National Finance Commission award: a way forward

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Introduction

The present civilian government, emphasizing on collaboration and consultation, is seeking to rebuild the country's political, economic and social institutions. Needless to say, numerous concerns have in this regard been pointed out by politicians and analysts alike. They are worried about issues surrounding political instability and worsening law and order situation. They are also concerned about the high fiscal and current account deficits, rapid inflation, low foreign exchange reserves, a weak currency and a declining economy that have put Pakistan in a very difficult situation. Moreover, inter-province politics is becoming a hot topic among people from different walks of life and belonging to different provinces. Therefore, the emphasis of this paper would be on the decades-old issue of fiscal allocations under the National Finance Commission (NFC).

Pakistan is a federal State and has different tiers of government; the federal at the centre, and the four provincial governments. There is also a third tier of local governments (comprising district, tehsil and union administrations) introduced in 2001. The Constitution of Pakistan divides functions between the federal and provincial governments. The main functions of the federal government, set out in what is known as the "federal list", include foreign policy, currency, and defence. The concurrent list, with subjects that can be dealt with by both the federal and the provincial governments, includes education and health. Anything that does not fall in either list becomes the responsibility of the provincial governments (the residual powers.)

To exercise these functions, these different tiers of government need funds to carry out their responsibilities. However, in Pakistan, the provincial governments do not have access to sufficient funds as most of the revenue is collected by the federal government, leading to what is known as the "vertical imbalance". That means the difference between the power of revenue generation in the form of tax collection and expenditure. Vertical imbalances are addressed by fiscal transfers from the federal to the provincial governments. Different provinces have different fiscal capacities and needs. Some generate more funds than others; some are more developed than others. All that leads to what are known as 'horizontal

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imbalances' between provinces. Both vertical and horizontal imbalances are addressed through the NFC award.

The purpose of the NFC award is redistribution of the divisible pool (including personal and corporate income tax, GST on goods, customs duties, etc.) among the provinces. The main charter of the NFC is to recommend on the following:

- The distribution of specified taxes and duties between federation and provinces.
- The disbursement of grants to provincial governments.
- The borrowing powers exercised by federal and provincial governments.
- Any other financial matter referred to the Commission.

Issues in distribution of financial resources

This section assesses some of the main issues with fiscal resource distribution in Pakistan.

Vertical imbalances

The main problem is the assignment of revenue generation which in most cases is collected by the federal government. That includes income tax, GST, import and excise duties. The Constitution assigns very few taxes; e.g., gas royalty; to the provincial governments. As a result, federal revenue is much greater than provincial revenue. That leads to vertical imbalances and the necessity for substantial fiscal transfers from the federal to the provincial governments. Consequently, the government tiers are often at odds with each other.

The NFC Award is supposed to ensure provincial autonomy by making fiscal transfers formula-based and predictable. At present, the federal government collects 91 per cent of taxes levied in the country, and the provincial governments collect between six to seven per cent. The federation takes more than 60 per cent of the collected revenue, and the remaining is distributed among provinces through a divisible pool. The only major source of revenue for the provinces is the NFC award to pay for health, education, social services and other needs. As a result, many provincial functions are undertaken by the federal government because it has the fiscal capacity to do so. Road construction, for example, is a provincial responsibility, but major road and other infrastructure projects are frequently undertaken by the federal government. Therefore, provincial dependence on federal transfers clearly reduces provincial autonomy.

The provinces have consistently demanded that at least 50 per cent of federal revenues (and ideally 60 per cent) go into their share of the divisible pool. But, there is great reluctance on the part of the federal government to do that. One way to achieve provincial autonomy is through matching grants, whereby provinces are rewarded for their fiscal effort with additional funds. The counter-argument is that provinces that already have strong fiscal capacity would benefit from the arrangement, thereby increasing inter-provincial differences.

Horizontal imbalances

Population was used as the sole factor in deciding the distribution of the provincial share of divisible pool between the four provinces. There are a number of problems with the use of this one criterion. Punjab, which has the biggest population and thus benefits the most from the current arrangement, is the only province that would like to see this retained. On the other hand, smaller provinces are backward in many areas like the literacy rate, social development, employment opportunities, education, health, infrastructure, peace and security. Therefore, they demand that there should be multiple criteria for distribution of resources. The early positive sign was that Punjab had been considering the significantly changed political environment and was prepared to accept multiple criteria for this horizontal distribution. The worrying feature consequently became the heightened expectations of the NWFP and Balochistan, beyond the size of the pool of national resources.

