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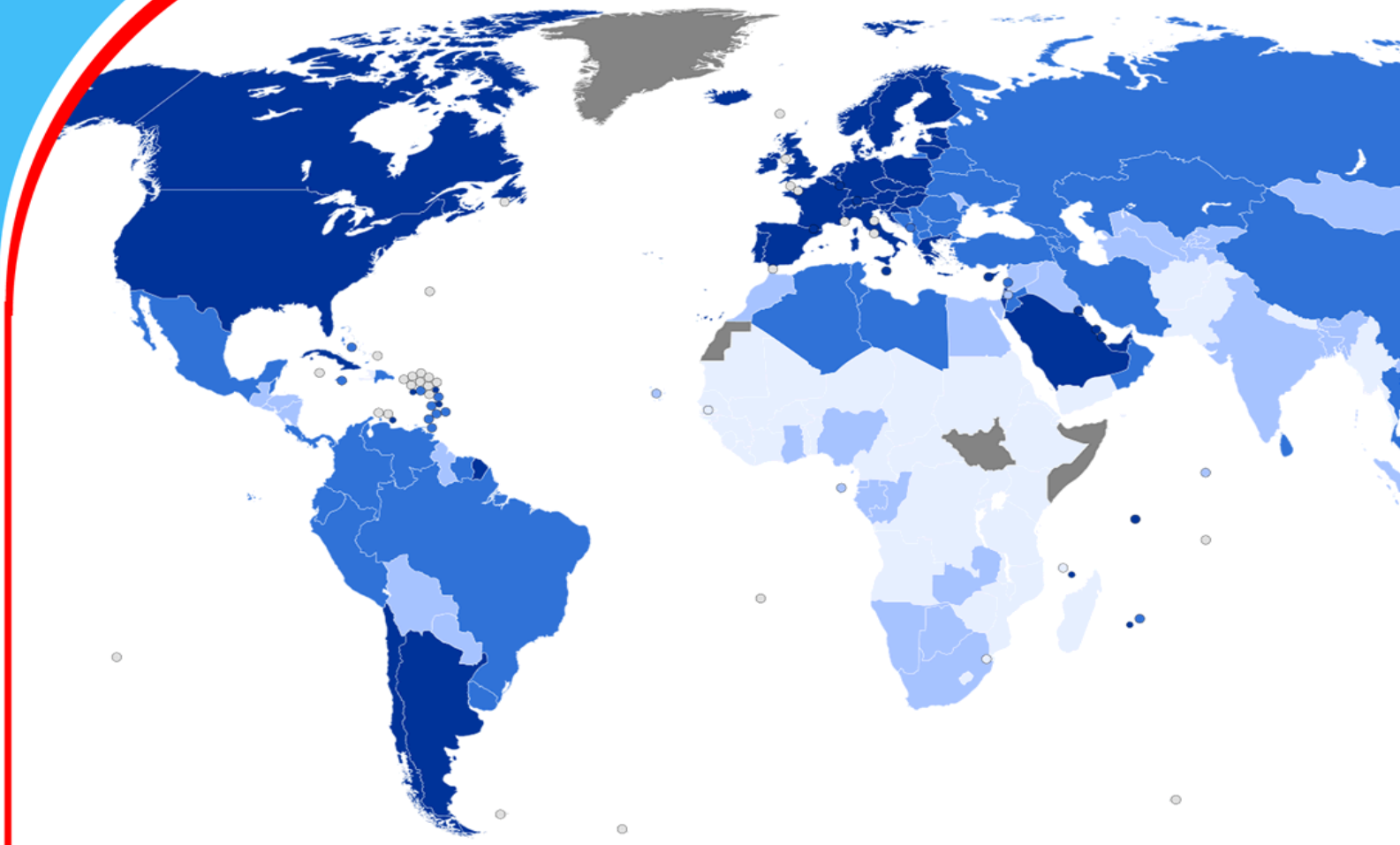

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The Dialectical Nature of Economic Growth and Fiscal Decentralization: The Story of Pakistan

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Abstract

Purpose: This current study aims at finding a connection between fiscal decentralization and the growth of the economy in Pakistan. This paper looked at the different iterations of the National Finance Commission and Riesman award as the two attempts at the distribution of finances to the provinces from the federal government.

