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National Finance Commission Award

Analysis of Inter-Governmental Transfers in Pakistan

By Abdul Wajid Rana

PRIME POLICY PAPERS

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List of Acronyms and Abbreviations

ADP	Annual Development Program
AIT	Agriculture Income Tax
BOR	Board of Revenue
CVT	Capital Value Tax
DP	Divisible Pool
E & T	Excise and Taxation Department
FATA	Federally Administered Tribal Area
FBR	Federal Board of Revenue
FRDLL	Fiscal Responsibility and Debt Limitation Law
GDP	Gross Domestic Prod
GDS	Gas Development Surcharge
GoP	Government of Pakistan
GRDP	Gross Regional Domestic Product
GST	General Sales Tax
HIES	Household Income and Expenditures Survey
KPK	Khyber Pakhtunkhwa
LGA	Local Government Act
MOF	Ministry of Finance
MTBF	Medium Term Budgetary Framework
MTIF	Medium Term Investment Plan
MVT	Motor Vehicle Tax
NFC	National Finance Commission
PA	Provincial Allocable
PCF	Provincial Consolidated Fund
PCGRDP	Per Capita Gross Regional Domestic Product
PFC	Provincial Finance Commission
PIFRA	Project for Improvement in Fiscal Reporting and Auditing
PR	Provincial Retained
PSDP	Public Sector Development Program
SDGs	Sustainable Development Goals
VAT	Value Added Tax

Executive Summary

1. Fiscal decentralization represents devolution of spending responsibilities from higher level to lower level of government accompanied by transfer of fiscal resources and administrative authority. The rising demand for decentralization in developing countries in recent years is a consequence of broader process of liberalization, deregulation, and urge for democratization with a need to bring the government closer to people for articulation of their needs and preferences. There is an increasing demand from regional and local leaders for more autonomy and taxation powers to support their expenditures. The literature on fiscal federalism identifies the basic principles governing the intergovernmental fiscal system based on expenditure assignments on the basis of economic efficiency, fiscal equity, political accountability, and administrative effectiveness; tax assignments; intergovernmental transfers and borrowings by the subnational and local governments. The intergovernmental transfers are necessitated to correct vertical and horizontal imbalances created because of mismatch between tax bases and expenditure assignments. These transfers can take different forms including sharing revenues and tax bases and establishing conditional or unconditional grants that throw the challenge of designing an appropriate system acceptable to all stakeholders in a federation.

2. Assigning expenditure responsibilities to a level of government is based on economic efficiency, fiscal equity, political accountability, and administrative effectiveness (Annex-A) whereas assigning taxing powers to a level of government is based on mobility, re-distributiveness of a tax, economies of scale, and tax base (even or uneven) with user charges for services assigned to local governments (Annex-B). The correction of consequential vertical and horizontal imbalances needs intergovernmental transfer system. The subnational borrowings are justified for intergovernmental equity, economic development, and synchronizing expenditure and revenue flows. The key factors in designing the intergovernmental transfers are: the distributive pool, distribution formula, conditionality, if any. Divisible pool can be determined on the bases of predefined taxes, spending plans of subnational governments, or annual budget decisions. The distribution of divisible pool across sub-national governments can be on derivation basis (counter equalizing), objectively defined formula, matching basis, and ad-hoc transfers.

3. Pakistan is no exception to this decentralization movement. Here, the intergovernmental fiscal relations have undergone major transformation with back-to-back devolutions in 2001 (transfer of functions, administrative authority and fiscal resources from provinces to district or local governments) and 2010 (abolition of concurrent list and transfer of functions, administrative authority and increased fiscal resources from federation to provinces through 18th Constitutional Amendment).Notwithstanding, despite this legislative redistribution of functions and fiscal resources (2010), the problems in inter-governmental relations continues. Higher level of governments attempt to encroach lower level governments' responsibilities on various pretexts, i.e. weak capacity, market failures, and weak fiscal capacity. This jurisdictional overlap

frequently leads to highly centralized decision-making, impairing accountability, and poor efficiency and equity in service delivery, particularly between provinces and local governments.

