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**AN ANALYSIS OF THE IMPACT OF FISCAL DECENTRALIZATION (FD) ON BUDGET DEFICIT IN PAKISTAN**

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**ABSTRACT**

The purpose of this paper is to empirically analyze the impact of fiscal decentralization on budget deficit. Applying the Engle Granger two step co-integration approach, it is found that both revenue and expenditure decentralization have significant impacts on budget deficit. To strengthen this finding two extra models were developed for both the measures of FD and each one were taken separately for analyzing its impacts over budget deficit and the final results of both the model support the results of the parental model. The other variables GDP and trade deficit also have significant impacts over budget deficit in the study period.

**KEYWORDS**

Fiscal Decentralization, Expenditure, Revenue, Budget deficit, Engle Granger.

**INTRODUCTION**

Since the last few decades the Fiscal Decentralization (FD) catches a significant attention throughout the world. Most of the countries around the world transfer their responsibilities from central governments to the local governments as it is viewed that because the local governments have the better knowledge of their localities and are in a position to launch that kind of policies through which economic growth of the locality in general and of the overall country in particular can be enhance. Also it is viewed that by devolving the decision making responsibilities to the local governments are helpful to boost up the efficiency of the government and bring transparency in the government affairs as monitoring of the local governments are in the hands of the local inhabitants. Another positive aspect of the transformation of the financial powers to lower tier governments is that that these governments are helpful to increase tax collection because these governments are more attached with the local community. Because of these benefits of fiscal decentralization it can be expected that this (fiscal decentralization) will also help to minimize the budget deficit of a country. Till to date this assumption regarding the relationship between fiscal decentralization and budget deficit is ignored at all except the single attempt that have been made by Billin Neyapti who find the positive impacts of fiscal decentralization over budget deficit in cross countries case.

Economic growth is the prime objective of each and every country in the world and fiscal decentralization, as stated earlier, help to achieve that objectives so nowadays whether it is developing or developed country transfer their decision to the local/lower governments. Government of Pakistan also looking forward for economic development and for that she also followed the same path, attempted to decentralize its financial decision. Different devolution plans have been launched in various era's and for the resource redistribution amongst the provinces National Finance Commission was formulated in 1974, (although it is a controversial/debatable issue amongst the provinces), so that the resources once collected can be redistributed according to the specified formula.

The current study will focus on to empirically analyze the impacts of Fiscal decentralization and budget deficit in respect of the Pakistan economy. Fiscal decentralization impacts is taken with both revenue and expenditure decentralization in combined and also individually so that to strengthen the findings of the study. This study is different from the study of Billin Neyapti as it take a country specific case while Neyapti conducted a cross countries study on the said subject.

The rest of the paper is organized as following! Section two consist of the brief history of the attempts made by Pakistan in respect of fiscal decentralization and the fiscal trends of Pakistan economy, the third section highlight the literature on fiscal decentralization, Data and Methodology employed in the study is discuss in the fourth section of the paper and before references there is regression analysis and conclusion of the study.

**FISCAL DECENTRALIZATION AND BUDGET DEFICIT TRENDS IN PAKISTAN**

Islamic republic of Pakistan is a democratic country whose matters are guided by 1973 Constitution. National Assembly and the Senate make the Parliament of Pakistan. The constitution differentiates between the duties of the provincial and federal government. Federal government has to address defence, foreign policy, currency, debt services etc. while the provincial governments concern with roads, tourism, culture, youth etc. To run these affairs both governments need financing and for that purpose a special finance commission is established whose major function is to redistribute the financial resources between the federal and provinces and amongst the provinces. This finance commission is called National Finance Commission (NFC).

NFC Award is constituted in article 160(1) of 1973 constitution (Annex I) and proposed to be held at intervals of five years. (Iftikhar Ahmad et al 2007). It is the distribution of financial resources among the provinces of Pakistan by the federal government on annual basis. Certain types of taxes collected in each province are pooled, and then redistributed according to the NFC formula. What taxes to include in the distribution pool and the distribution formula is a subject of debate. Pakistan has had seven NFC awards formulas for the redistribution of resources. A very brief description is presented here for understanding the pattern of the resource redistribution.

