NFC AWARD: DEVISING FORMULA FOR HORIZONTAL DISTRIBUTION

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1. Rational and scope of study

This paper proposes a formula for resource distribution between provinces-horizontal distribution- under the upcoming National Finance Commission (NFC). We maintain that the formula offered in 7th NFC is predominantly need-based and the (equity) indicators, whatsoever it has, by very construct, fall short of capturing full essence of equity. Further, we argue that existing indicators of efficiency, the size of provincial tax revenue, is not adjusted for size of the provincial economy thus fails to capture the efficiency part of resource collection, the tax effort.

Accordingly, we suggest some solutions which include i) adjustment in weights of respective indicators, ii) alternative composition of existing indicators, and iii) inclusion of new indicators. The underlying idea for the choice of new indicators is a gradual shift from need-based approach to efficiency-based resource distribution. Based on existing literature on the issue and the regional consultations, we also identify the major challenges to overcome the deadlock on NFC negotiations at the official level.

It seems imperative to note here some of the challenges facing the introduction of further efficiency in horizontal distribution of pooled resources. The first argument we faced was that NFC is a political question and any changes in the formula may create political tensions. It will be difficult to earn the consensus on any new formula so we should not even think towards discussing it at an intellectual level.

Second, after 18th amendment federal government must not intervene in the provincial matters. It is provinces choices how much revenues they collect and how do they spend the resources. Third, given the demographic structure and weak state of the local economy in several parts of the country we cannot ignore the need-based distribution so any discussion on changing the weight of related indicators, for example, 'population' in case of 7th NFC, is not required.

For greater clarity, we would like to submit that while we already maintain that the award is a political question, this, in no way, rules out the possibility of debate on improving the resource distribution mechanisms. NFC has always had a debate at a technical level. We are also aware that 9th NFC may not bring any fundamental changes as suggested in this paper, but this would at least start a debate that may materialize in future negotiations. The debate on these issues gradually slows down the resistance and create environment which is conducive for change. Critical shift to development-based distribution in 7th NFC from 100% population-based distribution in last six NFC awards is an example here.

We also submit that mixing the NFC guided productive provincial expenditures with the intervention in internal affairs of provincial matters warrants a quick clarification. We need to

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differentiate between incentivizing and regulating the provincial expenditures. The NFC award does the former through adding some indicators which are critical to be achieved. For example, many countries use forest cover to promote environment related expenditures.

This, by no means, equals regulating the provincial expenditures. Same holds true for the inclusion of indicators promoting tax efficiency of provinces. This does not undermine the role of provinces in collecting taxes, as is commonly believed. Rather it adds that the size of the revenue must be adjusted to the potential of the province. This actually benefits the provinces with smaller economy.

We would also like to highlight that this paper, or the formula presented herein, does not undermine, under any circumstances, the importance of need-base distribution of pooled resources. To be exact, the distribution still remains need based as the weight assigned to population of provinces shall continue to dominate the distribution.

We are only suggesting that policy makers need to start discussion on how to gradually incorporate the element of efficiency in distribution of resources to provinces. Further, any efforts to adjustment in weights of exiting indicators or inclusion of new indicators in this regard are bound to reduce the population weight as other indicators have already lower contribution in distribution.

In this context, this paper is an attempt to broaden the discussion on NFC objectives. We contend that the NFC has implications beyond "supply of finances to provinces". Inter-governmental transfers play a critical role in addressing the vertical and horizontal fiscal imbalances. In the same spirt, the very purpose of inception of NFC award in Pakistan was to address the initial imbalances by financially supporting provincial governments through a fair distribution of resources enabling federating units, the provinces, to meet the liabilities and to rescue them from horizontal fiscal imbalances.[2] Fiscal imbalances, in this case, refer to varying ability of provincial governments to raise revenues. For example, Punjab is always likely to raise more revenues than Balochistan as it has more vibrant economy.

We draw on review of existing literature on NFC award in Pakistan, best global practices and consultations across all provinces to offer arguments presented in the paper. The consultations were held with policy makers from across all provinces, and civil society organizations to document the perceptions and concerns of provinces regarding existing NFC award and expectations from the upcoming award. Also, the proposed changes in resource distribution formula were presented to the stakeholders during our meetings to solicit their feedback which, then, was used to update our proposals.

