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The Triad of Governance, Devolution, and National Prosperity

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PREAMBLE

I am privileged to have the opportunity to speak to this august audience of distinguished development economists very briefly, on what I have called the ‘Triad of Governance, Devolution and National Prosperity’. This, triad, I believe, lies at the heart of what constitutes the theme of this conference, namely ‘Institutional Change, Growth and Poverty’.

The National Reconstruction Bureau which I was privileged to create and lead for all the three years of General Musharraf’s tenure as Chief Executive of Pakistan, was meant to transtate into reality the vision we crystallised for addressing the persistent failure of the institutions of state to provide solutions to the ever growing political, administrative, financial, judicial and social problems that the people of Pakistan faced since independence. The vision was *‘Reconstruction of the Institutions of State for Establishing Genuine and Sustainable Democracy to ensure Durable Good Governance for an Irreversible Transfer of Power to the People of Pakistan as soon as possible’*.

I will first give you a fleeting birds eye view of the wide spectrum over which our National Reconstruction endeavour in pursuit of this vision was spread. In the second part of this talk, which will contain the core of what I want to put across today, I will talk about financial devolution of the state. The third part of my talk will deal briefly with the burning issue of what we should do for turning our common citizens’ poverty into prosperity.

POLITICAL AND ADMINISTRATIVE DEVOLUTION

In the first part of my talk let me take you back four years to when General Parvez Musharraf assumed control, and on 14th October 1999 gave out the structure of his government which was to be headed by a National Security Council that was to have a think tank to assist it. I was asked by General Musharraf to head this think tank and I made two proposals to him. The first was that the think tank be named the

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National Reconstruction Bureau. And second that, since Pakistan had come to the sorry pass at which it then stood principally because of the failure of the political, administrative, financial and judicial institutions of state to provide good governance to the people, we should focus on the reconstruction of the institutions of state to establish a genuine and sustainable democracy which could deliver good governance to the people of Pakistan on a durable basis, and thus close the doors to military interventions permanently. It was a vision to replace the colonial governance structures and systems prevailing in the country from bottom to top so as to enable the citizens, the nation and the State to prosper and flourish in the emerging environment of the 21st Century.

Consequently, on 16th November 1999, the NSC, headed by General Parvez Musharraf, approved the name of the think tank, its mission of '*Formulating, National Policy and Strategy Options for Approval by the NSC*'. And in pursuit of the Chief Executive's 7-Point Agenda, the NSC also approved nine '*Fields of Focus*' proposed by me, to orient the NRB's effort. A strategic plan to begin the effort in the first phase, with establishing a new empowered Local Government System across all the nine fields of focus, and to deal with devolution from the Federal to the Provincial level in the second phase preparatory to elections in the third phase was also approved.

You are aware that to replace the previous ineffective system of Local Bodies, a new Local Government System based on politically, administratively and financially empowered Local Governments was established between December 2000 and August 2001, and by Allah's grace, it is functioning. This was done by eliminating the colonial structure and system of rulership of the people directly by the bureaucracy led by commissioners at the division, district and sub-division levels. With the Executive Magistracy eliminated, criminal justice was transferred entirely to Judicial Magistrates, and the judicial arm of the state thus stood separated from the executive arm. The colonial Police Act 1861 was replaced by a new police law in August 2002, to transform the police from a purely coercive arm of the state into a people-friendly instrument controlled by the people, for providing policing service to the citizens as well as the state, to protect both against unlawful conduct. All this was supported by decentralisation of the judicial authority of *habeas corpus* from the High Courts to the District and Sessions Courts, and the establishment of Small Claims and Minor Offences Courts.

The second set of efforts of the NRB which bore fruit were at the very top—the political system. First, a new Political Parties Act, to replace the outmoded and heavily mutilated 1962 Act, was promulgated. This requires the political parties to practice internal democracy and federalism in order to qualify for the award of an election symbol for contesting an election. And second, the Legal Framework Order, which contained amendments to the Constitution in three areas, viz., Democratic Framework, Federalism, and Check and Balance measures, was promulgated prior to

the elections. This document was finally passed by the Parliament as a constitutional amendment, with minor changes, in December 2003.

