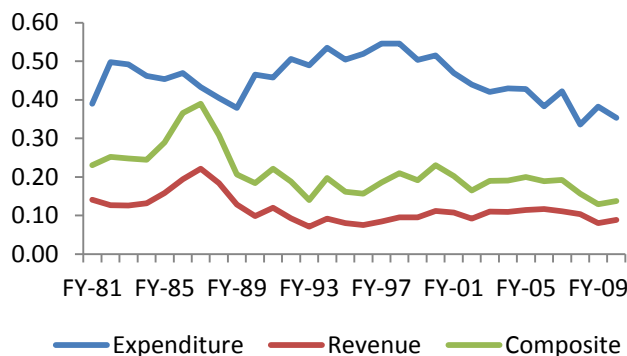


## Strengthening of institutional democracy is a pre requisite for achieving the goals of fiscal decentralisation

Government of Pakistan has undertaken two major developments by signing the 7<sup>th</sup> National Finance Commission (NFC) award and by passing 18<sup>th</sup> Constitutional Amendment. These developments would cause a fundamental shift in the division of powers between the centre and the provinces. The latter would have more autonomy in performing various functions like the provision of public goods and services, and macroeconomic management. Since role of democratic institutions in explaining growth effects of fiscal decentralization is very imperative thus it is a big question that if Pakistan, with a weak institutional framework, attain its objective of bringing prosperity to Pakistani people through fiscal decentralization (FD).

The endogenous growth framework is used to analyze the growth effects of FD. Empirical analysis is based on time series data covering the period 1972-2010. GMM estimation technique is used for estimation which overcomes problems of endogeneity and omitted variable bias. Figure 1 shows that share of provincial government revenue in total government revenue ranges from 10 to 25 percent, while share of provincial government expenditure in total government expenditure ranges from 30 to 60 percent during the last three decades. The share of composition of revenue and expenditure decentralization ranges from 13 to 40 percent in the last three decades

**Figure 1**  
*Decentralization in Pakistan*



The empirical analysis shows that revenue decentralization is growth enhancing in Pakistan. Decentralization of revenue generation produces positive externalities which boosts growth of the country. On the other hand, it is found that expenditure decentralization has a negative association with the growth. This is mainly due to the low institutional quality which may increase the corruption level and make public officials less accountable. Lack of human and physical infrastructure may also lead to inefficient outcome of

expenditure decentralization in Pakistan. Composite decentralization also has a positive association with growth mainly due to the positive effect of revenue decentralization. This implies that if Pakistan focuses simultaneously on both types of decentralization then it will be helpful in boosting growth. Further analysis reveal that FD becomes effective in the growth process if it is complemented with good quality institutions. It is observed that the interaction of expenditure decentralization and revenue decentralization with democratic institutions has a positive impact on economic growth. Thus expenditure decentralisation will not have fruitful effects unless it is complimented with good institutions. Following policy implications emerge from this study:

- The process of fiscal decentralization especially revenue decentralization is beneficial for the economy of Pakistan. To achieve long term economic growth, revenue decentralization should be better streamlined through making the provinces more reliant on their own resources. The positive association of revenue decentralization with economic growth has an important implication for the design of fiscal decentralization in Pakistan. The benefits of fiscal decentralization can only accrue when provincial governments have a real fiscal autonomy, adequate accountability and sufficient capacity to respond to the local requirements.
- Expenditure decentralization can only be effective when the provinces have sufficient administrative capacity and are made accountable and transparent through good institutions. The expenditure decentralization can make a positive contribution to economic growth if steps are taken to improve the administrative capacity of the provincial governments. This requires initiating programs that provide technical and administrative skills to the public officials at provincial level. These programs are more likely to enhance the spending management skills of the provincial governments.
- The present initiatives undertaken by the government in strengthening the provinces through providing more autonomy and resources have a clear implication for Pakistan's long term economic prosperity and macroeconomic stability. However, the outcome of these reforms crucially depends upon the institutional framework of the country. Strengthening of institutional democracy is a pre-requisite for achieving the goals of fiscal decentralization.

Iqbal, N., M-Din, and E. Ghani (2013), "Fiscal Decentralization and Economic Growth: Role of Democratic Institutions", PIDE Working Paper (forthcoming)