Overall our approach entails i) documentation of evolution of NFC award in Pakistan, ii) comparative analysis of resource distribution criteria over the time, iii) assessment of 7th NFC, iv) study of resource distribution criteria of peer countries and documenting feedback from participants of provincial consultation workshops. All these elements are then combined to also formulate proposals for the upcoming NFC discussions.

[2] See also, Jaffery & Sadaqat, 2006.

2. Composition of National Finance Commission (NFC)

A quick refresher on purpose and structure of NFC in Pakistan may help better grasp the discussion. Constituted under Article 160 (1) of 1973 constitution, the NFC has evolved over the time. The very purpose of its establishment was *optimal and judicious distribution of resources* which are *in line with the developmental goals of the federation and federating units*. The NFC, constitutionally mandated to be convened at five years interval, consist of Federal Finance Minister (Chairman), Provincial Finance Ministers and other members to be appointed by the President of Pakistan in consultation with the Governors of provinces. The prime charter of the NFC is to deliberate on the following:

1. Allocation of taxes and duties between federation and federating units
2. Extending grants to provincial governments
3. Exercise of borrowing powers by two level of governments
4. Any other financial agenda referred to the Commission.

2.1. A historical overview of NFCs in Pakistan

So far Pakistan has had 8 NFC awards. The 7th NFC was implemented in 2006-07 and extended without any changes in 2010 under the name of 8th NFC award. Prior to independence, the Government of India Act, 1939 governed the financial coordination between the center and the provincial governments. The Act specifically chalked out the constitutional responsibilities of both the entities concerning the distribution of resources revenues. As per 1935 Act, "*Neimeyer Award*" represented the resources sharing model between the federal and the federating units.

Post-independence the same resource sharing principle was used with certain adjustments for sales tax and income sharing till 1952 in the form of "*Raisman Award*". In 1955, "*One Unit*" declaration occurred under which all provinces of West Pakistan got declared as "*One Unit*", therefore, two awards were announced for 1961 and 1964 and distribution of resources took place only amongst these two units.

The new constitution was adopted in 1973, under which the center and provinces had a divisible pool constituting of net proceeds of specific taxes in addition to their indigenous revenue sources (SPDC 2018). The 1973 constitution made it obligatory for the center to compose and convene NFC at regular intervals of 5 years. In table-1 we provide a comparative analysis of NFC awards from 1974-2007 in the form of *NFC Distribution Matrix* encompassing all features of award.

Table-1 The NFC Distribution Matrix Vertical & Horizontal Distribution across Federal & Provincial Governments							
	Divisible Pool	**Revenue Sharing Criteria**	**Vertical Distribution**	**Horizontal Distribution**			
				Punjab	Sindh	NWFP	Baluchistan
1st NFC AWARD 1974 (CONCLUSIVE)	**Fewer taxes included which include** - Income tax - Sales tax - Export duty	Population (100%)	20% federal 80% provincial	60.25%	22.50%	13.39%	3.86%
2nd NFC AWARD 1979 (INCONCLUSIVE[3])	Followed 1974 NFC formula[4]. However, following the new census of 1981, population proportions changed and resources shares were changed accordingly	Population (100%)	20% federal 80% provincial	57.97	23.34	13.39	5.30
3rd NFC AWARD 1985 (INCONCLUSIVE)	Followed 1979 NFC formula, But remained inconclusive	Population (100%)	20% federal 80% provincial	57.97%	23.34%	13.39%	5.30%
4th NFC AWARD 1985 (CONCLUSIVE)	Included: -Income tax -Sales Tax -Export duties - Expansion in divisible pool & provincial shares by adding excise duties on sugar & tobacco -Custom duty remained with federal government	Population (100%)	20% federal 80% provincial	57.88%	23.28%	13.5%	5.30%
5th NFC AWARD 1996 (CONCLUSIVE)	All taxes and duties were included in divisible pool comprising of: -Income Tax -Wealth Tax -Capital Value Tax -Sales Tax -Export duties - Custom duties - Any other tax collected by federal government	Population (100%)	62.5% federal 37.5% provincial	57.88%	23.28%	13.5%	5.30%

[3] An inconclusive NFC award means that particular NFC could not be implemented and the arrangement of previous conclusive NFC award continued to be implemented. The NFC Award in Pakistan requires consensus of all members. In case consensus is not achieved, the Award stands "Inconclusive" & previous NFC award continues in practice and a Distribution of Revenues Order is issued by the President for continuation of the previous award.