A large number of changes in the Constitution that were considered necessary for further strengthening democracy, federalism and governance did not finally get included in the LFO. However, that now is history. But if Pakistan is to realise its full potential it must develop the intrinsic strength of its people, which is possible only if the people are politically empowered through a genuine and sustainable federal democracy down to the grassroots, and a just and efficient, people-centred, rights and responsibility based, service delivery oriented, governance system, focused on administrative and financial decentralisation, firmly supported by a system of justice that commands the confidence of the people, by keeping both democracy and administration on the path of justice. The NRB had therefore made comprehensive reconstruction plans across the entire spectrum of governance. But the Government ran out of time, and therefore had to leave all those National Reconstruction plans for the democratic government to take up for adoption and implementation.

Fifteen months having been consumed in the firm establishment of this government, the stage now appears set for taking up all those and other measures, so that democracy does not derail and governance does not fail the people. I will say a few words on all these measures merely to set the stage for the main part of my talk.

Starting with the top politico-administrative structures of the state, it is my conviction that in our socio-cultural milieu, characterised as it is by a feudal mindset, a feudal outlook, and a feudal approach to life as a whole, the parliamentary system is just a means for the institutionalisation of the feudal social order. Our political future lies in a federal presidential system of government led by a directly elected President, with a highly empowered Parliament, to exercise financial and administrative control over the executive branch headed by the President, and the judicial branch of government headed by the Chief Justice of Pakistan, so that the President does not become an autocrat, and the judiciary does not become a pawn in the hands of the President. This will ensure that the prime time and prime energy of the executive, headed by the President, is spent in governance, and not in perpetual politicking for political survival, as has been the case with our Prime Ministers.

The second structural change that is imperative for sustenance of democracy as well as good governance is the creation of administratively governable provinces to replace the existing geographically or demographically country-size provinces. The sooner we overcome our reservations about this measure the better. Some number between 10 to 15 provinces each with 7 to 10 districts would allow the country to be governed much more efficiently as well as reduce provincialism.

Federalism is the other measure that will enhance inter-provincial harmony, national unity and good governance. Raising the institutional esteem of the Senate by

making its members directly elected, and giving the Senate a major role in the continuance and removal of a state of emergency under the draconian colonial articles of the Constitution related to emergency, are essential measures. To go along with a federal-presidential system, however, the Senate must be a directly elected upper House. Almost equally important is legislative, and therefore administrative autonomy to the Provinces through a revision of the Federal and Concurrent Legislative Lists; and strengthening of the Council of Common Interests for giving the Provinces a substantive role in the formulation of policy and exercise of control over the vast array of institutions and facilities that were provincial in character before 1971. All these measures will require constitutional amendments and will therefore have to be handled and timed very deftly.

But devolution of political power to the provincial and local levels is not enough. Without decentralisation of administrative authority, the scope of exercise of political power gets restricted, and governance remains with the top bureaucracy. In this field it is imperative that five major institutional reconstruction initiatives be pursued with commitment and vigour. These are:

- (a) First the decentralisation of authority over human, financial and material resources within the Federal Government from the federal secretaries to the heads of the attached departments who wield the responsibility for executing government plans. The federal secretariats must have regulatory authority.
- (b) Second, at the Provincial level, apart from this objective, the provincial structures and systems need to be re-designed to function coherently in the new environment of devolution of political power and decentralisation of administrative authority to the local levels.
- (c) The third imperative measure is the total reconstruction of all the federal and provincial civil services of the country to harmonise their functioning with the new governance system; to ensure that they are served by men and women who deserve the status of the *élite* on the basis of their stature as the *élite*; and to ensure that the system of selection, training and career progression draws on the best from the whole lot to rise to the top positions.
- (d) The fourth administrative system that needs reconstruction is the Public Employment System. The new system of public employment must be based on selecting at least 50 percent people on merit, and applying the quota to just 50 percent; and over a decade, this 50 percent must gradually drop to zero. Coupled with this, the quota must apply to the under-privileged sections of the society, and not be a provincial quota.
- (e) And the fifth system that needs a fundamental reconstruction is the Public Information System. It is time we based a Public Information System not

on what should be known to the public, but on what may be necessary to conceal from the public for the sake of national security alone.