In 1974 first NFC award were launched and in this fewer taxes like income tax, sales tax and export duty, were included in the divisible pool. The population was taken as criteria for resource redistribution. The share of federal was 20% and of provinces was 80%. The provincial share was distributed as, Punjab 60.25%, Sindh 22.50%, KPK 13.39%, Balochistan 3.8%. (NFC report 1991).

In 1979 another award formula was set under the chairmanship of Ghulam Ishaq Khan who was a federal minister at that time. Because this committee never met so at that time the 1974 award formula was followed for resource redistribution. In 1981 a population census were conducted and this change the proportion of population and now the share of each province were, Punjab 57.97%, KPK 13.39%, Sindh 23.34%, and Balochistan 5.30%. (Gov. of Pak. 2006).

In 1985, under the chairmanship of Dr. Mehboob-ul-Haq, a new committee was formed for resource redistribution. This committee failed to bore any fruits, so for resource redistribution the 1974 formula was followed.

During the Nawaz regime, a committee was formed for the same purpose under the chairmanship of Sirtaj Aziz. In this award customs duties remained in the hands of federal governments while all other taxes and duties were with provinces. The share of federal Gov. was 20% and of provincial share was 80%. (Ghaus and Pasha 1994). The share of provinces was, Punjab 57.88%, Sindh 23.28%, KPK 13.54%, and Balochistan 05.30%. (NFC report 1991).

In Feb. 1997 an award formula was presented. This time the chairman of the committee for award formula was Shahid Javid Burki. Under this award all the taxes and duties were included in divisible pool. Upto certain limits the matching grants were introduced and decided that if any province revenue growth exceeds 14.2%, they will be provided matching grants. The share of the provinces under this award formula was, Punjab 57.88%, Sindh 23.28%, KPK 13.54%, and Balochistan 05.30%. (Government of Pakistan Report 1996).

Under the chairmanship of Shaukat Aziz an award committee was formulated on July 22nd, 2000. Because there was lack of common consensus amongst the provinces so after 11 meetings no final suggestion were recommended. At that time the provinces demanded for 50% share. Therefore no further progress has been made until 2005 when a new committee was set to give an acceptable formula for resource redistribution. Here as well there was no common consensus. Finally the authority was given to the president who announces it and says that this award formula will be affected from July 1st, 2006. According to this award the provincial share were, Punjab 57.36%, Sindh 23.71%, KPK 13.82%, and Balochistan 05.11%.

Today the award distributions are under the formula which was launched in Lahore under the chairmanship of finance minister Shaukat Tarin. Under this award formula the provincial share of divisible pool increased from 47.5% to 56% in first financial year of the award (2010-11) and 57.55 in remaining years of the award. Also in this award the tax change is reduced from 5% to 1%. The provincial shares under this award formula are, Punjab 51.74%, Sindh 24.55%, KPK 14.62% and Balochistan 09.09%.

Award formulas↓ / provinces share→	Punjab	Sindh	KPK	Balochistan
1	60.25%	22.50%	13.39%	3.8%
2	57.97%	23.34%	13.39%	5.30%
3	57.97%	23.34%	13.39%	5.30%
4	57.88%	23.28%	13.54%	5.30%
5	57.88%	23.28%	13.54%	5.30%
6	57.36%	23.71%	13.82%	5.11%
7	51.74%	24.55%	14.62%	9.09%

## FISCAL TRENDS IN PAKISTAN

For the economic growth of a country the importance of a sustainable fiscal performance cannot be denied. The poor fiscal performance is problematic for the economy and can leads to slowing down the growth of the economy. Pakistan, being a developing country always looking forward for enhancing economic growth and to minimize the gap that occur between the expenditures of the government and revenues that she collect. The economic survey of Pakistan (2007-2008) report that since the last seven years the poor fiscal performance of the economy was not taken seriously and where the reforms were demanded to be launched, these were delayed and this led the policy makers to a fix in the period of fiscal year 2008-2009 thus it became a challenging job for the rest of the period. But the positive thing about this year (2008-2009) was that here the fiscal deficit declined to 4.3% as a %age of GDP. This mainly happens in 2008-2009 because the subsidies on oil were reduced and the developmental spending was reduced to some extent.