[4] "Followed previous NFC Formula" denotes that the new NFC award adopted the arrangements of previous NFC award. For example, followed 1974 NFC formula" here refer to that 2nd NFC award adopted all the arrangements agreed upon under 1st NFC award.

	--Royalties on crude oil & surcharge gas			
6th NFC AWARD 2000 (INCONCLUSIVE)	Followed 5th NFC formula[5] Inconclusive due to lack of consensus among members	Population (100%)	62.5% federal 37.5% provincial	Punjab: 57.88% Sindh: 23.28% NWFP: 13.5% Baluchistan: 5.30%
7th NFC AWARD 2006 (CONCLUSIVE)	All taxes and duties were included in divisible pool comprising of: - Income Tax -Wealth Tax -Capital Val Tax - Sales Tax -Export duties - Custom duties - Any other tax collected by federal government --Royalties on crude oil & Surcharge gas	Population 82%, Backwardness & poverty 10.3%, Revenue generation & collection 5%, Inverse pop. density[6]2.7%	55% federal for first year and 1% decrease per annum for subsequent years for duration of award; 45% provincial for first year and 1% increase per annum for subsequent years for duration of Award.	Punjab: 57.36 % Sindh: 23.71 % NWFP: 13.82 % Baluchistan: 5.11%

Source: Ahmad, I., Mustafa, U., & Khalid, M. (2007)7 and SPDC (2018)[8]

Table-1 provides information on major characteristics of the NFC awards with a focus on horizontal distribution. One can clearly note some key characteristics of NFC award in Pakistan. One, over the four decades, 1974 to 2007, NFC award remained mainly limited to adjustment in divisible pool changes through inclusion and exclusion of various taxes. Two, 5th NFC award, did not see any structural change and broader structure remained almost similar except that the inclusion of all taxes in the divisible pool and accordingly the federal and provincial shares were reversed and the concept of matching grants was introduced in 5th NFC award. 6th NFC award adopted 5th NFC formula.

Third, and most important given the scope of this paper, first 6 NFC awards were exclusively need-based. The resources were distributed purely on needs base denoted by 100% weight to the population. The larger the population, the higher the share. Punjab, with share ranging between 57.88% and 60.27%, continued to enjoy the largest share with minor variation adjusted to changes in population size during the years 1974-2006. On the other side, Balochistan, the most deprived, received lowest resources at minimum 3.8% and maximum 5.30%.

[5] "The much-awaited NFC Award through consensus was then materialized in 1991. This was followed by the NFC Award 1997 constituted for a period of five years (1997 to 2002), but remained in practice till 2006, when a distribution order from the president of Pakistan replaced the NFC Award 1997" (SPDC 2018).
6 Inverse population density shows the dispersion of population (Inverse pop density = 1/pop density where pop density = Population/Area (in sq. km) Balochistan must have higher inverse population density as it has lower population per square kilometer area compared to Punjab and other provinces. Refer to Report of the National Finance Commission (2009) for details. It is available at http://www.finance.gov.pk/nfc/reportofthenfc_2009.pdf
[7] National Finance Commission awards in Pakistan: A historical perspective
[8] A Study of Intergovernmental Fiscal Transfers in India and Pakistan, Social Policy and Development Centre, January 2018

2.2. How different is the 7th NFC award?

The resource distribution apparently seems to have witnessed a fundamental shift in the form of 7th NFC award of 2006[9] It shifted the criteria of resource distribution significantly and introduced elements of so-called equity and progressivity. A new resource sharing formula was agreed upon. For the very first time the resource distribution amongst provinces was based not only on population but multiple factors such as inverse population density, backwardness and local tax revenue generation and collection.