Methodology: For the study, Ordinary Least Square (OLS) method with the Engel-Granger co-integration test was applied.

Findings: The results showed that in the longer run, both the desired variables were significant i.e. the ratio of revenue by the provinces to federal revenue, and the transfer of revenue to the provinces was statistically significant and impact the economic growth positively. In the short-run model, the variable of transfer to provinces was statistically insignificant and did not favor decentralization, while the second variable ratio of tax revenue by the provinces to federal tax revenue was statistically significant. This shows that there is potential in the idea of monetary decentralization in Pakistan, but only if it is designed for the long run, not as a short-term fix.

Recommendation: The analysis shows that decentralization shows a significant impact on economic growth in case of Pakistan and the research suggested that the policy should be design for long run rather than short run.

Keywords: *Fiscal Decentralization; Economic Growth; National Finance Commission; Federal Tax; Pakistan*

1.0 INTRODUCTION

Decentralization or devolution is a phenomenon where resources are pooled and authorities are delivered from upper tiers of government to local tiers. This distribution provides a chance to provincial government units to prove their efficiency and take an active part in the growth process of the economy by contributing their share. The decentralization phenomenon doesn't mean only the transfer from federal to provincial it may also handle the allocation of rights from provincial to local government level, such devolution is called Horizontal decentralization. Decentralization is an important measure that ensures the effectiveness of government at the provincial level. On one side it enables the provincial government to play an active part for the growth of the economy, and at the same time, it capacitates the national government to fulfill the national tasks effectively and efficiently. Economic decentralization can help in better targeting and can eliminate the needless actions of the national governments. In the words of Bird and Smart (2002), "*for services to be effectively provided, those receiving transfers need a clear mandate, adequate resources, and sufficient flexibility to make decisions*". Decentralization is the process through which the resources as well as responsibilities from national to sub-national governments, are transferred (Rondinelli, 1981). Thus, by decentralization, the national government gives power to the sub-national governments in such a way that can help in better utilization of resources. The decentralization approach affects growth positively.

Pakistan is a federal country which has a centralized tax system. The federal government collects the revenues and reallocates it among provinces to ensure equal distribution through NFC (National Finance Commission). But due to lack of transparency, this formula has failed to solve the issue of equal distribution as well as the issue of horizontal and vertical imbalance. From the federal government, resources are pooled towards the provinces to ensure fair distribution in different government times, but due to lack of skills and inadequacy of performances, decentralization didn't accelerate the growth of the economy over the longer period. The present study aims was to identify the impacts as well as the drawbacks of fiscal decentralization. And to identify those economic variables that are responsible for decentralization.

2.0 LITERATURE REVIEW

Decentralization and its effects on economic growth are discussed and various studies are found in analyzing decentralization impacts in developing and in developed countries. Lin and Liu (2000) found that fiscal decentralization has positive impacts on economic growth in China's provinces. They used the data of 28 provinces of China from the years 1970 to 1993. They found that fiscal amendments played a key role in the impressive growth of China. Akai and Masayo (2002) take the data of the United States and find a positive association between decentralization and economic growth. Data from 50 states were taken. They used four indicators i.e. production indicator, revenue indicator, production-revenue indicator & autonomy indicator, and evaluated positive relationship. Another research was done by Mello and Bernstein (2001) who used the cross country data for 78 countries from 1980-92. The study found that as the share ratio of funds, non-tax revenues, grants and federal transfer growths in the total sub-national revenues, the association between decentralization and governance became stronger.

