Social Capital and Fiscal Decentralization

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Abstract
Fiscal decentralization is not a new phenomenon for developing countries. Since the 1990s, most developing countries initiated the process of decentralization, combining political, administrative and fiscal aspects. It is a long-term gradual process of devolving revenue sources and expenditures functions from the central government to provincial and local levels. The benefits of engaging with this process include improved governance, accountability, democratization and citizen participation, the principle of subsidiary and an increased efficiency with regard to service delivery. Since local governments are closer to people and successful in extracting information on local preferences and needs at lower cost. This relation can, therefore, be instrumental in strengthening social capital. The paper defines the concept the social capital under decentralization and identifies the indicators for both fiscal decentralization and social capital. Analyzing secondary literature and case studies of best practices, we argue that giving people a voice in fiscal governmental decision making fosters social capital. The case of Pakistan is also explored and recommendations given on this process can be beneficial for the country.

Keywords: Fiscal Decentralization; Social Capital; Country Studies; Fiscal Decision Making; Pakistan

I. Fiscal Decentralization and Social Capital: Introduction
The key concept of decentralization resulted from people’s involvement in the process of government decision making and the failure of central government in trickling down the effects of their developmental policies. This global take off to decentralization is justified on the grounds that the more the transfer of resources and powers to sub-national level, the more the probability of efficient provision of public goods and economic growth.

Fiscal decentralization is a national policy plan with the intent of giving fiscal sovereignty and independence to the associated local governments (Paracha 2003). Being implemented in many developing, transition, and industrialized countries, there are multiple reasons for rethinking fiscal arrangements which are global and country specific:
collapse of economies with collective ownership and control, failure of central
governments in achieving national objectives, desire to break away from the remnants of
colonialism and ethnic strife as in Africa, courts asserting on citizen rights, globalization
of economic activities, federalism policies of sub-national governments like beggar-thy-
neighbor and fend-for-yourself, and the demonstration effects of the European Union and
Latin America (Shah, 2004). All these changes manifest a trend toward either devolution
(empowering people politically) and/or localization (decentralization of decision
making).

The theorem of decentralization was presented by Oates (1972) based on the
efficiency argument and it laid certain sufficient conditions for the decentralized
 provision of public goods to be pareto-superior to a centralized determination of public
goods. However, the theorem was not exempted from some flaws which were later
pointed out by Oates himself (2006) who called decentralization a “valuable laboratory”
for fiscal experiments.

World Bank (2000) defined decentralization a political process in which decision
making powers, resources and duties are transferred to lower levels of establishments.
These democratically elected establishments are wholly dependent on the federal or
central governments. Kardar (2006) pointed that the efficiency of decentralization
depends upon appropriate expenditure assignments among different levels of
government, appropriate tax or revenue assignments, efficient system of funds transfers
and its proper implementation. In this way, decentralization leads to minimal vertical
imbalances and shortens the distance between the recipients and suppliers of public goods
and services.

Kalirajan and Otuska (2010) pointed that decentralization in political, fiscal,  and
economic systems affects development outcomes in a number of ways like decentralized
 provision of social and physical infrastructures can accommodate the diversified needs
and demands of different regions by utilizing their resources endowment better than any
central provision. Secondly, contrary to monopolistic position of central government,
competition among sub-national authorities may promote innovations and enhance
productivity.

Post-Bretton Woods is an era when a strong emphasis was given on the
sovereignty of central government. It was argued on the basis of macro stability. Contrary
to this, the present scenario for achieving development is changing and switching from
centralized to decentralized economies. The examples of these decentralized economies
are Jordan, China, Thailand, Philippine, Indonesia, Latin America and Pakistan (NRB
2001) where the powers of centralized governments have been transferred to local
governments for achieving the desired goals of development.

A quantitative approach to decentralization has also been followed by researchers
like De Mello 2000 & 2010; Malik et al 2006, Uchimura and Suzuki 2009. These studies
enumerated the economic outcomes of fiscal stability, size of public sector and economic
growth by allowing some measures of decentralization.

These various studies empirically quote that fiscal decentralization, by bridging the
gap between central government and people, can be used as an instrument to strengthen
Social capital and enhance macroeconomic stability. There are many definitions of ‘social capital’ which range from social energy, community spirit, social bonds, civic virtue, community networks, social ozone, extended friendships, community life, social resources, informal and formal networks, good neighborliness and social glue.