Table 2. Horizontal Distribution of Resources (1975 to 2009)

Factors	NFC 1975	NFC 1991	NFC 1997	NFC 2006	NFC 2009
Population	100%	100%	100%	100%	82.0%
Poverty/Backwardness[10]	-	-	-	-	10.3%
Revenue Collection/ Generation[11]	-	-	-	-	5.0%
Inverse Population Density	-	-	-	-	2.7%
***Note:** the distribution is made from pool excluding 1/6th of sales tax collected and distributed in lieu of Octroi/Zila Tax					

The new NFC formula in 2007, formally known as 7th, as in table-2, included population with 82% weight while rest of the 18 percentage points were distributed amongst backwardness captured through poverty incidence (10%), inverse population density (2.7%) and tax revenue/generation (5%). The 7th NFC award also facilitated in resolving issues like hydro-electricity profit and "Gas Development Surcharge (GDS).

The 7th NFC (2006 mainly aimed for settling the disputes by agreeing upon an improved formula for resources distribution. The new formula, an amalgam of population, backwardness and poverty, inverse population density, revenue generation and collection depicted that Punjab's share dropped the most, while share of Balochistan increased considerably. Punjab remained dissatisfied with a high share of the federal government (44%). However, the federal government since 2014 advocated further rise in center's share by an additional 6-7 % for: expenditure on security, law and order; and development in Kashmir and Gilgit Baltistan region (Shah, 2019).

The 7th NFC Award proved to be effective in certain areas. It facilitated fiscal decentralization and provincial autonomy. There was considerable expansion of divisible pool by inclusion of all the

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[9] Literature reports conflicting start timeline for 7th NFC. It is evident that "Through Ordinance No. 1 of 2006, made amendment in the "Distribution of Revenues and Grants-in-Aid Order, 1997". Consequently, the new NFC was announced to take effect from 1st July 2006 [Pakistan (2006 a)]." Further Iftikhar, Mustafa & Khalid (2009) reports 7th NFC to be effective from 2006. SPDC Report (2018) however reports that "a major development in this regard was the 7th NFC Award of 2009 that significantly affected the resource distribution formula",

[10] Denoting state of backwardness, poverty here refers to incidence of poverty in respective provinces. This is a head count index which shows share of population living below poverty line. Refer to Report of the National Finance Commission (2009) for details. It is available at http://www.finance.gov.pk/nfc/reportofthenfc_2009.pdf

[11] "Sindh advocated the use of revenue collection as an indicator whereas the other three provinces demanded the use of revenue generation as an indicator", the 7th NFC commission decided to use both revenue collection and generation with 50% for each. As "Federal Board of Revenue showed inability to provide data on generation basis" withholding tax paid on electricity consumption, reported in FBR Year Book 2007-08, was used as proxy for revenue generation. Refer to Report of the National Finance Commission (2009) for details. It is available at http://www.finance.gov.pk/nfc/reportofthenfc_2009.pdf

taxes. However, there are some gaps in the 7th NFC model which impede the desired productive outcomes. We highlight some of these in this section.

Without any doubt, 7th NFC was a departure from previous NFC awards and a critical shift in resource distribution. However, contrary to the popular belief, 7th NFC award did not offer a progressive, equity and efficiency-based formula. First, it remains fundamentally needs-based as the variable of 'population' carries 82% weightage. And if we add the inverse population density, the 87% weight is allocated to need-based indicators. Two, inclusion of absolute size of tax revenues, as efficiency indicators, does not entail the required result because of problem in structure of the indicator at one hand while lower weight (5%) assigned to it on the other hand.

Absolute size of tax revenues does not capture the differences in "the size of economy" across provinces. The absolute share of provinces with larger economy, say Punjab, will always be higher in the divisible pool as, under current circumstances, it will always collect higher taxes compared with others. Most importantly, larger size of revenues does not reflect the "tax efficiency" rather it denotes "larger economic activity". Lower weight for revenue collection discourages the provinces to invest in revenue mobilization as the costs may override the gains. This has overtime increased dependency on federal governments.[12]

The tax system of Pakistan underwent considerable reforms over the past decades, however, tax assignments of federal and provinces remained unchanged since 1973. Even, no modifications occurred for federal and provincial tax portfolios under the *18th Amendment* of the constitution in 2010. Federal Government, under constitutional rights, collect taxes on income apart from agriculture income, immoveable property and capital value of assets minus taxes on immovable property. For indirect taxes, federal government collect taxes on the purchases and sales of goods (exported, imported, manufactured, produced or consumed) excluding the tax on the sale of services. The other major segment of federal indirect tax comprises of tax on international trade (excise duties, import export duties).