But contrary to the above results there also exists an inverse relationship between economic growth and decentralization. Davoodi and Zou (1998) explained the relationship between fiscal decentralization and economic growth. For experimental testing, they used panel data for 46

countries from the years 1970 to 1989. For the case of developing countries, an inverse association was found between fiscal decentralization and economic growth. Zhang and Zou (1998) highlighted the impact of decentralization in China. They found a negative association. They focused that usually there exists a positive relationship but in case of china central government is constrained by limited resources for public investment such as railroads, highways power station, etc. such infrastructure proved developing and enhanced the growth then provincial

Kalirajan and keijiro analyzed decentralization in India. Data related to the social infrastructure and development of the rural side was taken. Studies revealed a negative relationship. The government of India with a federal framework showed an increasing rate of development. Particularly in the area of health, science, and education. Phillips and Woller (1997) conducted the association between fiscal decentralization and economic growth for the sample of 17 developed countries and 23 countries lower down the development index for the period from 1974 to 1991. For the developed countries they noted that weak but significantly, an inverse relationship exists between fiscal decentralization and economic growth. However, they failed to provide evidence for the relationship between the two variables in the case of countries lower down the development index.

In the case of Pakistan, there is a strong influence on the government setup. As of right now, there are three sub-levels of government i.e. federal (national), provincial, and the local (district) governments. At all levels, there always remain the problems of resource allocation. According to Jaffery and Sadaqat (2006), there are four stages of resource allocation. At first, there is the National Finance Commission (NFC) award that decides the revenue allocation between the federal and provincial governments. Secondly, the Provincial Finance Commission (PFC) delegates resources from provincial to local tiers. Following this in the third stage, transfers are made from the federal to local levels and finally, vertical resource distribution occurs at local levels i.e. from District Government to Municipal Tehsil Administration. Before Pakistan there was:

2.1 Niemeyer Award

According to the 1935 Act of United India, provinces. According to this award, sales tax was to be levied and collected by the provincial governments. From income tax, half of the tax collected was to be reallocated to the provinces. After 1947, when Pakistan came into being, the same arrangements were kept in place till March 1952, although some alterations were made in the railway budget and the sharing of sales and income tax (Government of Pakistan, 1991).

2.2 The Riesman Award

The Riesman award was put forward in December 1947. The Riesman award financed the poor sectors of the national government. Half of the sales tax was allocated to the federal government. Provinces were allocated the other half of income tax, out of which 45 percent was associated to East Pakistan while the rest was divided among the provinces of Punjab, Sindh, NWFP, Bahawalpur, Khairpur, Baluchistan states union and a residual 5% was grated to others respectively (Government of Pakistan, 1991). During the operational period of the Riesman award, in the year 1955, all the four provinces of West Pakistan were merged and declared by the government as a single unit. Hence, after 1955 the whole country was having two parts only i.e. East Pakistan and West Pakistan. In April of 1970, for the first time, a committee was chosen to work under the federal finance minister and give suggestions for Intergovernmental resource

distribution. The committee suggested that resource dispersal between the federal and provincial governments should be 20:80 percent, respectively. In 1973, the new constitution of Pakistan was settled upon by the National Assembly and applied. In the new constitution, special provisions were made to make the resource distribution mechanism smoother and more acceptable. According to the constitution of 1973, it was the duty of the federal government to constitute the NFC after every five years. The finance commission was authorized to review & to give proposals for the resource distribution device in Pakistan. Hence an effort was made to make sure that a fair resource distribution occurred.

2.3 The first NFC Award 1974

The first NFC was set up under the constitution of 1974. Under the charge of this commission, the distribution was all about only income tax, sales tax, and the export duty on cotton. For resource distribution horizontally among the provinces, the population was taken as the only criterion for among the provinces. Considering the population as the sole criterion for revenue allocation, the share of Punjab increased up to 60.25 percent of the total. But the other provinces hurt negatively from this division.

2.4 The 2nd NFC Award 1979

The second iteration of the NFC Award was done during the government of President General Zia-ul-Haq, in the year 1979. Hence the revenue allocation was revised & the share grated to the provinces announced under the 1979 NFC award is shown in the table 1.

Table 1: Revenue allocation

Punjab	Sindh	KPK	Baluchistan
57.97	23.34	13.39	5.30

Source: Economic Survey of Pakistan.

2.5 The Third NFC Award 1985

This iteration of the NFC award was not able to recommend any improvements to the previous distribution setup. The resources kept on being distributed just like the 1974 NFC award with the revised provincial distribution of the population.