There are two sides of balancing the budget in Pakistan and these are the expenditure side and revenue side. The expenditure can further be divided into developmental expenditure and current expenditure. Similarly the revenue can also be divided into tax and non tax revenue. By looking at the performance of Pakistan economy it can be noted that in 1990-1991 the total expenditures as a %age of GDP were 25.7% while in 2008-2009 these were reduced to 18.6% as a %age of GDP. While the current expenditure share in the total expenditures in 1990-1991 was 19.2% and till 1999 the trend was increasing of the share of current expenditure in total expenditure and then in 2005 this share reduced to 13.3% as a percentage of GDP and again in 2008-2009 increased to 15.8% as a percentage of GDP. On the other hand the developmental expenditure also showed decreasing trend and in the period from 1992 to 2001 these reduced to 1.7% in 2001 from 5.7%. In the next five years it again jumped to 4.2% in 2006. While in 2008-2009 the share of developmental expenditure in the total expenditure is 2.8%.

The performance of the total revenue is also not very much different from the performance of the expenditures. In 1990-1991 the total revenue were 16.9% as a %age of GDP which till 1996 showed increasing trend and reach to 17.9 % and then start declining and in 2001 touch the lowest side of 13.1%. After that again start increasing trend and in 2008-2009 it jumped to 14.6%. amongst the total revenue the share of the tax revenue in these total was 12.7% in 1990-1991 and 11.3% in 2008-2009 while the share of non tax revenue in total revenue were 4.2% in 1990-1991 and 3.8% in 2008-2009.

As stated earlier that the sustainability in the fiscal performance is good for overall health of the economy but the dilemma with the developing countries is that they have a creeping fiscal performance on one hand and on the other how to fuel in this weak fiscal performance is another problem. Pakistan is one of those countries who had a persistent deficit in its fiscal performance. Over the last twenty or so years this showed a mix up trend and was high in 1990-1991 and were at lowest side in 2004 and then again increased to 4.3% in 2008-2009 which was 2.3% as a %age of GDP in 2004.

## LITERATURE REVIEW

With respect to this particular subject "impacts of fiscal decentralization on budget deficit" only a single study is conducted by Bilin Neyapti. She cover the period from 1980-1998 for sixteen countries and took the panel data for all these countries. The finding of the study shows that with increase in the size of population the fiscal disciplining effects of fiscal decentralization also increased. Further her study suggest that if there is no local elections then the fiscal decentralization is more effective and with ethno-linguistic diversification and with quality governance the expenditure decentralization is less beneficial in the sample countries.

In most of the cases the fiscal decentralization impacts are investigated with respect to both revenue and expenditure devolution. It is viewed that the transformation of expenditure responsibilities help to increase the delivery of public service goods in case where the country is heterogeneous because in such cases the local governments are in a more suitable position to deliver and help the local inhabitants. Adam et al (2008) investigated the public service delivery in case of OECD countries while Kyriacou and Sagues (2009) said the government efficiency with respect to fiscal decentralization can be better judged when we take the institutional framework and developmental level of the country.

Zhang (2006) and Bouton et al, (2008), divert the attention towards the draw backs associated with the fiscal decentralization. They are of the view that because local government's tax base is limited therefore they are not in a position to fully utilize/use in favor the present tax bases. In some cases there are legal limitations over borrowing of the local governments therefore their debt management capabilities are restricted/limited. Now because the local governments have limited revenue capabilities therefore they also have less autonomy with respect to expenditure responsibilities. Thus the fiscal differences increased considerably. Finally these authors are of the view that in the absence of the central redistributive system, the income distribution is unequal in cases where there is the variance in the revenue bases.