The provincial government-tax assignments include taxes on income, professional income, and direct property taxes. Concerning indirect taxes, provinces collect sales tax on services, excise duty on liquor/narcotics/alcohol, stamp duty and motor vehicle tax. It is also worth mentioning that majority of provincial tax assignments are through a bar in the federal tax list. "Through a bar" here means that part and portion of tax base comes under federal domain, while, the residual tax base comes under provincial jurisdiction e.g., income tax comes under federal domain while agriculture income tax is provincial collection. Similar is the case with Capital gain tax.

In such a tax framework, even the incentives of performance based-matching grants for provincial governments, under 1997 NFC Award[13], also failed due to deficiency in revenue generation by their own efforts. The provisional tax collections for a long time also remained subdued due to lack of capacity, non-availability of data on incomes and wealth available with the provincial governments, and lack of accountability with in the revenue generation framework.[14]

[12] See Ahmed and Naqvi (2016); Jamali & Ahmed (2016); Nazir et al. (2018).
[13] If revenue growth of 14.2% was posted.
[14] See Ahmed (2017). See also Kardar, 2006 and Ahmed, Mustafa and Khalid, 2007.

The 7th NFC is also applauded for higher provincial shares which occurred in the shape of enhancement of 45% provincial share to 50% (tax revenue + grants) in the subsequent 5 years. However, there is a down side to this increase as it has been observed that overtime whenever a raise in share occurred it turned out as an increase in *non-development expense* which is not a desirable solution for provincial governments.

Throughout the Awards, population has been focused as the sole criteria for division of resources, which is definitely not the best practice in the world of today. Across the world multiple factors like income distribution, population density, revenue generation and poverty/backwardness are used for disaggregating federal revenues. As a consequence, there has been no serious change in distribution of resources amongst the provinces despite greater disparity in economic and demographic landscape (Ahmed, Mustafa and Khalid, 2007).

3. What needs to be done?

It is in this context that NFC award in Pakistan needs to start gradually a shift from need-based distribution of resources to efficiency-seeking sharing of resources. The NFC award, going beyond federation consensus, must start acting as tool to promote economic efficiency through promoting efficient provincial expenditure and incentivizing progressive taxation to collect revenues through i) adjusting the weights of exiting indicators ii) changing the composition of existing indicators and ii) inclusion of new indicators. Before we offer the alternatives, a look into Indian experience of resource distribution may establish how the finance commissions reflect the evolving needs in changing times.

We argue that a constitutionally acceptable debate should be on agenda for establishing the benchmarks for not only the federal-provincial share and the share of each province but also the objective of NFC. The benchmark can be adopted from the neighboring India, where the Finance Commission of India experimented with different criteria over time. For addressing horizontal imbalance across the state, the *Indian Finance Commission (henceforth IFC)* used the two criteria of collection of taxes and population for distribution of *inter se shares* of the states concerning income tax under first seven financial awards.

Population was the largest determinant of horizontal distribution till 6th IFC award, but its share fell from 100 to 75%. The 7th IFC award shifted the distribution to fundamentally new paradigm and decreased the population weight to 25%. Further the change triggered the use of other indicators relating to fiscal weaknesses and economic backwardness (SPDC 2018). From 8th IFC award, there was a step towards consolidating the formula for *inter se distribution* of both Union excise duties and income tax. The following tables, 3, 4 and 5, exhibit how weights assigned to population reduced significantly and how the base for resources distribution expanded to four sets of determinants.