- (f) The NRB's plans on most of these were left in August-September 2002 for the new government to take up.

What I have spoken of so far is devolution of political power and decentralisation of administrative authority both within each order of government, as well as from a higher order of government to a lower order of government. These measures are not meant to serve some altruistic purpose or serve a theoretical need. They are almost directly related to creating an environment of liberty for the common people, for the government functionaries and for the political leadership, within which to set goals, objectives and targets to address the people's needs. And so long as this liberty is exercised in a legal and just environment, it is bound to lead to the prosperity of the citizens individually, the nation collectively and the state as a guardian of both.

FINANCIAL DEVOLUTION

This sets the stage for the second part of this talk, which relates to financial devolution and decentralisation. Among democracies the world over, Pakistan is by far the most financially centralised state in the world. This is a distinction that needs to be gotten rid of as soon as possible if we wish not only to utilise our available financial resources to better effect, but even for raising our financial resources, both as common citizens and as a state.

Our existing system of managing the economy has failed us over the first half century of our national existence, because it has resulted in the ballooning of the external and internal debt of the country and yet failed to check the growth of poverty. While no system can under-write the economic health of the nation and the state if placed in the hands of self-serving profligate leaders, it is probably equally true that a system based on checks and balance would certainly make it difficult for such leaders to hold unbridled sway over the economy.

The existing structures and systems suffer from two fundamental flaws. First, they are too centralised and are therefore not responsive to the imperative of spending money in accordance with the needs of the people as perceived by the three orders of government—the federal, the provincial and the local. The second major flaw is that the governmental structures that manage the national economy do so in an environment of conflicts of interests. Together, these flaws take away the incentive for optimising the raising of revenue, and simultaneously undermine fiscal responsibility down the line.

What follow are some of the recommendations arrived at in the National Reconstruction Bureau over the three years of General Musharraf's rule as Chief Executive of Pakistan, on the subject of Reconstruction of the Economic Structures

and Systems, meant to address these flaws. The NRB made these proposals to the government in 2002 but did not succeed in having them adopted. Their acceptance and adoption however, is critically important for the survival of the nation and the state. In this context I will speak briefly on the following four issues:

- (a) Economic Management,
- (b) Monetary Management,
- (c) Financial Management, and
- (d) Expenditure Management.

Economic Management

- (a) **National Economic Council.** The structure at the apex of the economic management pyramid should be the National Economic Council, but with a much leaner and clearer mandate than spelt out in the 1973 Constitution. The NEC must be an inter-governmental executive body (and not, as the Constitution says, a recommendatory body) for deciding on the economic, social, financial and commercial policy for the nation (and not for making plans, as the Constitution says). Secondly, it must decide all policy issues related to debt management. Thirdly it should advise all governments on economic matters. And finally since economic management is a continuous process the NEC must meet at least four times a year, and its decisions should serve as directives for all ministries, the State Bank and the Provinces. When the NEC is not in session, the Executive Committee of the National Economic Council (ECNEC), led by the Chairman Planning Commission, and composed of the ministers for Finance, Commerce, Industries and Privatisation, and the Governor State Bank, should be responsible to the NEC for taking decisions on economic management issues, presented before it by the Planning Commission.
- (b) **Planning Commission.** Led by a full-fledged Minister as Chairman, the Planning Commission should be recognised and organised as a think tank for the National Economic Council, as well as serve as its secretariat. Its functions should include formulation of draft economic, social, financial and commercial policies for approval by the NEC. The Commission must also manage adherence to the approved policy by all concerned. And thirdly, the Commission must be responsible to the NEC for all aspects of debt management. The Commission must not be involved in making development plans; it could therefore be re-named the Economic Commission instead of the Planning Commission.
- (c) **Planning Division.** The Planning Division is a hold over from the era of central planning in the Soviet mould. It must therefore, at the very least,