2.6 The fourth NFC Award 1991

The fourth iteration of the NFC was formed in 1990 by the government of Mian Nawaz Sharif. The commission provided its recommendations in April 1991. This iteration of the award was considered successful as it gave positive results on the economy. Thus, according to the 1991 NFC award, the horizontal revenue share of the provinces reflected growth from 28 percent to 45 percent of the tax revenues. The resources were allocated among the provinces according to their population size, as presented in the table 2.

Table 2: How provincial share were awared in 1991

Punjab	Sindh	KPK	Baluchistan
57.88	23.28	13.54	5.30

Source: Economic Survey of Pakistan

2.7 The 5th NFC Award 1997

This NFC award contained all other taxes that were levied by the national government. It was made up of income tax, wealth tax, sales tax, export duties, custom duties, and royalties

2.8 The 6th NFC Award 2000

The sixth NFC Award was conducted during the government of General Pervaiz Musharraf. According to this award, it was decided that a 45%share will be granted to provinces but there was a conflict between the demand & supply because provinces were asking 50% of share hence this award was completed but without success.

2.9 The 7th NFC Award 2006

As the 6th NFC Award didn't bring the desired results hence the Chief Ministers of all the provinces entrusted the authority to the President for declaring an acceptable and just monetary resource distribution formula. Hence, President General Pervez Musharraf amended the "Distribution of Revenues and Grants-in-Aid Order, 1997" by issuing the Ordinance No. 1 of 2006. then growth rate increased up-to 14.2%). In this award, the share of provinces was kept higher than the share of the federal.

In brief, the history of NFC Awards indicates that they are not very successful as mixed results are found in different governments' time. But mostly results showed a negative relation of delegated powers & economic growth in the scenario of Pakistan.

2.10 18th Amendment

The most recent step towards decentralization is a reform in the constitution of Pakistan during the tenure of President Asif Ali Zardari. Amendment was passed on April 08, 2010, by the National assembly of Pakistan. According to that, the president dissolved his powers to the Prime Minister. The amendment was passed by the Pakistani Senate on April 15, 2010, and it became an act of parliament when signed by President Asif Ali Zardari on April 19, 2010. It was the first time in Pakistan's history that a president abdicated from a substantial part of his powers willingly and handed over those powers to the parliament.

2.11 Empirical evidence

In the case of Pakistan, history depicts a negative relation of decentralization with the growth of the economy. In the education field, a step was taken by the government to dissolve the Higher Education Commission of Pakistan. The federal institute providing funds, grants, scholarships & all the educational incentives devolved to each provincial level. It proved negatively for the case of Pakistan. Atta-ur-Rahman (former chairperson) and others objected & condemned this devolution plan because according to decentralization the funds would be transferred to provinces & would not be allocated properly. From the background history, the step towards dissolving HEC

was putting a negative impact on the education sector of Pakistan. That is why the Supreme Court of Pakistan took notice of this "Devolution Plan". And this is not yet properly implemented.

3.0 DATA AND METHODOLOGY

To evaluate the association between economic growth and fiscal decentralization, data from secondary sources were utilized. The economic growth of the country the dependent variable in this study. Per capita real gross domestic product (GDP) is utilized as a measure of economic growth. Variable is expressed in real terms to imitate the real behavior of economic growth over time. The data for variables have been picked from the World Development Indicator and Economic Survey of Pakistan.

To measure the effect that decentralization has on the economy, the revenue approach is used. Lars et al. (2004) used the same to measure the effect of decentralization on local tiers of government. The more the revenues of the government levels below the national government, the higher will be the degree of monetary decentralization. In this paper, two variables are responsible for revenue assignments. The first is the ratio of provincial tax revenue to federal tax revenue and the second is 'FEDERAL transfers to provinces.' These variables determine provincial governments' taxation power as well as the actual behavior of transfers. Data for these have been taken from the Pakistan Economic Survey, as well as from the 'Hand-Book of Statistics on Pakistan Economy' (2005)'. Investment is taken here as Gross Fixed Capital Formation and the data for this is picked from World Development Indicator.to add to that, a measure of trade openness is also used. This variable is demarcated by adding the imports and exports and then divided them on GDP. Data on imports and exports are taken from World Development Indicator.