Table: 3 Inter-se sharing[15] of Income Tax in India

Finance Commission	Weights (in percent)		Income Distance[16]	Inverse Per Capita Income[17]	Backwardness[18]
	Population	Collection of taxes			
	80.0	20			
Second, Fifth, Sixth & Seventh (1957-1984)	90.0	10			
Eighth (1984-89)	22.5	10	45.0	22.5	
Ninth (1989-95)	22.5	10	45.0	11.25	11.25
Source: Finance Commission Reports					

Table-4 Inter-se sharing of Union Excise Duty in India

Finance Commission	Weights (in percent)		Income Distance	Inverse Per Capita Income	Backwardness
	Population	Collection of taxes			
	80.00	20			
Second, Fifth, Sixth & Seventh (1957-1984)	90.00	10			
Eighth (1984-89)	22.5	10	45.0	22.5	
Ninth (1989-95)	22.5	10	45.0	11.25	11.25
Source: Finance Commission Reports					

Table5 Inter-se sharing of tax-India

Finance Commission	Finance Commissions				
	Tenth (income Tax and union excise)	Eleventh	Twelfth	Thirteenth	Fourteenth
Population[19]	20.0	10.0	25.0	25.0	17.0
Income Distance[20]	60.0	62.0	50.0		50.0
Area Adjusted[21]	5.0	7.5	10.0	10.0	10.0
Infrastructure Distance [22]	5.0	7.5			

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[15] ***Inter se*** is a Legal Latin phrase that means "among or between themselves". The phrase is "used to distinguish rights or duties between two or more parties from their rights or duties to others"

[16] It is the distance of actual per capita income of a state from the state with the highest per capita

[17] Inverse Per Capita Income implies inverse relationship between population growth and per capita income

[18] *Backwardness* measured through poverty, geographical remoteness, per capita income,

[19] The **population** criterion reflects the assumption that a state's expenditure needs generally grow proportionally with the number of its inhabitants. The criterion does not take in account the differences of states in their fiscal capacities, but provides equal per capita transfers to all states.

[20] **Income distance** criterion primarily aims to remove the poverty and the backwardness of the poorer States and takes into account the per capita income of the States. It is the distance of actual per capita income of a state from the state with the highest per capita and it is the only measure of fiscal capacity.

[21] The indicator is intended to reflect cost disadvantages to state governments for providing basic services to its citizens. Less densely populated areas typically require higher levels of government services and these create higher costs

[22] Infrastructure Distance can be interpreted as a criterion that reflects cost deficiencies of a state. The assumption involved is that the greater the infrastructure deficiencies of a state are, the greater will be its costs of providing public services.

Fiscal Self Resilience[23]/ Distance		7.5	7.5	17.5	
Tax Effort[24]	10.0	5.0	7.5		
Fiscal Capacity Distance				47.5	
Demographic Change					10.0
Forest Cover[25]					7.5
Source: Finance Commission Reports					

The IFC adopted different mechanisms to address horizontal inequalities and clubbed multiple criteria under five broad categories namely i) need based, ii) equity based iii) efficiency based iv) fiscal disability[26] and v) non-plan revenue expenditure[27] based approaches. These criteria, predominantly a deviation from need-based to equity and efficiency based, exhibited progressivity of transfers when implemented through successive FC Award.

The Tenth IFC selected tax effort as the efficiency-based criteria. It is important to note here that we use IFC to show that how it kept modifying the resource distribution mechanism in the face of arising developmental and other challenges. In this regard, our focus is on the composition of IFC and the balance it has to decide on changing the distribution mechanisms. IFC is technical body and decisions are not necessarily consensus based.

The weight of need based criteria decreased from 8th Indian FC awards and equity criteria got introduced to tackle backwardness and poverty across states. Table 5 clearly exhibits how dynamic IFC has been over the time. Not only that changed weights of indicators, but also introduced the new indicators as and when required. Juxtaposing, Pakistan only followed the criteria of need based (population) for divisible pool-horizontal distribution in first 6 NFC awards.

Despite being federally constituted, the ad-hoc nature of NFC in Pakistan failed to come up with optimal resources distribution formula. Only 7th NFC award witnessed some cut in weight of population that was then distributed amongst poverty, tax revenue and inverse population density. The status-quo prevailed in 8th NFC and it is likely to continue in 9th NFC as well. Some have argued that the mechanisms exclusively based on consensus always suffer from inertia.

3.1. Proposals for future NFC Awards

We emphasize that for a judicious formula the parameter choice should not be narrow and sub optimal like population which is based on census; conducted after decades and has issues of demographic dividend and migration. Therefore, due weightage to some important indicators which are adopted by the rest of the world, must be given. We also acknowledge that shift to

[23] For Fiscal Self Resilience index, the commission adopted the improvement in the ratio of own revenue receipts of a State to its total revenue expenditure related to a similar ratio for all States as a criterion for measurement. The ratio so computed is used to measure the improvement in the index of fiscal discipline in a reference period in comparison to a base period.