According to Putnam (2000) social capital has vigorous effects on our lives that can be quantified. As per his illustration, lower crime rates, better health and education, improved levels of income equality and less corruption are amongst these quantifiable effects. Social capital is a multi-faceted concept which is defined “as trust, norm, and networks” (Putnam 1993, 1995, 2000). Interpersonal trust, social cooperation among associations and groups fosters social capital by promoting cooperation in society (DeMello 2000).

Social capital has two branches: first one is bottom-up (Putman 1993) and the other is top-down (Maloney et al. 2000). Delegation of powers at lower levels of government encourages the citizens to take on more responsibility for social and economic development. The difference between bottom-up and top-down approach is the role of institutions which contribute in the formation and development of social capital in the later but not in the former.

Social capital, as a by-product of social relations, is a private and public good (Putnam 2000) because it benefits both the creator and bystander. In literature, on the basis of its characteristics social capital has been divided into three branches namely bridging, bonding and linking social capital (Putnam 2000; Woolcock 2001 and Cade, Carran and Gardner 2006). Bonding social capital refers to relations amongst homogenous groups such as family members and ours close friends. The relation amongst distant friends, associates and colleagues refers to bridging social capital (Putnam 2000) and relation between individuals and groups in different social stratum is known as Linking social capital (Cote and Healy 2001). Woolcock (2001) broadened this definition by allowing ideas and information of formal institutions beyond the community. De Mello (2010) bridges the gap between decentralization and social capital and argues that the vertical structure of government plays a vital role in the formation of social capital.

II. Fiscal Decentralization and Social Capital: Inter-linkages

Kostyuk & Kostyuk (2003) argued that social capital contributes to negative externalities like corruption. They found these negative externalities in case of Ukraine. They further demonstrated that negative externalities, like corruption, do not weaken the usefulness of social and public policy concept rather provide an opportunity to the government in improving public policies. Pose and Ezcurra (2010) also prove the negative relationship between FD and economic growth for the sample of 21 OECD countries. However, much more of the literature is indicative of the positive interlinkages between fiscal decentralization and social capital.

De Mello (2010) used a seemingly unrelated probit model to estimate and test the hypothesis that institutional settings like vertical structure of government, does have bearing in the formation of social capital. On the basis of cross country analysis he found
that cohorts for Brazil that have been exposed to decentralization to be more pro-voice and trustful to the stranger, while the same is less clear cut in case of Indonesia. He also found that people living in decentralized countries give more importance to their voice in government decisions than a centralized country.

Toya’s (2010) analysis provides evidence that fewer deaths are followed in those countries which are more decentralized. Rao (2008) examines the appropriate design and implementation strategy for general purpose and specific purpose transfers. The former are necessary for augmenting capacity which should be designed to alleviate the fiscal disabilities in poor regions. While the transfers for specific purpose serves as a short term safety net for the poor. These intergovernmental transfers serve as important policy instruments for alleviating poverty.

Busemeyer (2007) measured the impact of fiscal decentralisation across different types of spending. The study was carried out by using pooled time series analysis of education, social spending and public spending in OECD countries for the period of 1980-2001. The impact of fiscal decentralization either positive or negative is conditional to the distribution of spending across levels of government. It was assessed that higher the local competition in the provision of public goods higher would be the spending. Uchimura and Jutting (2007) also find similar results of fiscal decentralization with a focus on health expenditures. Akin, Cakir and Nayapti (2006) present a model to analyze the implications of fiscal decentralization for fiscal discipline. This study focused on a redistributive rule that takes into account both local governments’ tax collection effort and the deviation of local incomes from their targets. It highlighted that the mechanism of revenue transfer has two main components, namely income compensation and punishment component, where the second component is used to address the fiscal discipline aspect of redistribution.

Parker and Thorton (2006) reviewed the fiscal evolution of China and Russia. It was observed that the size of China’s budget sector was smaller than Russia and that budget decentralization was greater. The local governments of China had more incentives to support growth oriented policies like promote foreign investment and export oriented production. However, the absence of financial markets serves as a barrier in the promotion of investment outside the local region. This leads to inefficient use of capital and protectionism. According to the findings, although China and Russia both faced the threats of fiscal deficits and hasty expansion of credit but China is more successful in managing macroeconomic policies.