Regression Model

For the paper, Ordinary Least Square (OLS) model of Davoodi and Zou (1998) is used. It is the most expounded model which determines the impact of monetary decentralization on the growth of the economy. According to their model, the production function has dual inputs i.e. public and capital spending. Keeping in view the state of Pakistan, over time public spending is done by the two government tiers, national and provincial. Given all the variables which influence the economic growth, the final regression equation is as;

$$\boldsymbol{lnGDP_{pc} = \beta_0 + \beta_1 lnFDT_{Province} + \beta_3 lnPrR_{FR} + \beta_4 Trade_{openess} + \beta_5 GFC + \varepsilon_0 \ldots\ldots (1)}$$

Where;

$lnGDP_{pc}$ is the log of real per capita gross domestic product (GDP), $lnFDT_{Province}$ is the log federal transfer to the province, $lnPrR_{FR}$ is the log of revenue of provinces as a ratio of federal revenue, $Trade_{openess}$ is the trade openness and GFC is the gross fixed capital creation (as a %age of GDP).

Engel-Granger Test for Co-integration

In 1981, Granger put forth the idea of linkages between the non-stationary data series in the long-run. They posited a four-step method to evaluate the existence of a long-run association between the variables of the same order. In the first step, all the variables are examined to solve the issue of stationarity. For this purpose, Dicky-Filler (DF), Augmented Dicky Filler (ADF), or Phillips

Perron (PP) test can be utilized, depending upon the data's nature. Once the data become stationary we proceed to Co-integration techniques.

In the next step, the long-run association is assessed by regressing the dependent variable on the set of independent variables therefore the residual series of the said regression is gotten which is then used for checking the existence of a long-run relationship among the variables. In step three, the existence of the long-run association is observed. At this step the regression error term is studied for unit root test if the error term becomes stationary at level then it means that dependent and independent variables are co-integrated and long-run association is present. As the final step, once the long-run association establishes, the error correction model is valued.

4.0 RESULT ANALYSIS

First of all, the ADF test is conducted results for unit root are discussed. Whenever the ADF test statistic is greater than the critical value, the variable becomes stationary at level. If stationarity is not achieved at level then further proceed to the first difference and second difference test. The dependent variable i.e. GDP has a unit root at level but attains stationarity at first difference

Table 3: ADF unit roots test for ln GDP

ADF Test Statistic	-4.6196	1%	Critical Value*	-3.691
		5%	Critical Value	-2.980
		10%	Critical Value	-2.613

Source: Author's calculations

Similarly, the next variable i.e. federal transfer to provinces have a unit root at level but become stationary at first difference as:

Table 4: ADF unit roots test for lnFDTprovice

ADF Test Statistic	-3.430500	1%	Critical Value*	-3.691
		5%	Critical Value	-2.980
		10%	Critical Value	-2.613

Source: Author's calculations

The other variable i.e. ration of provincial revenue to federal revenue also attained stationarity at first difference as:

Table 5: ADF unit roots test for LnPRfr

ADF Test Statistic	-2.931842	1%	Critical Value*	-3.691
		5%	Critical Value	-2.980
		10%	Critical Value	-2.613

The other variables i.e. trade openness and gross fixed capital formation are stationary at level. Their results are given respectively:

Table 6: ADF test of unit root for Trade openness:

ADF Test Statistic	-4.445	1% Critical Value*	-3.691
		5%Critical Value	-2.980
		10%Critical Value	-2.613

Table 7: ADF test of unit root for GFC

ADF Test Statistic	-3.739879	1%	Critical Value*	-3.691
		5%	Critical Value	-2.980
		10%	Critical Value	-2.613

Source: Author's calculations

As all the variables have achieved the stationarity, we then follow step two of Engle model here we regress our dependent variable on all independent variable series. The results are as follow: In step three of the Engle-granger test, we take the residual test and apply the unit root test on it. The residuals are stationary at a level that reflects that variables are co-integrated and have a long-run relationship.

