipt side of the revenue budget shows that the out of total resources provincial tax and non-tax revenues altogether are only 16 percent, federal tax assignment, O&ZT and other federal grants provide about 55% of provincial government revenues

| TABLE – 1 | | |
|--|---------------------|---------------|
| SINDH GOVERNMENT'S RESOURCE SUMMARY | | |
| <i>(Rs.in Million)</i> | | |
| Heads | BE (2002-03) | |
| | Amount | Share |
| Federal Transfers & Grants | 47,069 | 54.8% |
| Federal Tax Assignment | 37,069 | 43.1% |
| Federal Grants | 10,000 | 11.6% |
| Straight Transfers | 18,847 | 21.9% |
| Provincial Tax Revenues | 9,360 | 10.9% |
| Provincial Non-Tax Revenues | 4,670 | 5.4% |
| Expected IDA Credit | 6,000 | 7.0% |
| TOTAL RESOURCES | 85,947 | 100.0% |

after inclusion of straight transfer the share reach to 76 percent. Another point to flag is the inclusion of IDA credit in the revenue resources. In general, external resources are classified under deficit financing and are the part of revenue resources. However, inclusion of IDA credit in revenue resources might be the out come of the low transfers from federal to provincial government as a result of 1997 NFC Award.

2.2 What Happens to the Money?

Table 2 presents the summary of current revenue expenditures of the Sindh government as per budget estimates for the year 2002-03. The biggest amount is allocated for the social services, which includes education, health and other social services. After the social services organ of state, which is the sum of general administration and law and order, is 29 percent of the total current revenue expenditures. The amount and share of general administration is highest among

the four provinces and one of the weaknesses in the provincial budget structure. This is the outcome of substantial provision of block allocations. The block allocations represent expenditures which have either not been firmed up or which are used as a facade to meet unforeseen expenditures or to protect against unexpected fall in revenues during the year. As annual accounts are neither timely available nor accurate, it is difficult to assess whether these allocations are used for the purposes intended or are simply a hedge against unforeseen events.

Another big category, which requires attention, is the debt servicing payments. Debt servicing is a charged expenditure on the Provincial Consolidated Fund, constituted an important component of provincial expenditure. This is because, in past, Government of Sindh supports its development program through Cash Development Loans (CDL) from the Federal Government. These loans are repayable in equal installments of

| HEAD OF ACCOUNTS | BE (2002-03) | |
|-----------------------------------|---------------------|---------------|
| | Amount | Share |
| General Administration | 15,500 | 18.4% |
| Law and Order | 8,574 | 10.2% |
| Community Services | 2,143 | 2.5% |
| Social Services | 24,861 | 29.6% |
| Education | 18,129 | 21.6% |
| Health | 5,930 | 7.0% |
| Other Social Services | 803 | 1.0% |
| Economic Services | 6,967 | 8.3% |
| Subsidies | 5,610 | 6.7% |
| Total Debt Servicing | 18,335 | 21.8% |
| Other Expenditures | 2,120 | 2.5% |
| TOTAL CURRENT EXPENDITURES | 84,111 | 100.0% |

principal and interest over 25 years including a grace period of 5 years, during which only interest is payable. Government of Sindh borrowed Rs. 52.8 billion; as Cash Development Loans so far, against which it has paid a total of Rs. 82.2 billion (Rs. 72.8 billion interest and Rs. 9.3 billion of principal). An amount of Rs. 43.5 billion is still outstanding.

2.3 Fiscal Ills of the Provincial Economy

There is a long list of fiscal ills of the provincial economy, however, in this paper we present selected issues just to highlight provincial rigidities. In our view transfers of provincial share of taxes as well as straight transfers have a statutory protection. The taxes are collected by the federal government on behalf of the provinces. Federal government has repeatedly made at

source deductions from the share of provincial NFC transfers, on account of WAPDA dues and provincial debt servicing liabilities, by compromising the above protection. As a result, the provincial cash flow faced acute pressures and its overdraft peaked Rs. 10.00 billion plus at one stage. This was despite the fact that WAPDA dues were disputed and the recommendations of Shafi ur Rehman Commission have not been implemented by WAPDA.

Another very important issue is collection of GST on services, especially on provision of electricity, telecommunications and air travel, falls within the constitutional domain of the provincial governments. The Federal Government has however decided to take over the GST function from the provincial governments through an administrative order and has levied federal excise on these services. This has not only deprived the Province of an important source of direct revenue but is also considered by the Province an intrusion into the provincial domain. All the GST revenue (less 2% of collection charge) is distributed among the provinces on the NFC formula basis rather than on collections share basis.