Neyapti (2003) investigates the relationship of fiscal decentralization (FD) with budget deficits and inflation. He used a large panel data set for various measures of expenditure and revenue decentralization and showed that FD is significantly and negatively associated with budget deficits and inflation. A dummy was assigned to catch the effect of developed countries in the measure of expenditure decentralization. It was also observed that the relationship between FD and macroeconomic performance is made stronger through the country size, good governance and local accountability. The results are also supported by De Mello (2000a). He took a look at 30 countries over the period of 1970 till 1995 and showed that higher social capital has positive association with fiscal decentralization, especially when measured by vertical imbalances. In order to support these results, a sensitivity analysis was carried out by the researcher after including some
control variables that may affect social indicators. These social indicators are ethno-
linguistic fragmentation ratio, the ratio of public debt to GDP, the age-dependency ratio,
the developing-country dummy, the Human Development Indicator, the corruption
indicator, and the interaction term between the decentralization indicator and the
corruption index. This sensitivity analysis explains the robustness between fiscal
decentralization and social capital. One of the findings among them is that fiscal
decentralization also plays role in poverty reduction. Flores and Rello (2003) also quoted
the same results that SC is necessary factor in the fight against rural poverty in Mexico.

III. Fiscal Decentralization and Social Capital: Country Studies

Philippines
Philippine’s local government structure and intergovernmental structure is based
on the 1991 local government code. It has four sub national levels in the form of
provinces, cities, municipalities and the villages. Some of the cities are highly urbanized
and the left over are in the form of municipalities, which are under provincial
supervision. Each level of local government units (LGUs) is relatively independent.
According to World Bank (2005), across East Asia, the basis for decentralization varies
widely, but the Philippines in enriched with stronger and specific legal basis for local
government. In order to capture the quantitative picture of decentralization in Philippines,
Uchimura and Suzuki (2009) focused on the following five indicators: (1) the local share
of total fiscal expenditure which measures the ratio of local expenditure to total fiscal
expenditure including local and central expenditures, hence, quantifies the degree of local
expenditure responsibility compared to central government, (2) the local share of total
fiscal revenue: it measures the ratio of local revenues to total fiscal revenues, (3) local
dependency on fiscal transfer: it measures the ratio of fiscal transfer to total local
revenue, (4) local fiscal autonomy: measures the ratio of local own revenue to local total
revenue, (5) local expenditure discretion: measures the ratio of general revenue to local
total revenues. The study reveals that a large number of personnel were relocated from
central to local governments in the process of decentralization. The health, agriculture
and social security sectors were chosen in this study to measure the ration of personnel
cost and local expenditures. The ratio showed that in Philippine the discretion of the
expenditures is very high. This shifting of personnel and authority from central to local
governments causes to boost the expenditure responsibility on the part of local
governments. The increase in the expenditure was more than the revenues which
contributed to widen the gap of vertical fiscal imbalances. This sudden increase in the
responsibility of local government for financing the expenditures and reliance on fiscal
transfers from central government, contributes to weaken the Philippine’s local fiscal
autonomy. The study also reveals that vertical fiscal gaps can be bridged by (i) increasing
own local revenues,(ii) reducing local expenditures responsibilities, (iii) by the
adjustment in the alignment of intergovernmental expenditure responsibilities and (iv) by
providing fiscal; transfers from central to local governments.

Mexico
According to Chakraborty (2005), decentralisation initiative in Mexico began with
the federal government transferring social sector responsibilities to all the states in 1992.
Mexico has 32 states and 2440 municipalities. There is a high dependency of state and
municipal governments on the intergovernmental fiscal transfers in Mexico. The two
types of transfers are followed in Mexico namely Conditional and Unconditional. The
conditional transfers comprises on the transfers for specific purposes while the
unconditional transfers are used for general purpose. Like other countries experiences,
Mexico also has irregularities in revenue and expenditures spending at the level of
federal, provincial and municipals. Chakraborty’s paper looked at the scope and
limitations of gender responsive budgeting in Mexico within the overall framework of
fiscal decentralization. One of the identified potential areas of the study was
incorporating gender in the criteria for fiscal transfers. These transfers can be made more
equitable if the proper representation population density, age, and gender is allowed
across the provinces in Mexico. It was further elaborated that the situation becomes the
ideal one if gender would be incorporated in the conditional transfers.