Table 8: ADF unit root test for residuals

ADF test statistics	-3 .938196	1% critical value	-3.691
		5% critical value	-2.980
		10% critical value	-2.613

Source: Author's calculations

Short Run Analysis

For the short-run analysis, we apply the Error Correction model. In this model lags of a dependent as well as independent and residual series are regressed. The result of the model is given below.

Table 9: Short-run analysis

Dependent Variable: D(LNGDPPC(-2))				
obs:	28 adjusted			
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.034608	0.068768	-0.503250	0.6198
D(lnfdtrtpv(-2))	0.034789	0.064086	0.542844	0.5927
D(lnratpvtfd(-2))	0.817438	0.384418	2.126428	0.0449

Tradopns(-2)	-0.000390	0.000519	-0.751119	0.4605
Gfc(-2)	0.002353	0.004120	0.571112	0.5737
E(-2)	0.979667	0.228803	4.281716	0.0003
R-squared	0.491318	Mean dependent var.		0.021429
Adjusted R-squared	0.375709	S.D. dependent var.		0.041786
S.E. of regression	0.033016	Akaike info criterion		-3.796262
Sum squared resid.	0.023981	Schwarz criterion		-3.510790
Log-likelihood	59.14767	F-statistic		4.249813
Durbin-Watson stat	1.980041	Prob.(F-statistic)		0.007431

Source: Author's calculations

Contrary to the long-run analysis the results of the short-run are quite different. In the short run, the first and important variable (federal transfer to provinces) is statistically insignificant. This reflects that in short-run federal transfer payments to provinces are not favoring decentralization. The second important variable (ratio of provincial tax revenue to federal tax revenue) is significant. Hence the result reflects that both in short and long-run analyses this ratio shows the positive impact on decentralization. The rest of the independent variables i.e. trade openness and Gross Fixed Capital Formation is statistically insignificant in the short-run case. Another important variable in the error correction model is lagged in the error term. The error term is significant. This equation contains both the influences of short-run analysis as well as long-run analysis. Its coefficients reflect the adjustment behavior as well as the time frame for the adjustment of disequilibrium, which is two years.

Long-Run Analysis

Once the necessary condition is satisfied, the estimated regression can be interpreted for a long-run relationship. Results obtained to determine the situation of Pakistan under decentralization. The first variable that is of prime importance is (ratio of provincial revenue to federal revenue), is statistically significant and has a positive sign. This indicates that over the long run, there is a positive relationship between the ratio of provincial tax to federal tax revenue and the per capita GDP. The second important variable (transfer to provinces) is also highly significant according to the above results. The relation shows that over time this transfer has increased and the positive sign shows that it is good to provide share to the provinces. Hence above two important variables have supported decentralization in the long-run.

Table 10: Regression results

Dependent Variable: lnGDPpc				
Obs:	31			
Variable	Coefficient	Std. Error	t-statistic	Prob.
C	7.708793	0.121750	63.31682	0.0000
Lnfdtrtpv	0.036626	0.031483	1.163341	0.2553
Lnratpvtfd	0.864379	0.124309	6.953476	0.0000
Gfc	-0.000857	0.003557	-0.240966	0.8115
Tradopns	-0.000300	0.000470	-0.638699	0.5286
R-squared	0.974387	Mean dependent var.		10.12903
Adjusted R-squared	0.970447	S.D. dependent var.		0.184740
S.E. of regression	0.031759	Akaike info criterion		-3.914603
Sum squared resid.	0.026224	Schwarz criterion		-3.683315
Log likelihood	65.67635	F-statistic		247.2796
Durbin-Watson stat	1.744020	Prob. (F-statistic)		0.000000

Source: Author's calculations

Apart from these variables, other explanatory variables didn't yield a good result. Trade openness posed a very insignificant impact on growth over the long run. Another variable that is Gross Fixed Capital Formation (a proxy of investment) showed a highly insignificant result in the long-run. One reason for such a result might be the non-productive use of investment.