4. Intergovernmental fiscal relations in Pakistan are complex because of smaller number of provinces of which first is larger in terms of population, second is larger in terms of area, the third is relatively backward, and fourth has high economic and business activities. The existing intergovernmental transfer system does not provide any mechanism to ensure fiscal discipline and compliance of national priorities and objectives by the lower levels of governments. Consequently, inter-governmental fiscal transfers in Pakistan have been characterized by large vertical imbalances, first in favor of the Federation and now tilted towards provinces. The structure of provincial and local governments' revenues indicates an increasing dependency of the lower level governments on transfers from higher level of government with weak political will to mobilize local resources, which has a direct bearing on subnational and local governments' fiscal autonomy. Recognizing acute vertical and horizontal imbalances and varying fiscal capacities of provinces, the Constitution provides for institutional mechanism to correct these imbalances. The National Finance Commissions (NFC-empowered to distribute revenues between the Federation and Provinces and among provinces) and Provincial Finance Commission (PFC responsible for distribution of provincial resources between province and local governments and amongst local governments) offer a unique opportunity for the realization of one of the principle objectives to remove regional disparities and to promote harmony and trust among the provinces and between the Federation and the provinces. Indeed, the pursuit of supreme national interest needs to be translated into policies that equitably distribute economic and financial gains to the common man across all provinces. The NFC Award is not a pure financial document dealing with distribution of shared resources but also a statement of policy objectives of the government during the course of the award period. It necessitates that Articles 160 to 164 of the Constitution may not be considered in isolation but should be read with Articles 37 and 38 which provides the guiding principles for designing a sound system of intergovernmental fiscal transfers.

5. Nevertheless, the provinces in Pakistan became weary of the whole NFC process because of their experiences under the 1997 (6th NFC) Award, as the actual receipts fell far short of the projected receipts despite inclusion of custom and export duties, CVT, and wealth tax. This delayed the process of finalizing the 7th NFC Award for 9 years as the federation and the provinces got stuck not only on vertical distribution of the pool but also on the criteria for horizontal distribution of resources amongst themselves. Punjab kept insisting on continuation of population alone basis for horizontal distribution whereas the smaller provinces demanded a multi-indicators formula, each gunning for its own criterion to be given weightage: revenue generation/collection by Sindh, inverse population density by Balochistan, and backwardness or poverty by Khyber Pakhtunkhwa (KPK). The debate continued on the veracity of each indicator suggested by the small provinces particularly Sindh's suggestion which, according to

academicians, suffered from many constraints and tends to be fiscal in-equalizer. It was in this backdrop that the 7th NFC accommodated viewpoints of all the provinces and converged to a multi-indicators formula for horizontal distribution of resources of the divisible pool as follows:

Population (82%) + Revenue Generation/Collection (5%) + Backwardness (10.3%) + Inverse Population Density (2.7%).

The KPK, as a frontline province against the war on terrorism, was additionally compensated by awarding 1 percent of gross divisible pool.

6. The 7th NFC Award has turned the federal government into perpetual fiscal deficit. The Federal and Provincial Governments are once again stuck on recommending a fresh NFC Award. The 8th National Finance Commission wounded up without recommending an award while the 9th NFC is deliberating for the last three years without getting closer to developing fresh recommendations. While the provinces are demanding increased vertical share moving from current 57.5 percent to 70 percent of the divisible pool, the federal government is attempting to increase its share from current 42.5 percent to 49.5 percent (3 percent for national security and 4 percent for Federally Administered Tribal Areas and Gilgit-Baltistan). The federal government is not in a position to enhance vertical shares of the provinces.

7. Accordingly, it is proposed that:

(a) **Composition of NFC and PFC:** Existing institutional mechanism and composition of NFC and PFCs may be retained as their structures are more viable for evolving a political consensus. However, it may be backed up by a technical team to conduct technical discussions and developing its recommendations for consideration of these bodes (For detailed argument, see Annex-D).

(b) **Independent NFC and PFC Secretariat**: The federal and provincial governments may establish independent NFC and PFC Secretariats manned by professionals and experts in Fiscal Decentralization and Inter-Governmental Transfers or making some research institution adjunct to these Secretariats for research on various issues (i) International Best Practices and Recent Trends in Fiscal Decentralization (ii) Rationalizing the Divisible Pool (Federal, Provincial); (iii) Fiscal Capacity and Fiscal Equalization of Provinces; (iv) Revenue Sharing Formula and Borrowings Limit; (v) Incentives Demographic Change; (vi) Fiscal Accountability and Fiscal Performance; and (vii) all other related matters, for informed discussion and decision-making. Additionally, the formula based transfers from federal to provincial to local levels needs timely, reliable, and comprehensive data and its periodic updating for designing the formula and

determining benchmark for each of the indicators and a monitoring system to evaluate performance of the provinces. It necessitates permanent Secretariats for National and Provincial Finance Commissions.