[24] Tax Effort is measured by weighted tax-GDP ratio, i.e. the ratio of per capita own tax revenue of a State to its per capita income weighted by the inverse of per capita income. The intention of the measure is to reward poorer States, which exploited its tax base as much as a richer State.

[25]The commission assigned 7.5 per cent weight to **forest cover** as the new criteria to balance the benefit of the huge ecological benefits and the opportunity cost in terms of area not available for other economic activities that becomes indicator of fiscal disability.

[26] This indicator was used to compensate the forgone revenues by converting lands into forest. The states which mainly shared the forest cover were not able to put the lander under forest to any other use creating a fiscal disability.

[27] Non-plan revenue expenditure includes interest payments, statutory transfers to provinces, pensions etc.

efficiency-based distribution is not possible overnight. However, at this point, we need to start at least a debate on moving towards efficiency-led distribution through i) reducing weight of population and ii) including efficiency-based indicators such as tax effort captured through difference between tax collected and estimates of tax potential.[28]

We also need to improve existing indicators of backwardness from absolute poverty to relative poverty. To guide provincial expenditures towards development, essentially without regulating, Pakistan needs to think transitory indicators which may include i) changes in provincial forest cover to tackle environmental challenges, ii) social expenditures to promote development efforts in the provinces. To meet these goals, we propose the following for future NFC negotiations.

i. Cut the population weight down by, at least 10% in next two NFC awards. Subsequently slash another 15% in the subsequent two awards to ultimately reduce the weight of population to 50%
ii. Replace the existing indicator of absolute tax revenue with tax efforts i.e. difference between revenue collected and the estimates of revenue potential. Also increase the weight for this indicator to 10% in the next two awards
iii. Keeping the current weight, replace absolute poverty with relative poverty. India uses income-distance, but until the time provincial level gross (provincial) product data is not available so we propose poverty-distance as an indicator where poverty-distance is the difference of provincial poverty incidence with respect to (any of the following);
    a. Poverty target set under the provincial SDGs framework
    b. Province with lowest poverty incidence
iv. Incorporate expenditure efficiency indicators which may include for example, expenditures on forest cover

Table 6 Proposed for future formula

Existing formula in 7th NFC		Proposed Formula for next two NFC awards		Comment
Indicator	**Weight (%)**	**Indicator**	**Weight (%)**	
Population	82.00	Population	72-67%	-Cut the weight by 15% in the next two NFC awards. -Deviation from need based approach to efficiency
Poverty	10.30	Poverty Distance	10.30	-Indicator composition changed –-Indicator of progressivity
Inverse Population Density	2.7	Inverse Population Density	2.70	No change
Tax Revenue	5.00	Tax Effort (tax revenue-tax potential[29])	10.00	-Weight doubled -Indicator composition changed -Captures efficiency

[28] See also Ahmed and O' Donoghue (2009). Hussain and Rana (2010) also calculate fiscal effort for provinces of Pakistan.

[29] World Bank can be approached to measure the tax gap. It has already been working on the issue. The study entitled "Public Financial Management and Governance" mentions that "recent studies of the World Bank estimate a tax gap of about 75 percent between the current receipts and potential of taxes collection"
https://peri.punjab.gov.pk/system/files/Chapter%2010%20Public%20Financial%20Management%20and%20Governance_0.pdf

				-Addresses the size of provincial economy problem
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3.2. Challenges in moving towards the new formula

The NFC by and large remained an unsuccessful forum to evolve and address the issue of fiscal decentralization in an optimal manner. Majority of the times, little consensus was achieved, paving way for interim awards that only benefited the larger provinces. Overtime this has led to increased resentment by the economically smaller provinces. Drawing on feedback from participants of workshops across all provinces, we highlight some of the key concerns of different federating units. We maintain that failing to overcome these challenges may force the status-quo to prevail.