5.0 DISCUSSION

This research aims to find the correlation between fiscal decentralization and economic growth. The research shows that Pakistan has seen a negative relationship between economic growth and decentralization. The results have shown that the ratio of provincial tax revenue to federal tax revenue both in short and long-run analyses has shown to have a positive impact on decentralization. The other important variable that is the ratio of provincial revenue to federal revenue showed positive results in the long run analysis and negative results in the short-run analysis. This is in keeping with the literature cited which said that decentralization in developing and underdeveloped countries has been shown to have a negative impact on economic growth. This shows that if the decentralization set up in Pakistan is planned out and managed in a careful and simply better way it has the potential of increasing Pakistan's economic growth. Furthermore, these results build upon the literature cited which discusses that decentralization is not a sure-fire way towards economic growth and success. It is an economic tool and must be seen and used like that. It must be supplemented with and by economic strategies that enhance its effects and allow it to be a success. Hurdles such as political red tape and internal disputes between provinces should not stand in the way of implementation of such schemes, which our analysis has shown, have the potential to improve Pakistan's economic growth in the long run.

Fiscal decentralization has shown to have a positive impact on economic growth as Akai and Masayo (2002) showed that in the U.S, all fifty states showed a positive relationship between economic growth and decentralization. This coupled with the research done by Mello and Bernstein (2001) showed that the effect of decentralization, whether positive or negative has an association with the governance and economic state of the country. Pakistan is a developing country and has been in that state for almost the entirety of its existence and this can be attributed to the failure and negative impact of decentralization on the country's economic growth so far. Steps such as dissolving a central authority organization in the education sector to divulge the matters of the field to the provinces have been met with failure and resistance from within the political and judicial bodies.

One of the hurdles in the implementation of any form of decentralization in Pakistan is the number of hoops that have to be jumped through to allocate resources to the local governments. Firstly, the national finance Commission Besides how much money goes to the provincial governments then the provincial government decides the resource allocation to local and district governments then this money is transferred from the federal do the district tier of government. It is at this point that the district government receives the fund. This process takes a lot of time in getting the money through to the district governments where it is needed, this time can be reduced add the system made more streamlined if the economy is decentralized. This would allow the funds will be available faster and two fewer steps Google bodyguards in the current format that Pakistan employs the revenue is shared equally between the federal and the provincial governments

The literature shows that the attempts at decentralization in Pakistan have not been successful, this can be down to poor administration and planning of the rollout of the program. The administrative faults combined with the complicated way in which the funds are allocated to the local governments have been the key reason for the failures of such programs. This research implies that decentralization programs if better planned out for the long haul can have positive impacts. Thus far the attempts have been for the short term and this has also contributed to the lack of planning and the eventual failure. The limitations of this research were that Pakistan has been a federal first country since its formation and there has been a reluctance up until the 18th amendment to forgo that power. This has meant that there has been a reluctance to attempt complete fiscal decentralization. Future researchers should focus on the impacts of decentralization on countries that are underdeveloped as opposed to the focus that has been on developing and developed countries.

6.0 CONCLUSION

In the case of Pakistan, resource distribution between federal and provincial has always remained as a complex issue. That is the one reason for the failure of the NFC Awards in Pakistan. Secondly in decentralization, when authority is given to local tiers then there is a need for more efficiency, transparency, and regular flow of funds to increase economic development. Decentralization is not a phenomenon which when implemented might bring growth to the economy. Instead, it is an economical tool which if used carefully, properly and efficiently then brings desire results. In worldwide trends, many countries accelerated growth with decentralization and there are also many countries whose growth is hidden in their 'centralized' mechanism. In the case of Pakistan, whenever decentralization is implemented, in the beginning, it gave positive results but with time due to inefficiency, this phenomenon proved negatively (as in the above results of the short-run

and long-run). So, for the better results government should not only give a properly planned devolution phenomenon but also keep check and balance on it over time to time.

7.0 POLICY RECOMMENDATION

The analysis shows that decentralization shows a significant impact on economic growth in case of Pakistan and the research suggested that the policy should be design for long run rather than short run.

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