Apart from the rigidities imposed on the provincial financial management due to federal government's actions, Sindh has its own structural rigidities. Sindh's salary related expenditure is substantial; about 60% of its total revenue. The delivery of services cannot become a priority unless this is changed, as no fiscal space can be created until adequate service reforms are initiated. Another important area of attention is high magnitude of debt servicing obligations. However, debt-servicing payments can be considerably reduced if the federal government decides to rationalize the terms and conditions of Cash Development Loans and major part of the structural adjustment credit is utilized for the purpose.

3 FISCAL DECENTRALIZATION

Literature on fiscal decentralization provides a vast list of objectives, which can be achieved through the effective fiscal decentralization and can also be applied in the context of Sindh. We summarized these objective in six broad categories: (1) increase allocative and regional government operational efficiency; (2) meet regional aspirations, improve overall fiscal structure, and mobilize regional and therefore national revenues; (3) enhance accountability, increase transparency, and expand constitutional participation in decision making at the regional level; (4) mitigate fiscal disparities among regional governments and assure the delivery of basic

services of basic public services to citizens across the country; (5) ameliorate social welfare of the country; and (6) support macro-economic stability.

It is understood, of course, that it is not possible to fully achieve all the above objectives, everywhere, all the time. One obvious reason for this is the fact that some of the goals may, in certain instances, be in conflict with one another. However, the above enumeration of fiscal decentralization goals is intended to provide a basis for evaluating the relative success of the implementation of fiscal decentralization programmes. It is too early, of course, to provide a comprehensive and rigorous evaluation of fiscal decentralization in Sindh. Instead, the paper presents a snapshot of the status fiscal decentralization in Sindh as of fiscal year 2002-03.

3.1 Decentralization of Expenditures

Based on the guidelines provided by NRB, Government of Sindh published the list of decentralized departments in the First Schedule of Sindh Local Government Ordinance 2001. According to the Ordinance 31 department or sub department, which previously worked under provincial administration have been decentralized to districts. This is a reallocation of the department and their sub-departments to the district governments. Major reallocations have been made in education and health. In addition, a few new departments have been created such as information technology, district coordination etc.

Table 3 presents the post devolution distribution of expenditures between provincial and local governments. The two important messages emerge from the distribution: (1) 85 percent of the provincial social services are devolved at the district level; and (2) almost 90 percent of the devolve expenditures are salary expenditures. These both messages are very significant and have serious implications for the present and future. For instance, any shortfall in revenues to local government in future largely affect the social services and without any borrowing powers the implications will be much more significant then expected.

The implications of second message is that local governments have only 10 percent of the revenues in their hands, which is insufficient to improve the quality of services because the 90 percent of the salary related expenditures is directly transfer to the employees through a separate account of State Bank of Pakistan. For this purpose, State Bank of Pakistan Account IV has been

established for operating District Funds. The monies are to be transferred from Account I to Account IV, on a cash basis. The funds then become part of the District Fund, any savings at the year-end will not revert back to the province.

| HEAD OF ACCOUNTS | Provincial | | | Total Districts | | |
|---|---------------|---------------|---------------|-----------------|--------------|---------------|
| | Salary | Non-Salary | Total | Salary | Non-Salary | Total |
| General Administration | 932 | 14,060 | 14,993 | 440 | 68 | 508 |
| Share | 67.9% | 99.5% | 96.7% | 32.1% | 0.5% | 3.3% |
| Law and Order | 7,218 | 1,338 | 8,556 | 17 | 1 | 18 |
| Share | 99.8% | 99.9% | 99.8% | 0.2% | 0.1% | 0.2% |
| Community Services | 740 | 484 | 1,225 | 439 | 479 | 918 |
| Share | 62.8% | 50.3% | 57.2% | 37.2% | 49.7% | 42.8% |
| Social Services | 2,509 | 1,243 | 3,752 | 19,227 | 1,882 | 21,109 |
| Share | 11.5% | 39.8% | 15.1% | 88.5% | 60.2% | 84.9% |
| Education | 686 | 379 | 1,065 | 15,879 | 1,184 | 17,064 |
| Share | 4.1% | 24.2% | 5.9% | 95.9% | 75.8% | 94.1% |
| Health | 1,486 | 593 | 2,078 | 3,165 | 686 | 3,851 |
| Share | 31.9% | 46.3% | 35.1% | 68.1% | 53.7% | 64.9% |
| Other Social Services | 338 | 271 | 609 | 183 | 12 | 194 |
| Share | 64.9% | 95.9% | 75.8% | 35.1% | 4.1% | 24.2% |
| Economic Services | 3,059 | 3,061 | 6,119 | 730 | 118 | 848 |
| Share | 80.7% | 96.3% | 87.8% | 19.3% | 3.7% | 12.2% |
| Subsidies | 0 | 5,610 | 5,610 | 0 | 0 | 0 |
| Share | | 100.0% | 100.0% | | 0.0% | 0.0% |
| Debt Servicing | 0 | 18,335 | 18,335 | 0 | 0 | 0 |
| Share | | 100.0% | 100.0% | | 0.0% | 0.0% |
| Other Expenditures | 0 | 2,120 | 2,120 | 0 | 0 | 0 |
| Share | | 100.0% | 100.0% | | 0.0% | 0.0% |
| TOTAL CURRENT REVENUE EXPENDITURES | 14,458 | 46,252 | 60,710 | 20,853 | 2,548 | 23,401 |
| Share | 40.9% | 94.8% | 72.2% | 59.1% | 5.2% | 27.8% |