(c) **Legislation to avoid Delay in Awards:** NFC could not finalize its Awards in 1979, 1985, 2002 and 2007. The 9th Award has already been delayed by two years. Likewise, the final PFC's Awards have not been notified by the provinces since elections under Local Government Act 2013. The present stalemate tends to suggest the need for legislation to regulate affairs of NFC and PFCs and to provide for a mechanism that may help in finalizing the award within prescribed time-frame in case of any dispute, as the net loser of delay in awards are the lower levels of government. Article 160 (4) of the Constitution does provide room for legislation. It is proposed to legislate to regulate NFC matters in terms of (i) qualifications of such other persons, (ii) nominating private persons other than non-official members, (iii) time frame for finalizing recommendations, (iv) public hearings, (v) summoning of reports, documents, and experts, (vi) broad principles for sharing of revenues between federal and provincial governments; and (vi) a mechanism to handle stalemate or impasse in NFC that allows finalization of the Award within the prescribed time frame. Similar arrangements may be provided for PFC in the Local Government Act 2013.

(d) NFC must continue to be constituted every 5 years and meet to review Horizontal Distribution Criteria for making necessary adjustments, in population based on census and other adjustments needed, following thorough research.

(e) **Rationalizing the Divisible Pool:** Since the divisible pool now includes all taxes for sharing with the provinces, the existing size may continue. The argument for including surcharges in the Pool may impair federation's capability to discharge its obligations with respect to debt servicing, defense, and development.

(f) **Resource Distribution Formula:** It is important that the guiding principles for any future distribution of divisible resources, vertical and horizontal, must be (i) achieving federal fiscal target as enunciated in the Fiscal Responsibility and Debt Limitation Act; (ii) fiscal equalization; (iii) convergence of regional income; (iv) stimulating revenue effort at all levels of government; (v)maintaining fiscal discipline; and (vi) achieving national development priorities (education, health, and SDGs). The same holds true for PFC Awards.

(g) **Sharing of the Pool:** The pool may be shared in the ratio of 42.5: 57.5 (all inclusive) between the federation and subnational governments. There must be an

end to announcement of discretionary grants by the Prime Minister or the Chief Minister or appropriation for Parliamentarians' development fund as these grants create systemic distortions and tilt the divisible pool's allocation in favor of a province or provinces where the government belongs to same political party which is in power in the federation. However, the Ministry of Finance and Provincial Governments may develop and institutionalize a system of conditional grants, if required, to achieve national priorities rather than following the Robin Hood Approach.

(h) **Determination of Actual Vertical and Horizontal Imbalances in Pakistan:** This requires development of a scientific method to ascertain fiscal needs and fiscal capacity of subnational and local governments. Pending that, fiscal needs and capacity may be assessed using weighted average cumulative growth rates of actual provincial revenue and expenditure during 1991-92 to 2014-15 to bring the receipts and expenditures of benchmark year (say 2014-15) at par, which then may be projected on the basis of agreed growth rates for receipts and expenditures over the next five years.

(i) **Multi-Indicators Formula:** The current horizontal distributional factors viz. Population, Backwardness, Revenue Collection/Generation, Inverse Population Density may be considered for expansion to include Inverse Demographic Change and Income Distance in the formula. Once the Regional Gross Domestic Product data becomes available, Income Distance may also be added as one criterion. Backwardness should be comprehensively measured either on the basis of Human Development Index (life expectancy, primary education, primary healthcare) or Multi-Dimensional Poverty Index (MPDI) Index which will require data base to determine the benchmark. It will need to commission a technical study to evaluate the implications of various scenarios as the inclusion of above criterion in the formula could make the intergovernmental transfer system complex without achieving fiscal equalization, if designed poorly. Following options are suggested subject to detail technical study examining each option:

Option I P (60%) + MPDI (7%) + RG (5%) + IPD (3%) + IDC (10%) + ID (15%)

Option II P (70%) + MPDI (7%) + RG (5%) + IPD (3%) + IDC (10%) + ID (5%)

Option III P (75%) + MPDI (7%) + RG (5%) + IPD (3%) + IDC (5%) + ID (5%)

where

P = Population
IPD = Inverse Population Density
MPDI= Multiple Dimensional Poverty Index
IDC = Inverse Demographic Change
RG= Revenue Generation
ID= Income Distance

(j) **Introduction of Value Added Tax:** The Federal Government and the Provinces must endeavor to converge on replacement of existing General Sales Tax with single-tier Value Added Tax to simplify tax structure as well as to increase the revenues.