Balochistan is the largest province, covering 40 per cent of the total area of the country. It complains of abject poverty and maintains that nothing has been done by succeeding governments to do away with its problems. It demands 100 per cent royalty of natural gas and the gas development surcharge. The NWFP, on the other hand, points out the problems of Afghan refugees and the internally-displaced persons (IDPs). It has also been sustaining the impact of becoming a frontline region in the ongoing war against religious extremism and terrorism. Sindh is the province that fetches the biggest share of federal revenues in terms of taxes and duties on imports and exports through its seaport at Karachi. The Sindh government demands the return of the right to collection of GST on services and GST on goods back to the provinces. Punjab was considered the lone beneficiary of all previous awards as it got the lion’s share in the divisible pool on the basis of the lone criterion of population. It is, however, a fact that the province has to look after more than half of the country’s population.

These inter-provincial differences, as well as disagreement between provincial governments and the federal government on the distribution of the divisible pool, had been the major obstacles in finalizing a new NFC Award.

The new award

The longstanding issue of the seventh NFC award was resolved harmoniously among the four provinces on distribution of financial resources allocated for them in the federal divisible tax pool on the basis of a four-point formula. The announcement of the new NFC award is going to have a far-reaching impact on the political economy of Pakistan. Under this award, the share of the provinces in the national revenues has been raised to 56 per cent from 46 per cent. This transfer of additional financial resources of the country from the federal to the provincial government is arguably the first step toward financially strengthening the provinces and providing them monetary space, if not autonomy.

The new award will come into effect from the next financial year, i.e., 20010-11. In its formulation, population to be given 82 per cent weightage, poverty 10.3 per cent, revenue collection 5 per cent (2.5 per cent revenue generation, 2.5 per cent revenue collection) and area 2.7 percent. Consequently, Punjab would get 51.74 per cent from the divisible pool, Sindh 24.55 per cent, the NWFP 14.62 per cent, and Balochistan 9.09 per cent. In addition, the NWFP would receive an additional resource of one per cent from the total divisible pool for expenses incurred by the province on the war on terror during the award period. That would be equivalent to 1.83 per cent of the provincial pool. Balochistan would receive Rs 83 billion from the pool during the first year of the award. In compensation for its acceptance of allocation of an equal weight to generation and collection of revenue, Sindh would receive an additional transfer of Rs 6 billion from the federal government, which is equivalent of 0.66 per cent of the provincial pool.

The centre has also agreed to reduce collection of taxes to just one per cent from the existing five per cent, which would increase the actual transfers to the provinces from the divisible pool under the next award to more than 60 per cent. While transferring more financial resources to provinces, the federal government has to cut its size. That would come in the form of reducing the number of federal ministries, divisions and departments. Recently, the federal finance minister has said that the reducing of centre’s expenditure to 12.5 per cent from the current 14.1 per cent of the GDP would facilitate the payment of increased shares to provinces under the new NFC award.

In addition to replacing the single-point, population-based criterion with four-point multiple criteria, the Commission has also cordially addressed non-NFC issues like the federal government's dispute with the NWFP on net hydel profits and with Balochistan on gas development surcharge. The two provinces are set to receive over Rs 100 billion each as a result of resolution of these issues. The centre has also accepted the constitutional right of the provinces over sales tax on services and allowed them to collect the tax if they so desired.

Economic experts and analyst have appreciated the consensus reached on the NFC award among the four provinces, which would help boost national economy, and develop less developed provinces and regions. Federal Finance Minister Shaukat Tarin has said the federal government recognised the need of the provinces for a larger share in the divisible pool since provinces are assigned the task of provision of basic services like health, education, water supply and sanitation. He observed that strengthening of the federation is directly linked with the strengthening of provinces, and hence it is essential to reinforce them.

According to Pakistan Institute of Development Economics (PIDE) Vice Chancellor Dr Rashid Amjad, the agreement on the new NFC is a good sign and a positive step for the country which would help in better utilisation of national resources for the benefit of the country. Moreover, it would also help bring back confidence of investors on Pakistan's economic potential and future development of the country. Former Finance Minister Dr Salman Shah has also welcomed the award, describing it as a good omen for the country as the four provinces have reached an agreement. He was of the view that this agreement has been worked out on give and take basis, which is a positive step for the federation. Dr Zafar Moeen Nasir, the head of economic research department at the Pakistan Institute of Developmental Economics, has said that with more resources to the down-trodden people and underdeveloped areas, people would start having a feeling of belonging to the country.

This shows that the civilian government has realised that the strength of the federation hinges on strengthening the federating units. Therefore, the agreement of the federal government to give more than 50 per cent share of the State's financial resources to the provinces would strengthen Pakistan in real terms. However, without bringing transparency in their governance system and departments, the transfer of additional financial resources to the provinces would fall short of serving its intended purpose.