Amongst most of the researchers the expenditure decentralization is not favored because of the following drawbacks associated with expenditure decentralization; 1- because the local governments do not have the institutional framework and also they lack administrative know how therefore the cost with respect to information and coordination is much higher than the central government. 2- These governments while supplying the public goods and services do not have economies of scale as compared to the central government. 3- if there is no local accountability then the expenditure decentralization may leads to corruption in the society and divide the society into rich and poor where the favors will always for the rich. 4- Implementation of the macroeconomic policies became difficult.

On the bases of the above stated arguments the literature investigated the effectiveness of fiscal decentralization moves in both direction, in favor and against, as far as its role to improve the fiscal efficiency of the government is concerned. Tanzi (2000) suggest that to improve the performance of fiscal decentralization following factors such as country total size, revenue generation abilities of the local government, privatization capabilities of the economy, government transparency, and the administrative abilities and capabilities of the local governments, must be take in mind. Fleinkman and Pleakanov in 2005 study the Russian economy and they noted that in Russia decentralization have negative impacts and suggest that in those regions where the incentives has been distorted by decentralization a more higher degree of intraregional decentralization is needed.

With respect to the cross countries studies conducting on investigating the impacts of fiscal decentralization, De Mello (2000), noted the following factors that have positively impacts of fiscal decentralization and these factors are, citizen's cooperation, people confidence over government, etc. De Mello and Barenstein (2001) are of the view that if the non tax revenue collection is greater than the relationship between governance and local spending will be stronger. Fisman and Gatti (2002) while conducting their study they found that expenditure decentralization has negative impacts over corruption. Treisman (2000) while studying the same variables finds that there is no significant relationship between expenditure decentralization and corruption. Based on the case of China, Chen (2004) studying the decentralization phenomenon with respect to revenue decentralization in China finds that there is positive relationship between the revenue decentralization and corruption.

The country specific literature that have been carried on the impacts of fiscal decentralization, in most of the cases are inconclusive, e.g. Hope (2000), Barrett (2000), Lin and Liu (2000), Dethier (2000), Norris et al. (2000), Eaton (2001), Faguet (2001), Feltenstein and Iwata (2005), Neyapti (2005),.

## DATA AND METHODOLOGY

To analyze the impacts of fiscal decentralization on budget deficit annual time series data is used. The study period is taken from 1979 to 2009. The data for the study is taken from the various issues of Economic Survey of Pakistan and a handbook of statistics published in 2005 by the State Bank of Pakistan.

In this study the Engle- Granger two step approach for cointegration (1987) is used to check the long run relationship between fiscal decentralization and budget deficit. Before going to estimate the data it is necessary to check the order of integration of the variables. When this became clear that each variable have the same order of integration then the study will be proceeds to investigate the long run relationship amongst the variables. For unit root purpose both Augmented Dicky Fuller (ADF) and Phillips Perron (PP) tests were used. It was observed that at level all the variables were non-stationary but after taking the first difference these became stationary and thus we conclude that all the variables are integrated of order one or I(1). Now we are in a position to apply the Engle Granger cointegration approach. According to this approach if there is same order of integration of the variables then the first step to find (estimate) the long run relationship between the variables under study is, to apply the Ordinary Least Square method and save the residuals. In the second step of the saved residuals the unit root property has to be checked and if there is no unit root in the saved residuals that mean that there is long run relationship between the variables and so the null hypothesis is rejected.

Here in this study the budget deficit is used as a dependent variable while fiscal decentralization is measure with respect to both revenue and expenditure assignment. Our decentralization variables are

GEXP: Total central government expenditure;

PEXP: Total provincial expenditure less defence expenditures and payment of interest on debt;

GREV: Total central government revenue, and

PR: Total provincial revenue less grants-in-aid to total government revenues

According to Phillips and Woller (1997), the use of the PEXP and PR as a two straight forward measures of fiscal decentralization sometimes mislead. At the time when local taxes, tax rates and tax bases are established by the central government then in such cases confusion is natural. Also it leads into a fix when the provincial expenditures are exercised by the central government or when the grants in aid are used for specific purpose and also when we account the defence expenditures. All these are the difficulties associated with the measuring fiscal decentralization but as all of them cannot be addressed here, therefore we make only two adjustments to our FD measures which are suggested by Wasylenko (1987). We subtract the defence and debt expenditures from total expenditures to calculate the provincial expenditures and the second adjustment is regarding with the calculation of the provincial revenue where we subtract the grants in aid to calculate the ratio of provincial revenue. Our basic model is;

$$BD = \alpha_1 + \beta_0(GEXP) + \beta_1(GREV) + \beta_2(GDPfc) + \beta_3(TD) + \beta_4(PR) + \beta_5(PEXP) + U_t$$

The GDP is used for economic growth and TD is the trade deficit in our model.