(k) **Federal Revenue Receipts:** Federal Government may explore some Non-Tax Avenues to enhance its revenues as relying on provincial surpluses to achieve fiscal deficit target is highly risky and amenable to various vulnerabilities as the Federal Government has no instrument to bind the provinces in this regard except moral suasion.

(l) **The Public-Sector Development Program (PSDP):** and its components may be analyzed to determine its effect: equalizing or dis-equalizing to ensure its judicious distribution across provinces to correct regional disparities to bring them all close to national standards.

(m) **Provincial Taxes and Piggybacking:** The provinces' own revenues have been stagnant at 0.6 percent of the GDP for quite long. The political will to mobilize local resources, both at the subnational and local levels, is quite weak and needs special efforts. The additional revenues can be tapped by exploiting the full potential of Agriculture Income Tax, Property Tax, Motor Vehicle Tax, matching the user charges to cost of services, and plugging the leakage by reinvigorating the revenue administration in the provinces, which will promote greater provincial fiscal autonomy. The provincial governments must plan to optimize the potential of their taxes and improve their tax administration. The provinces may be allowed to piggyback income and corporate tax between the ranges of 0.5 to 1.0 percent to improve their base.

(n) **Compliance to National Priorities:** With devolution of spending functions and fiscal decentralization, it is important to develop a mechanism to channel subnational and local governments' expenditures towards meeting national

objectives (Sustainable Development Goals targets and other priorities) either through formula for distribution of resources or institutionalizing conditional transfers out of divisible pool for meeting clearly defined objectives/targets.

(o) **Golden Rule for Borrowings:** It is proposed that borrowing powers of the provinces may be linked with development needs and laying upper limit for each of the province depending on their fiscal capacity.

(p) **Urban-Rural Gap:** The PFC's Awards, though already factoring for backwardness in formulae for revenue sharing between subnational and local governments need to review urban-rural gap and human development indicators in each district for providing sufficient weightage to bridge the gap and bringing all districts at par during a predetermined period and Awards' allocation to districts may be regulated accordingly. Else, the Provincial Governments should develop conditional grant mechanism to address these problems.

(q) **Fiscal Responsibility and Debt Limitation Law:** The Provincial Governments may be encouraged to design Provincial Responsibility and Debt Limitation Law and these laws, both for the federal and provincial governments, must include penal clauses for breach of limits prescribed or to be prescribed in the Laws.

(r) **Public Financial Management Law:** Federal and Provincial Governments must frame Public Financial Management laws as required under Articles 79 and 119 of the Constitution to strengthen financial management and to discipline their finances.

(s) **Role of Legislature in Budget Making:** The proposed Law may provide for enhancing the role of legislature in budget making and to strengthen the legislative oversight particularly the Public Accounts Committees.

(t) **Local Government Tiers:** The number of Local Governments tiers may be reduced to only two tiers and also create Special Purpose Districts for economizing the cost of services moving towards phasing out rural-urban distinction. Local Governments must be empowered with strengthening their capacities in governance and administration and strict accountability**.**

(u) **Provincial Finance Commission and Local Government Commission:** The provinces must activate PFCs to finalize the provincial awards and Local Government Commissions.

(v) **Resolution of Net Hydel Profit:** In the larger interest of national integration and provincial harmony, the impending issue of net hydel profit needs to be resolved on permanent footing.

8. Likewise, the key challenges to devolution include jurisdictional overlap, developing complementarity between national priorities and objectives and subnational and local governments' programs. The economic and financial gains need to be distributed equitably to the common man across provinces that may mandate transfer of larger share of revenues to local governments. However, the index of fiscal autonomy demands increased efforts to mobilize resources by lower level of governments to decrease their dependency on higher level of government. A mechanism is also required to put in place to minimize the risk associated with mid-course changes in duties and taxes, part of the divisible pool, without consulting the provinces. To conclude, the NFC and PFC Awards should not be a mechanical exercise but must be taken as instruments of national integration and channels of transmitting the national economic gains to grass root level engaging all stakeholders in national development.

