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|  | New fiscal federalismTHE NEWS June 25, 2012 |  |
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|  | **By Dr Ishrat Husain** |  |
|  | Most of the pre- and post-budget seminars, TV shows and discussions, and public discourse this year focused exclusively on the federal budget. Past traditions are hard to break but the new realities in our face should wake us up.http://magazine.thenews.com.pk/upload_image/10/2854_6-25-2012_1.jpgThe 7th NFC award and the 18th amendment to the constitution have brought about a fundamental structural change in the fiscal affairs of Pakistan. The federal government is no longer the main driver of fiscal policy. Power and resources have shifted, rightly so, to the provinces. The share of the federal government in the net proceeds of the divisible pool has come down to 42.5 percent while that of the provinces has gone up to 57.5 percent. Adding straight transfers, grants/ subventions and development loans to the provinces pushes this share further up.In the last four years, the total outlay of the provincial governments has risen from almost Rs1,000 billion to Rs1,800 billion – an increase of 80 percent. Almost 89 percent of this amount has been financed by the federal transfers, which have almost tripled from Rs.520 billion to Rs.1545 billion. Only 11 percent has been raised by the provincial governments from their own revenues – tax and non-tax. In 2007-08, the provinces’ own contribution to the total outlay was 15 percent. How has this increase in federal transfers affected the pattern of expenditures? The share of development expenditure in total expenditure has declined from 34.5 percent to 33.3 percent while that of current expenditure has risen from 65.6 percent to 66.7 percent.It was widely believed that as the provinces spend most of their money on education, health, drinking water, agriculture & irrigation, the ordinary citizen would benefit from this transfer of resources from the federal to the provincial governments. Preliminary estimates show that this assumption has not proved to be true. Punjab has allocated only six percent of the total outlay while Khyber Pakhtunkhwa seven percent for health and education. Only Sindh has increased the allocations this year.The devolution process remains incomplete as the functions, authority and resources have not been delegated to the district governments. As there is an administrative vacuum at the district level, most of the financial resources that were accruing to the districts are now retained by the provincial governments.While the provinces are now quite flush with resources that are derived from the divisible pool, the federal government is stuck in a difficult fiscal situation. As most of the rigid and inflexible expenditures such as debt servicing, defence, civil armed forces and subsidies fall upon the federal government, it faces financing problems in the face of a declining share in the overall tax pool. The growing fiscal deficit cannot be brought under control because of the asymmetry in the assignment of revenues and location of responsibility for expenditure. The financing of the fiscal deficit by borrowing from the State Bank of Pakistan has kept inflation high. Macro-economic stability remains elusive, investor uncertainty prevails and growth is subdued. We have to recognize the new realities of fiscal federalism for Pakistan. Attention and policy objectives have to shift from the federal to the provincial governments. Institutional arrangements of the past are no longer adequate to respond to the challenges of the future. New institutional arrangements and policy changes have to be put in place. What are these?First, the present practice of budget formulation by the federal and provincial governments in isolation has to be replaced by an integrated budgetary framework prepared, discussed and debated at the Council of Common Interests (CII) and approved by the National Economic Council (NEC). The federal and provincial governments will have to formulate their budgets within the parameters approved by the NEC. Sanctions should be put in place for violations, breaches and deviations. However, the provinces should be allowed to exceed the NEC-approved parameters if they raise additional revenues from their own sources. Second, a new fiscal responsibility law should be enacted by each province in which the limits for fiscal deficit/ surplus, revenue mobilisation and expenditure on development should be imposed. If the allocation for the provinces from the divisible pool rises or provinces make an extra tax effort, the incremental resources should be earmarked for development projects or for education and health. Provinces have to generate budgetary surpluses in order to offset the deficit of the federal government.Third, the provincial governments should not be allowed powers to borrow from the domestic capital markets or financial institutions. Foreign loans for development projects and foreign grants should be channeled through the federal government and conform to the NEC-approved national plan and annual budget. The advances of the SBP should be strictly used for smoothing cash flow problems rather than as additional financing for the budget or non-budget expenditure. Fourth, responsibilities for education up to matric, primary healthcare, rural health centers, tehsil and district hospitals, drinking water, sanitation and sewerage, agriculture and community development should reside at the district level and should be administered by the elected local governments. The provincial finance commissions should be revived to divide the revenues between the provincial and district governments. Backward districts and rural areas should be given higher weightage in the allocation of resources.Fifth, education, health, police and the judiciary should be taken out of the purview of the national pay scales as they have created rigidities and distortions and reinforced income disparities between the advanced and backward districts. A female science teacher employed at Mithi or Kandhkot should earn a higher salary than the one in Karachi or Hyderabad. Similarly, doctors, nurses and paramedics serving in remote and inaccessible areas deserve much higher compensation than those living in cities.Sixth, tax effort by the provinces has slackened after the 7th NFC Award. Incentives have to be built in the 8th NFC award by giving weightage to the tax effort by the provinces. Urban immoveable property tax, agriculture income tax, abiana and GST on services are some very obvious avenues for additional revenue mobilisation by the provinces. Rough estimates show that, if designed properly and implemented faithfully, the provinces can raise at least two percent of the GDP.International experience has shown that if fiscal federalism is not tackled in a responsible manner, it can create serious economic dislocations and disruptions. Argentina and Brazil had suffered from hyperinflation due to the fiscal profligacy of state governments. The institutional and legal arrangements had to be redrawn to overcome this problem and since then checks and balances have worked well. China had to rework the federation-province tax arrangements, which have now provided adequate fiscal space to the federal government. Presently, Spain is facing the consequences of fiscal excesses of strong regional governments. Domestic and international markets are punishing Spain by either withholding credit or raising the price of credit to levels that may make Spain insolvent. We may be at the beginning of the path towards a similar precipice and ought to take preventive measures at this stage and retreat from this dangerous path. The writer is the dean of the IBA and a former SBP governor. |  |
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