While our model to capture the impacts of expenditure decentralization on budget deficit is

$$BD = \alpha_1 + \beta_1(GEXP) + \beta_2(GDPfc) + \beta_3(TD) + \beta_4(PEXP) + U_t$$

and for revenue decentralization we develop the following model;

$$BD = \alpha_1 + \beta_1(GREV) + \beta_2(GDPfc) + \beta_3(TD) + \beta_4(PR) + U_t$$

## RESULTS AND DISCUSSION

### (i) Test for order of Integration

In the first step we check the order of integration as the pre-condition for Engle Granger co-integration is that the variables must have the same order of integration otherwise this will not be applied. For this purpose both Augmented Dicky Fuller (ADF) test and Phillips Perron (PP) test are used in the study. The results of ADF and PP test at level and at first difference of the variables are given below.

TABLE 1: ADF AND PP TESTS AT LEVEL AND FIRST DIFFERENCE

variable	ADF test				PP test			
	intercept	Prob.	Trend & intercept	Prob.	intercept	Prob.	Trend & intercept	Prob.
BD	-1.77170	0.3866	-3.65998	0.0413	-1.50479	0.5175	-3.77823	0.0321
DBD	-7.13365	0.0000	-6.9885	0.0000	-7.2801	0.0000	-7.12039	0.0000
GEXP	4.19057	1.0000	1.55431 -3.69568	1.0000	7.88354	1.0000	2.34659	1.0000
DGEXP	-2.85513	0.0063		0.0038	-2.85037	0.0063	-3.56196	0.0051
GREV	4.17246	1.0000	1.85799	1.0000	6.43995	1.0000	2.22948	1.0000
DGREV	3.19396	0.0030	-4.37658	0.0086	-3.27962	0.0025	-4.41811	0.0078
GDP	12.2077	1.0000	8.17479	1.0000	12.2077	1.0000	8.23600	1.0000
DGDP	3.10684	0.0001	1.65132	0.0003	7.31274	0.0005	7.31372	0.0005
TD	3.01173	1.0000	1.39045	0.9999	3.53870	1.0000	1.77572	1.0000
DTD	-3.71885	0.0091	-4.72926	0.0037	-3.86704	0.0063	-4.90671	0.0024
PR	4.47652	1.0000	0.19296	0.9968	4.36651	1.0000	0.14136	0.9963
DPR	-2.74777	0.0089	-4.28825	0.0010	-2.6115	0.0012	-4.0127	0.0012
PEXP	-1.93454	0.3128	-1.77576	0.6912	1.88869	0.3328	-1.81378	0.6728
DPEXP	-7.34860	0.0000	-7.49941	0.0000	-7.37614	0.0000	-7.57097	0.0000

Note: all the variables are significant at 1% level of significance; hence they have the same order of integration.

(ii) Regression Analysis:

From the above table 1 it is clear that our model is quite suitable to apply Engle Granger cointegration technique over it as all the variables have the same order of integration i.e. I(1). When we apply the OLS at level over our model the following results were obtained.