While she looked at the initiatives taken by the Mexican government in terms of
gender budgeting in the health sector areas like social security schemes, services
provided by department of health and health care in private sector through pre-paid
private medical insurance schemes, she also analyzed the “the initiatives to incorporate
gender concerns in federal budgets to capture the effectiveness of top-down approach in
conducting gender budgeting.” The two components were considered in processing
gender responsive budgeting in health sector. The first one was the gender mainstreaming
in health sector and the second was to reprioritise the budget allocation for reducing
gender gaps. The Mexican case study was analyzed by focusing on Oaxoca, one of the
southern states of Mexico. The initial analysis showed that women’s tax payments
account for 34 percent which makes it visible that women’s’ contribution to development
is invaluable. Although the contribution is less than that of men, but the steady
contribution of women’s tax payment led the Mexican government to include gender
responsive budgeting to make the Oaxacan experience a success.

Thailand

Kureathep (2009) studied the role of fiscal decentralization on macroeconomic
growth for the economy of Thailand. Thailand has been implementing a comprehensive
decentralization policy since 1999 under the promulgation of decentralization plan and
process Act of 1999. It was realized that the centralized public administration was one of
the major causes of the nation’s political and economic instability (UNDP 2003).
According to the Decentralization Act of 1999, some assignments must be shifted from
national agencies to local governments. Under this act, a great degree of autonomy was
given to the local governments in decision making and the management of transferred
personnel’s in local governments. A multiple regression analysis was carried out by
Kureathep’s to examine the relationship between fiscal decentralization and
macroeconomic growth.

To measure FD, the author used two measures namely FD₁ and FD₂. FD₁ measures
the ratio of total local expenditures over total national government expenditures. FD₂ is
the rate of change of local government spending. Moreover, it also allows to (a) examine
the incremental decentralization impacts on the ratio of local governments expenditures,
including spending from intergovernmental transfers to total expenditures of the national
government and (b) a marginal growth rate of total local expenditures. Despite these two
variables i.e. FD₁ and FD₂, some other variables were also included in the multiple
regression model like level of education attainment, domestic and foreign direct
investment, national savings, trade openness, private banking credit (% of GDP), population growth, inflation rate, tax burden and labour growth rate. The study revealed that fiscal decentralization variables, $FD_1$ and $FD_2$, have weak statistical relationships with macroeconomic growth in all the four models (which were estimated by adding control variables). In conclusion, the study did not detect any relationship between FD and economic growth.

**Italy**

Asquer (2010) conducted an organizational study of a regional tax agency in Italy. This study theorizes the process of implementing fiscal decentralization by addressing the issue of how fiscal policy decision affects the management of tax agencies in the start up stage. On 11 May 2006, the regional government of Sardinia (region of Italy), directed the assembly to pass Regional Act 4 for the establishment of Tax agency in region Sardinia. The aforementioned Regional Act was passed for the introduction and promulgation of new taxes on holiday houses, boat and aircraft transit. The agency was assigned the responsibilities of (i) regional tax collection, (ii) to monitor and control of levies and licences, (iii) to provide assistance to regional administration in fiscal policy formulation and its implementation, (iv) to monitor cash inflows of the regional administration (v) and to research for economic effects of taxes and provide necessary information to tax payers. The study mainly focuses on the problems which are being faced at the start of fiscal decentralization and setting up of new administration for obtaining the combined effects of various social combinations. The study concludes that a special consideration should be given on the association of fiscal decentralization and social mechanism. A possibility of uncertainty in the implementation process should be kept in mind. The analysis further suggested considerations relating to the development of theoretical accounts of public management policy implementation.

**Pakistan**

Pakistan’s human development stagnation particularly in education, health, infrastructure, sanitation is not because of lack of resources but failure in the implementation of public programs by central and provincial government (Keefar et al 2003). To match the provision of public goods and local demands requires information on local preferences and needs. This information gap can be cheaply and effectively filled by local governments rather than central governments. However, the structure and provisions of local government are not well defined in the constitution of Pakistan. Local government is a provincial subject and clearly laid out in their statutes Functions and revenue raising tasks are assigned through provincial laws. Local government systems have been implemented in the past in 1959, 1979 and 2001. In 2000 National Reconstruction Bureau put forward the Local Government Plan.