First and foremost, the concern of provinces is that existing mechanisms of resource distribution are not implemented in letter and spirt. The AGN Qazi formula[30] was referred as a case. A trust gap is created between federal government and provinces. The participants from the provinces feel that it is useless to talk about the new formula when existing formula is not being implemented fully. Bridging this trust gap shall be very critical to proceed on any meaningful debate on resource distribution amongst provinces.

The provincial participants further flagged that constitutional provisions are not being fully met. In this context they highlighted that present narrative of the federal government on 18th amendment worries the provincial administration. Often times cabinet members in the federal government publicly say that the current NFC award formula weakens the federation – a view not shared by the provincial administrations.[31]

Another challenge has been a non-systematic approach to devolve, capacitate and empower provincial governments to create their own revenue collection mechanisms. The provinces should have been facilitated in a timely manner so that their dependence on the center could have reduced. Despite expansion in the overall resource pie since 1st NFC due to greater collection of indirect taxes, the federal government maintained the status-quo in the distribution rather than coming up with a rule-based mechanism (of distribution) and expanding the resources flow to provincial and local administrations.

Finally, the stakeholders saw the composition of NFC as one of the major challenges itself. NFC is intergovernmental platform and has no mandate or discretion to take decisions and implement with some discretion. The legal framework of NFC in Pakistan needs an overhaul. It must be given a status of a technical body with some discretion to take decisions. It is however important to

[30] The Aftab Ghulam Nabi (AGN) Kazi committee was formed in July 1985 to frame a formula for the calculation of the Net Hydel Profits (NHP) to the provinces under the article 161(2) of the constitution and was headed by Planning Commission deputy chairman AGN Kazi. Article 161 (2) of the Constitution states, "the net profits earned by the federal government or any undertaking established or administrated by the federal government from the bulk generation of power at hydro-electric station shall be paid to the province in which the hydro-electric station is located". The committee finalized its report two years later, in July 1987 to be exact, which was approved by the CCI in Jan 1991 and since then, KP and center have been trying to reach a settlement on the issue.

[31] See Hussain 2019, and Ismail 2019.

note here that introduction of elements of discretion may not be read as undermining the importance of consensus-based decision making.

4. Conclusion

Despite the challenges, we maintain that the scenario is favorable for the debate on the new criterion of distribution. The latest electoral process led to a situation where the ruling party (PTI) holds majority seats in the National Assembly; forming government in Punjab; experiencing second term in Khyber Pakhtunkhwa and creating a coalition government in Baluchistan; a milieu where public consensus, approval and implementation is comparatively easier to create. Since 7th NFC Award two aspects changed; the data availability and evidence. Currently, it is much convenient to identify the distribution rule that provides effective solution to financial disparities. Furthermore, the SDG localization with the support of provincial and local governments is altering the socio-economic thinking.

With the SDG construct in the backdrop, the distribution criteria discussed above is not only logically appealing but need of the hour. The countries which realize the importance of fiscal federalism, never compromise it; never leave it on an inconclusive note. Like in India, Finance Commission is a technical body and functions as an independent agency. Whereas in Pakistan, NFC is an inter-governmental platform comprising of federal and provincial representatives along with technical members from provinces. In Pakistan, it is essentially a consensus-based award.

Going beyond mere resource distribution, the future awards need to ponder on some bigger questions as well. Particularly, two questions need deliberation. First, are the provinces ready to deepen the elements of equity and efficiency in the formula? What will be the key tradeoffs of moving to a more refined efficiency-based distribution formula? And who are the winners and losers? Second, how effective is NFC as a legal mechanism? Do we need to introduce some elements of discretion in NFC?

We are well aware that these are difficult questions. And that breaking the status-quo will take time. However, addressing these questions is essential if we envisage a stronger state of federation in the future.[32] From our consultations, we note that awareness about NFC is weak. A public debate led by the federal government can bring forward progressive ideas. Federal government needs to highlight that NFC is tool to create economic efficiency and seeding the developmental priorities across the country.[33] In this regard, government may set permanent NFC caucus in provincial assemblies. A continued and broad base dialogue on NFC must be ensured through involving media, civil society, academia and policy think tanks. The development partners in Pakistan, having experience from other countries, may also help in offering technical advice on this subject.

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[32] See also Ahmed and Qadir (2018), Khan et al. (2016), and Ishfaq et al. (2017).
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