not encumber what I have suggested be called the Economic Commission. Instead it may be a separate ministry tasked exclusively to develop a planning policy based on the ruling party's manifesto, which may serve as a guideline for the federal divisions to develop their respective development plans and projects. Secondly, it should oversee and coordinate the efforts of the federal ministries towards the faithful implementation of those projects on behalf of the Prime Minister. The development plans should be limited to projects funded out of the federal budget. In the true spirit of federalism, the provinces must enjoy full financial autonomy over their respective provincial revenues, irrespective of the original source of the revenue. This implies that the ECNEC and CDWP must cease to accord approval to provincial projects. Whether these bodies should even approve federal projects needs to be re-examined.

Monetary Management

The State Bank exclusively should be responsible to the NEC for monetary management, and should be mandated to ensure money supply exactly in accordance with the inflation rate and growth rate decided by the National Economic Council. If increase in money supply is considered necessary, it is the NEC alone that should decide to raise the inflation rate or accept a reduction in the growth rate, based on the recommendations of the Planning Commission. The existing Monetary and Fiscal Coordination Board, which allows the Ministry of Finance to manage the economy through monetary expansion beyond the inflation rate decided by the NEC, in the face of inadequate revenue collection, should cease to exist. Instead the ECNEC should make the appropriate recommendation to the NEC and seek its approval. This would take care of the conflict of interest inherent in the Monetary and Fiscal Coordination Board.

Financial Management

- (a) The system of economic management outlined above would streamline the functions of the Finance Ministry. The Finance Division will then be able to focus on its wide-ranging core functions of budgeting, collection of revenue, distribution and provision of financial resources to the federal ministries and the provinces, accounting of all federal expenditure, overseeing expenditure management of all federal ministries and departments, and control over government owned financial institutions.
- (b) A critically important component of financial management is the subject of National Finance Award for the sharing of state revenue by the three orders of governments, the federal, the provincial and the local. After a year of intensive work the NRB developed a set of alternate proposals, each of which could serve as a basis for the 6th National Finance Award.

- (c) The most far-reaching one out of these proposals was presented by the NRB in June 2002 before the President of Pakistan, the Governors and the Ministry of Finance. But a decision on it was pended because the Ministry of Finance prevailed upon the President to leave this issue for the next government to handle. However, since this proposal involved amendments in the Constitution to reduce its rigidity on the issues of devolution of taxes to the provinces and the composition and functions of the National Finance Commission, we lost the ideal opportunity for it in 2002.
- (d) The essence of this proposal was as follows:
- (1) The Federal Government would retain one major tax i.e. Income and Corporate Tax, and two minor taxes i.e. Federal Excise excluding Gas, Tobacco and Tobacco Manufacture, thus increasing the Federal Government's own source revenue by 122 percent.
 - (2) The Provinces would get all other taxes presently assigned to the Federal Government or the Divisible Pool of Taxes, thus raising their own source revenue by 126 percent. In the process, the Provinces would be able to meet almost 40 percent of their total expenditure even at the existing poor levels of collection, instead of just 17 percent.
 - (3) In addition the Provinces would get 1/6th of the GST (2.5 percent out of the 15 percent) for straight transfers to the Local Governments.
 - (4) The Local Government would get two taxes: while the Tehsil/Town governments will get 2.5 percent (out of the 15 percent) GST, the Urban Immovable Property Tax would go to the District Governments after collection by the Provinces.
 - (5) Only one major and one minor tax would form part of the Divisible Pool viz. the General Sales Tax (12.5 percent out of 15 percent), and the Custom Duty. This Divisible Pool, divided equally viz. 50 percent to the Federal Government and 50 percent to the four Provincial Governments, would enable the Federal Government to meet 64.5 percent of its expenditure, as opposed to 62 percent at present, from own sources and its share in the Divisible Pool. The Provinces would, however, be able to meet 92 percent of their expenditure compared with 80 percent now.
 - (6) The Federal Government has the facility to meet the balance of its expenditure through loans, aid etc. the Provinces could be helped to reduce their deficit by another 5.5 percent if the Federal Government writes-off their loans on the lines of IMF helping out the Federal Government. They could manage the remaining 2.5 percent deficit through better expenditure management.