Contrary to the local governments, almost 95 percent of the non-salary expenditures falls in provincial domain. Moreover, almost 100 percent of non-salary expenditure on general administration still in the hand of provincial government and provide cushion to provincial government for unforeseen expenditure. This kind of cushion is not available to the local governments. In addition provincial government has the facility of access to credit, which can be utilized in the crises, however, such type facility also not available to local governments and they have hard budget constrain.

3.2 *Impact of Devolution on Provincial Resources*

In the absence of new NFC Award, the Government of Sindh established a Provincial Finance Commission in June 2002 in accordance with the third amendment in SLGO 2001. A proper *fiscal* transfer mechanism has been evolved by the PFC in which revenues are predictable and governments have some incentives to levy taxes and user charges, with due regard to long-term economic growth of their communities. The district governments have some flexibility to formulate budgets that reflect local preferences. The transfers are transparent and operate without informal or hidden incentives and deterrents. It, however, provides no flexibility or adjustment mechanism if the actual transfer of revenue is less than the budgeted revenue. The district governments are likely to face serious constraints if the revenue targets are not realistically fixed by the federal government. On the whole, it is a good beginning and it is expected that with passage of time, the institution of district governments would be placed on sound grounds.

Based on the recommendations of PFC, in the first step first, a divisible pool is formulated to the distribution of the resources between provincial and local governments. The provincial divisible pool contains federal tax assignment, straight transfers, federal grants and provincial tax revenues excluding district taxes (property and entertainment taxes). In

the second step, resources are distributed according to the requirements of both tiers of the governments. The share of local government revenues named as provincial allocable amount and the rest is called provincial retained amount. It is recommended that provincial retained amount in provincial divisible pool would be Rs. 38,539 million, 60 percent of provincial divisible pool and provincial allocable would be Rs. 25,692 million, 40 percent of provincial divisible pool.

| Heads | 2002-03 Budget Estimates |
|-----------------------------|-----------------------------|
| Provincial Divisible Pool | 64,231 |
| Provincial Retained Amount | 38,539 |
| Share (%) | 60% |
| Provincial Allocable Amount | 25,692 |
| Share (%) | 40% |

3.3 **Financial Resources of Local Governments**

As a result of the recommendations of PFC Award, the resource picture of provincial and local governments substantially changed. Table 5 presents the financial resources of the local governments. These resources can be divided into four broad categories: (1) local government

taxes (property and entertainment taxes); (2) federal grants (O&ZT grants); (3) non-tax revenues (user charges- education, health and works); and (4) provincial divisible pool transfers. It is also decided in the PFC that during the interim period of three years, local taxes will be collected by the provincial government and transfer to the local government based on collections after deduction of collection charges. According to estimates district governments expect to receive more than 43 percent of revenues excluding IDA Credits.

| TABLE – 5 LOCAL GOVERNMENTS RESOURCES | |
|--|----------------|
| <i>(Million Rs.)</i> | |
| Heads | 2002-03 |
| Straight Transfers (On The Basis of Collection) | 1,045.4 |
| Property Tax | 999.6 |
| Entertainment Tax | 45.8 |
| O&Z Grants | 7,500.0 |
| User Charges (On the Basis of Collection) | 345.6 |
| Education | 195.7 |
| Health | 106.3 |
| Administration (Works) | 43.6 |
| Divisible Pool Transfers (Formula Based) | 25,692.4 |
| Total Transfers & Grants to Districts | 34,583.4 |
| As % of Total Receipts | 40.2% |
| As % of Total Receipts (Excluding IDA Loans) | 43.3% |