The 2001 local ordinance was developed at federal level and provinces complained about their limited participation in its compilation (Bahl and Cyan 2009). Local governments were created and paradoxically thrived under military regimes. But with the return of civilian governments these institutions were abolished linking them as the engineering of dictatorships to create a cadre of loyal political leadership (Haider and Badami 2010). There has been rapid urbanization in Pakistan in the past few years but it coupled with deteriorating state of municipal services and infrastructure. The need for
efficient and effective local governments is felt but there has been a constant friction between provincial and local governments (Cheema et al 2005). Provinces have been duplicating the role of federal government in terms of exercising control on the local budgetary functions, prescribing local priorities, retaining control on establishment and sometimes requiring ex-ante provincial approvals to incur expenditures (Bahl and Cyan 2009).

Pakistan being a parliamentary federation and central type of government, most of the revenues are collected by the center and later re-distributed vertically (federal and provincial) and horizontally (among provinces). Vertical and horizontal imbalances are created given the differences between taxation powers and expenditures.

According to Article 160 of 1973 constitution of Pakistan it is mandatory to compose NFC Award for resource distribution among federation and its units. Since 1973, out of seven commissions only four came up with additional parameters for distributions among the federating units. The award has been a significant move forward in providing more financial autonomy to provinces. It has three components: Divisible Pool, Provincial Origin Revenue and Special Transfers. New criterions, population, revenue, backwardness and “inverse density population” (the less the population, the greater the allocation) have been finalized for the 7th NFC Award. Population would be given 82% weight, poverty 10.3%, revenue collection 5% (2.5% revenue generation, 2.5% revenue collection) and area 2.7%. Thus, the Award would enable Punjab to secure 51.74% of resources, Sindh 24.55%, Khyber Pakhtunkhwa 14.62% and Baluchistan 9.09%. The new Award has removed disparities regarding revenue collection and generation from Sindh and Punjab, hydel royalties from Khyber Pakhtunkhwa and gas development surcharge (GDS) from Baluchistan. Khyber Pakhtunkhwa has been given 1% of divisible pool for recognizing its role as a front line province in war against terror.

ANALYSIS
Fiscal decentralization has a positive impact on the public spending and helps in the creation of social capital (Busemeyer, 2007). It leads to more efficient production of local public goods like health and education (Jutting 2009, Busemeyer 2007) Scholars have studied the relationship between fiscal decentralization, economic growth and development (Feld et al, 2004), governance (De Mello and Barenstein 2001) and social capital (De Mello 2004, 2010). 18th Constitutional amendment and 7th NFC award contribute to the economic sustainability of Pakistan. Fiscal decentralization has significant positive effect on the macroeconomic stability of Pakistan (Iqbal and Nawaz 2010). Local governments are not only important in terms of providing public services (education, health and water supply) but because of the failure of federal and provincial governments to provide these services (Kardar 2006). Social capital investments made by local governments are more progressive and responsive to poor than investment decisions made by central governments (Azfar et al 2000, Keefar et al 2003). Effective decentralization is pro-poor, empower communities, promote democracy, reduce corruption, cost effectiveness of services and efficiency in social safety net programs (Ismail and Rizvi 2000).
IV. Decentralization Framework and Indicators

Fiscal decentralization is a system and all pieces must fit together. First fix the assignment of expenditures then assign revenues that correspond to expenditure needs. Fiscal decentralization needs to start with a strong centre ability to monitor and evaluate. Given the diversity of provinces/districts/urban rural sector, one system will not fit, it should be tailored accordingly. Central and provincial governments need to honor its commitment to decentralization following the rules it makes. The process and transition should be simple but impose a strict budget constraint (Bahl 2006).

For successful implementation, the local government needs to have a strong support from the central and provincial governments. This calls for political sustainability which means the authorization of legal and regulatory frameworks, financial autonomy and authorization to oversight the control structures. The local structures itself remain a skeleton until it has the skills, system and resources. Democratic governments in Pakistan have been complaining about absence of local technical capacity being an important element for local governance (Guess 2005).