- (7) The NRB worked equally rigorously on the horizontal distribution of the provincial share of the Divisible Pool, and came to the conclusion that this could be fairly equitably done on the basis of a formula driven by four factors viz. Population – 65 percent, Fiscal Effort – 15 percent, Human Development – 15 percent, and Area – 5 percent, or with some reasonable variations in these percentages, yet ensuring that all four factors remained intact.
- (8) This proposal is first of all a lot simpler than the existing Award. But more importantly, this proposal gives to all orders of government a stake in widening the tax base of all the taxes allocated to them, as well the taxes in the Divisible Pool, and thus cause the raising of the national revenue, and indeed through its use, the GNP itself. The next issue is expenditure management.

Expenditure Management

- (a) The most serious area of concern here is that, in violation of the constitution, the Auditor General of Pakistan continues to be the head of both the accounting and the auditing functions of the state. And the conflict of interest inherent to this structure is compounded by the fact that the accounts and the audit personnel of the government of Pakistan continue to belong to a single service headed by the Auditor General of Pakistan. This conflict of interest has been partly addressed by the Controller General of Accounts Ordinance promulgated by the ministry of Finance in 2001-2002. Much, however still needs to be done, particularly the separation of the audit service from the accounts service at the federal level.
- (b) The second area of concern here is the issue of accounting. There is a dire need to accept the fundamental fact that the agency that spends money must also maintain its accounts. Obvious as it sounds, the Federal Government is at least hip deep, if not neck deep, into accounting of provincial money, because the Accounts Service of the Federal Government does not want to pull out of the District Accounts Office structure and consequently reduce its numbers as well as its clout at that level. Fortunately the NRB was able to get all governments to agree two years ago to hand over all provincial accounting to the provinces by the year 2006. But apparently there is no movement by the Provincial Governments towards building the capacity of their accounting services to do so.
- (c) The third area of concern is that most, if not all Local Governments were on a single entry system of accounting. With devolution, the need to build accounting capacity through crash courses became imperative two years ago. The provincial governments do not appear to be focussed on this critically important issue either.

- (d) The fourth issue concerning expenditure management relates to the Financial Advisor System. This system purports to prevent bad expenditure management but ends up creating the very opposite results, largely because the FA and his subordinates wield authority over expenditure without any responsibility for good financial management as a whole. Briefly what is necessary is that the Financial Advisors must turn into Finance Directors with Financial Analysts below them, and should be answerable to the head of the Department or Division they serve with. The Finance Secretary or the Controller General of Accounts should also report on them as countersigning officers. Project delays and cost over-runs are thus likely to remain within limits, and demoralisation of the dynamic officers of the government will be substantially reduced.
- (e) There is also a strong case for establishing internal audit organisations within each department of the federal, provincial and local governments, to serve as eyes and ears of the executive and check fraud before it grows and gets out of hand at each level of government.

This ends the second part of my discourse this morning, which concerned the management of the economy to harness the available financial resources to better effect.

NATIONAL PROSPERITY

The last part of my talk relates to creation of individual and national capital, thus eradicating poverty and taking the proven road to national prosperity. The road from national poverty to national prosperity is what Hernando De Soto, a Peruvian gentleman, shows the world in his classic book called “The Mystery of Capital”. Hernando De Soto heads what The Economist regarded as the second most important think tank of the world, called the Institute of Liberty and Democracy he established in Lima, Peru. As Personal Representative and Principal Advisor to the President of Peru, De Soto initiated Peru’s economic and political reforms, and was later named by the *Time* magazine as one of the five leading Latin American innovators of the 20th century.

The ‘Mystery of Capital’ revolutionises our understanding of what capital is, where it comes from, and why capitalism triumphs in the West and fails everywhere else. De Soto argues that foreign investment is, of course, a very good thing; the more of it the better. Stable currencies are good too, as are free trade and transparent banking practices, and the privatisation of state-owned industries and every other Western economic medicine dispensed by the IMF. Yet we continually forget that global capitalism has been tried before. These macro-economic and structural adjustment reforms, asserts De Soto, fall so far short as to be almost irrelevant.