3.4 Post Devolution Provincial Fiscal Scenario

Finally, it is important to analyze the impact of vertical distribution of resources on provincial and local government's current revenue budget 2002-03. As a result of the PFC recommendations local governments estimated resources are Rs. 137 million higher than their devolved current expenditures. However, the provincial retained expenditures including Pension and Debt Servicing, for the year 2002-03 is Rs. 52 billion. and the total revenue

| TABLE – 6 PROVINCIAL BUDGET 2002-03 | |
|--|---|
| <i>(Million Rs.)</i> | |
| Heads | 2002-03 Budget Estimates |
| Current Revenue Expenditures | 52,087 |
| Salary | 14,458 |
| Debt Servicing | 11,515 |
| Superannuation and Pension | 6,200 |
| Utilities | 3,000 |
| Other Non-Salary Expenditures | 16,913 |
| Resources | 51,363 |
| Provincial Retained Amount | 38,539 |
| Non-Tax Receipts* | 4,325 |
| Federal Grants | 2,500 |
| Expected IDA Credit | 6,000 |
| Resource Surplus/Deficit | -723 |
| *Excluding transfer to districts | |

resources for the financing of the current revenue expenditures are Rs. 51 billion (see Table - 6) . As a consequence, expected revenue deficit in the fiscal 2002-03 would be Rs. 723 million.

3.5 Horizontal Distribution of Resources

For the distribution of resources among the districts PFC Award recommend a formula based transfer mechanism by using four criteria: (1) population (50); (2) backwardness (17.5); (3) tax collection; and (4) transitional transfers. These criteria synchronize with the basic economic principles such as: the districts with larger population have a larger public services infrastructure, which requires greater resources to maintain; the districts with proportionately greater extent of under development need proportionately greater resources to overcome absolute deprivation and relative inequality; the districts with greater contribution in provincial exchequer must get some incentives for more collection and should provide better services. In addition in order to link the expenditure needs with the fiscal transfers, the expenditures have been proposed to finance through the transitional transfers for filling the fiscal gap. These transfers subsequently will be replaced by other criteria.

3.6 Implications of PFC Award on District's Budgets

Finally, this section provides the analysis about the impact of recommended formula on districts budget 2002-03 (only decentralized departments). Table 7 presents the aggregated budget of the district governments. The estimated expenditures of the district governments are Rs. 25.9 billion and estimated fiscal transfers are Rs. 26 billion, which provides an additional amount Rs. 137 million. This amount is insufficient to make a big change in the services delivery mechanism and remove district government's rigidities, however, it is good beginning if these additional resources properly transfers to the district governments.

| TABLE - 7 | |
|---|-------------------|
| DISTRICT'S BUDGET COMBINED 2002-03 | |
| <i>(Rs. In Million)</i> | |
| Heads | BE 2002-03 |
| Current Revenue Expenditures | |
| Salary Expenditures | 20,853 |
| Utilities | 2,500 |
| Other Non-Salary Expenditures | 2,548 |
| Total Current Revenue Expenditures | 25,901 |
| Straight Transfers / User Charges | |
| Education | 196 |
| Health | 106 |
| Administration (Works) | 44 |
| Total Straight Transfers | 346 |
| Divisible Pool Transfers Based on: | |
| Population (50.0%) | 12,846 |
| Backwardness (17.5%) | 4,496 |
| Tax Collection (7.5%) | 1,927 |
| Transitional Transfers (25.0%) | 6,423 |
| Total Divisible Pool Transfers | 25,692 |
| Resource Surplus/Deficit | 137 |

4 CONCLUSION AND POLICY IMPLICATIONS

The rigidities in the existing budget allocations for the district governments (over-dependence on the federal/provincial government for resource generation, narrow base of own resources, a major chunk of resources going towards establishment charges whose efficiency, competence and integrity is doubtful and inadequate resources for maintenance and creation of assets) are, however, overpowering and allow very little fiscal space to the district governments to undertake meaningful reforms and development initiatives. Of these rigidities, two issues; centralization of resource generation and service reforms; are crucial. Unless these are adequately addressed, the new tier of governance is likely to become unresponsive to the needs of the people.

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