$$BD = \alpha_1 + \beta_0 (GEXP) + \beta_1 (GREV) + \beta_2 (GDPfc) + \beta_3 (TD) + \beta_4 (PR) + \beta_5 (PEXP) + Ut$$

$$BD = 0.16 - 1.0 GEXP + 1.0 (GREV) - 8.16 (GDPfc) - 3.0 (TD) - 4.46 (PR) + 6.21 (PEXP)$$

$$t\text{-stat: } (0.8579) (-4.2347) (2.8091) (-0.0296) (-0.1538) (-0.6211) (0.2609)$$

$$R^2 = .976$$

$$F\text{-stat. } 2.86$$

$$\text{Adj. } R^2 = .979$$

$$\text{Prob (F-stat) } = 0.0000$$

$$\text{Durbin - Watson Stat. } 2.156$$

Now we saved the residuals of the estimated model and then check these residuals for their order of integration. In case if these saved residuals integrated at level i.e. I(0), then we have what we looking for, the long run relationship between our variables. Results are displayed in the table below.

variable	ADF test				PP test			
	intercept	Prob.	Trend & intercept	Prob.	intercept	Prob.	Trend & intercept	Prob.
residuals	-5.74817	0.0000	-5.64967	0.0000	-5.91218	0.0000	-5.78962	0.0000

Note: the saved residuals are significant at 1% level of significance and is integrated of I(0).

It is clear from the above table that there is no unit root in the saved residuals and the saved residuals are integrated at level or I(0) so we can conclude that in the long run the fiscal decentralization have its impacts on budget deficit.

Also an attempt has been made to investigate individually the relationship of our fiscal decentralization measure with budget deficit. First we present the expenditure decentralization impacts over budget deficit and then there will be the results of our estimation showing the relationship between revenue decentralization and budget deficit. The model which was estimated to investigate the impacts of expenditure decentralization on budget deficit is;

$$BD = \alpha_1 + \beta_1 (GE) + \beta_2 (GDPfc) + \beta_3 (TD) + \beta_4 (PE) + Ut$$

Here the GE and PE are the central and provincial government expenditures respectively. As we know earlier that our variables of the study are I(1), therefore we have to estimate them at level and not going for checking the order of integration again. After regressing the variables at level by applying the OLS technique we saved the residuals and then went for checking the unit property of the saved residuals and note that there is no unit root in our residuals at level and thus these are I(0), which mean that individually the expenditure decentralization also affect budget deficit in the long run in case of Pakistan economy. The results of the saved residuals to check the unit root property is pasted in the below table.

variable	ADF test				PP test			
	intercept	Prob.	Trend & intercept	Prob.	intercept	Prob.	Trend & intercept	Prob.
residual	-5.24741	0.0002	-5.15891	0.0001	-7.28522	0.0000	-7.23057	0.0000

Note: the saved residuals are significant at 1% level of significance and is integrated of I(0).

Once we have noted that expenditure decentralization, in the long run have some effects on budget deficit, then it seems necessary to check the same effects of revenue decentralization in the long run. For that purpose we develop a new model which is;

$$BD = \alpha_1 + \beta_1 (GR) + \beta_2 (GDPfc) + \beta_3 (TD) + \beta_4 (PR) + Ut$$

GR and PR are the central and provincial government revenues. From our below table of the Residuals checking for unit root, it can be noted that here the results are same as that were in case of expenditure decentralization, a long relationship is found between revenue decentralization and budget deficit.

variable	ADF test				PP test			
	intercept	Prob.	Trend & intercept	Prob.	intercept	Prob.	Trend & intercept	Prob.
residual	-4.24546	0.0024	-4.17397	0.001	-4.24546	0.0024	-4.17397	0.001

Note: the saved residuals are significant at 1% level of significance and is integrated of I(0).

### CONCLUSION

This study is an extension in the literature to analyze the impacts of fiscal decentralization on macroeconomic variables. Very rare literature is found over the relationship between fiscal decentralization and macroeconomic variables. In respect of the budget deficit and fiscal decentralization relationship it is the first study where the focus is on a specific country. In the current study an attempt has been made to investigate the relationship between the two by applying Engle Granger two step cointegration Approach. Two separate models, other than the main model, were developed for the study so that to check and better analyze the phenomenon that which type of decentralization can be helpful to minimize the budget deficit and the results of the study showed that in the long run both type of decentralization have a significant impacts over budget deficit and both are helpful to minimize the budget deficit. While the other variables GDP and trade deficit also have a valuable impacts over budget deficit.

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