De Soto demonstrates that the major stumbling block that keeps the poor nations from benefiting from capitalism is their inability to produce capital. He interprets Adam Smith, the father of modern economics, to define capital as the 'potential an accumulated stock holds to deploy new production', and the 'force that raises the productivity of labour' and creates the wealth of nations. His research shows that most of the poor already possess the assets they need to make a success of capitalism. But they hold these assets in defective forms: houses built on land whose ownership rights are not adequately recorded, unincorporated businesses with undefined liability, and industries located where financiers and investors cannot see them. Because the rights to these are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside narrow local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against investment. In other words these massive assets of the poor being illegal are not fungible.

By De Soto's calculations, the total assets in terms of real estate held, but not legally owned, by the poor of the Second and Third Worlds is at least \$ 9.3 trillion. What does this \$ 9.3 trillion mean? De Soto explains this with three equivalents.

- (a) First, that if the US were to raise its foreign aid budget to the level recommended by the United Nations, viz. 0.7 percent of its national income, it would take this richest country on earth more than 150 years to transfer this amount to the world's poor.
- (b) Second, he says this \$ 9.3 trillion is 93 times as much as all the development assistance from all advanced countries to the Third World in the last three decades of the 20th century (i.e. \$ 100 billion).
- (c) The third equivalent is that \$ 9.3 trillion is the total value of all the companies listed on the main stock exchanges of the world's most developed countries.

This probably explains why the Bretton Woods institutions have not succeeded in turning even one Second or Third World country's poverty into prosperity ever since these institutions were created.

De Soto's answer to the problem of capital creation at the individual level lies not in trying to force the masses of people owning illegal assets to somehow join the existing legal system; because, he says the existing legal systems are protected by and for the privileged sections of the society. On the contrary, the answer lies in integrating the formal legal system on which the overt economy is based, and the informal legal system on which the underground economy is based, and thus lend formal legality to the assets of all the people who own these resources. To undertake such a project De Soto has synthesised his dynamics into a formula which he calls the 'Capitalisation Process' with which he assists various governments throughout

the World. His book gives this formula in outline on two full pages, comprising four strategies viz. the Discovery Strategy, the Political and Legal Strategy, the Operational Strategy and the Commercial Strategy.

The President of Pakistan, General Parvez Musharraf has very graciously accepted my proposal last November to invite Mr Hernando De Soto to Pakistan to hear him out; and then to decide what, if anything was needed to do on this critically important subject of national prosperity.

CONCLUSION

The essence of this thesis on ‘The Triad of Governance, Devolution and National Prosperity’ can be encapsulated in four conclusions:

- (a) First, that the transition to a federal presidential system of government with a powerful bicameral legislature spearheaded by a strong Senate, and the division of the existing four into 10 to 15 politically, administratively and financially autonomous provinces, are fundamental structural changes necessary for establishing the foundation on which the edifice of national prosperity can be erected.
- (b) Second, that good governance flowing as a consequence of devolution of political power, decentralisation of administrative and financial authority, and deconcentration of management functions, are prerequisites for unleashing and orienting the enthusiasm and creativity of our people towards meaningful progress.
- (c) Third, that the reconstruction of the economic structures and systems at the federal and provincial levels, will help the governments optimise the production and utilisation of the available financial resources.
- (d) And fourth, that taking De Soto’s route to individual prosperity through capital formation at the grassroots, promises to lead to the eradication of citizen poverty and its substitution by national prosperity.

I have a deep conviction that in the emerging environment of peace and cooperation in the subcontinent, coupled with the new governance system providing us the politico-administrative infrastructure to tackle poverty at the grassroots, and all in the backdrop of our recent achievements in the macro-economic field, we need to take the bull (of poverty) by the horns, by going De Soto’s way; and over the next decade or so, consign poverty in Pakistan to the oblivion of history. This ushering in of an era of sustained national prosperity, will get Pakistan in step with the emerging environment of the 21st century, help the country exit the Third World for good, and propel it on the course to realising the full power potential of its dynamic people.