Understanding of political culture is important as these are values and attitudes that affect institutional and policy decision making. It determines how people behave when they are not being watched. Local informal and formal institutions are a catalyst for good local governance if understood and implemented within that framework. There are issues of baradari system, nepotism, corruption, distrust and staff loyalties to groups or families at local level. But persistent administrative practices, vibrant civil society and media help in sequencing the local government system and main transparency. In Pakistan civil society and media remained an active participant during 2001 local
government regime (Guess 2005). By design and implementation we mean creating new institutions building on existing practices with support from central/ provincial governments and other intermediate organizations.

Local governments should avoid the dependence on the funding from central government and broaden its revenue base. In order to measure the impact of decentralization following indicators can be used. Subnational tax autonomy[^1^], Subnational nontax autonomy[^2^], Vertical imbalances[^3^], Government size[^4^], and Subnational expenditure share[^5^]. (De Mello, 2004) Subnational tax autonomy and subnational nontax autonomy measure the extent to which subnational governments are capable of mobilizing local revenues to finance their expenditures. Government size and subnational expenditure share measure their importance as providers of public goods and services in absolute terms, the government size and relative to central government spending, the expenditure share. Decentralization should be associated with service delivery comprising of both technical and allocative efficiency. Provision of social audits to measure the performance of services at local level. Finally greater local authority to hire and fire officials being paid by local government, it ensure the responsiveness towards citizen needs (Winkler and Hatfield 2002, Guess 2005).

Social indicators help to assess the impact of fiscal decentralization, social services - primary and preschool education, secondary education, public health, hospitals, transportation; urban highways determine the confidence in government. Other provision of utility services - drinking water and sewerage, waste collection, electric power supply can be used as determinants of social capital. Memberships of trade unions, charities, political and social institutions determine the extent of civic cooperation and associational activity.

Important lessons for reform of fiscal systems in developing countries from various experiences include:

i. Enabling environment for decentralization i.e. institutions of citizen participation and accountability must be addressed in any serious reform of fiscal systems.

ii. Societal norms and consensus on roles of various levels of governments and limits to their authorities are vital for the success of decentralized decision making.

iii. Civil service reform is critical to the success of a decentralization program.

iv. Evaluation capacity development is of fundamental importance in public sector reform in developing countries.

v. Traditional administrative capacity matters but should not be considered as an impediment to decentralization.

[^1^]: It is the ratio of tax revenue to total revenue of subnational governments (tax, nontax, intergovernmental transfers, and capital revenue net of grants)
[^2^]: Ratio of nontax revenue (rents and fees) to total revenue of subnational governments.
[^3^]: Ratio of intergovernmental transfers to total tax revenue of subnational governments. It measures the gap between subnational expenditures and own revenue.
[^4^]: Ratio of total government spending to GDP, per government level.
[^5^]: Ratio of subnational government spending to total government spending.
vi. A major separation of spending and taxing decisions leads to lack of accountability in the public sector.

vii. Sharing of revenues on a tax-by-tax basis distorts incentives for efficient tax collection.

viii. Successful decentralization cannot be achieved in the absence of a well-designed fiscal transfers program.

ix. The role of fiscal transfers in enhancing competition for the supply of public goods should not be overlooked.

x. A developing country institutional environment calls for a greater degree of decentralization than needed for an industrialized country” (Shah 2004).

V. Conclusion

Fiscal decentralization not only promises economic growth but development at grass root levels. It acts as a catalyst and reboots the nascent social capital. Local governments are more responsive to the needs of people since their policies can be easily implemented and monitored by local communities fostering transparency, accountability and local participation. Local democratic traditions, political participation and public awareness can be enhanced by bringing the expenditure assignments near the revenue sources. As policy making assignments are devolved at local level, citizens are encouraged to take part in the economic development. Social norms and contracts are easy to implement in small jurisdictions (Putman 1993). “Civic cooperation improves allocative efficiency as the total benefit to the society of cooperation outweighs the total cost. Social capital development boosts participation of the citizenry in the policy making process and empowers the poor through political participation, fiscal decentralization may be an integral part of poverty reduction and development strategies” (De Mello 2000). Local governments are more likely to promote social cohesiveness, civic virtue, facilitate interactions and de-spirit self interest. Pakistan is not a new player in the implementation of local government programs but has experience and learnt from its previous mistakes. Given the economic and political crisis and inefficiency of federal and provincial governments the country should decentralize in the democratic regime and empower the people.

References


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