I. Introduction

Fiscal decentralization is the devolution from the central government to sub-national governments (states, regions, municipalities) of specific functions with the administrative authority and fiscal revenue to perform those functions(Wallace Oates, 1977). Fiscal decentralization contributes to economic growth (Nobuo Akai and Masayo Sakata (2004) and provides incentives for governments to promote local economies (Huizhong Zhou 2000 whereas others (Hamid Davoodi and Heng-fu Zou) found a negative relationship between fiscal decentralization and growth in developing countries though, none in developed countries (1998). However, the theoretical underpinnings for a direct relationship between fiscal decentralization and economic growth remain an open question (McNab and Matinez-Vazquez 2003). Secondly, fiscal decentralization is expected to boost public sector efficiency as well as accountability and transparency in service delivery and policy making by bringing the government closer to the people. Though, the empirical evidence suggests that coordination failures in intergovernmental fiscal relations are likely to result in deficit bias in decentralized policy-making, particularly of developing countries (Luiz R. De Mello Jr 2000).

2. Fiscal decentralization gained strength for the reasons: (i) central governments are increasingly finding it impossible to meet all of the competing needs of their various constituencies, and are attempting to build local capacity by delegating responsibilities downward to their regional governments; (ii) central governments are looking to local and regional governments to assist them on national economic development strategies; and (iii) regional and local political leaders are demanding more autonomy and want the taxation powers that go along with their expenditure responsibility.

3. In Pakistan, back-to-back two key devolutions[1] have transformed Pakistan from a layered-cake hierarchical federalism to participative and collaborative federalism. Concomitantly, the debate on fiscal decentralization and transfer of more resources to intermediate and lower tiers of the government ensued to correct 'increasing vertical and horizontal imbalances' that were perceived to be impeding the provincial autonomy in fiscal decision making. Seventh National Finance Commission (NFC) Award, effective from FY2010/11, attempted to address these imbalances in favor of the provinces. In addition, the Award was a marked shift from the previous Awards in terms of both vertical transfers (from 47.5% in 2008/09 to 57.5% of the divisible pool in 2001/12[2] to the provinces) as well as criteria for horizontal sharing: from population as sole criteria to population (82%), backwardness

[1]Local Government Ordinance 2001 devolved spending functions from provincial to district governments while 18th Constitutional Amendment deconcentrated federal functions and devolved them to the provincial governments in 2011

[2]Including grants and development expenditure, share of the provinces increased to 65%

(10.3%), inverse population density (2.7%) and fiscal effort (5%) to accommodate the demands of all the federating units.

4. However, unrealistic underlying assumptions and failure to enforce Value Added Tax (VAT) led to severe criticism on the 7th NFC Award, such as: (i) extensive decentralization constrained the ability of the federal government to conduct countercyclical stabilization policies; (ii) the large dependence of the provinces on shared revenues and transfers from federal government created disincentive for the provincial government to mobilize its own resources; (iii) unsynchronized and unbalanced devolution of funds and spending responsibilities to the provinces exacerbated the fiscal strains at the federal level forcing them to press the provinces to throw up surpluses; (iv) accelerated augmentation of resources allocated to the provinces stretched their ability to spend these effectively that resulted into misallocation and waste spending or transfer of funds to different non-treasury accounts; and (v) fast and poorly designed fiscal decentralization resulted in increased regional inequalities. Overall, the rapid and far-reaching fiscal decentralization in Pakistan complicated macroeconomic management and adversely affected economic performance while failing to improve the service delivery of services, the key objective of devolution, and reduce fiscal inequality among the provinces.[3]

5. These risks, perceived or actual, are delaying the finalization of fresh NFC Award. Eighth NFC (2015) wounded up without giving its recommendations and the Ninth NFC (2016) is deliberating on various proposals since its constitution but the Award has not been finalized. While the provinces continue to demand for larger share in the divisible pool (DP), the Federation has asked for an allocation of 7 percent of the DP for national security (3 percent) and Gilgit-Baltistan, FATA and Azad Jammu and Kashmir (4 percent).The delay in resolution of issues relating to both vertical (sharing of the divisible pool between the federation and provinces) and horizontal distribution (basis for distribution of provincial share amongst the provinces and the regions) of resources is raising concerns about present status, composition, and effectiveness of the National Finance Commission, as the provinces are sticking to their position and the federal government is constrained to provide additional resources because of its fiscal position.

6. This paper focuses on an analysis of intergovernmental fiscal relations. Chapter II examines the theory behind intergovernmental fiscal relations across continents and fiscal decentralization between different levels of the government. Chapter III identifies major challenges and issues confronting fiscal decentralization and intergovernmental transfers in Pakistan. Chapter IV evaluates the 7th NFC Award. Chapter V highlights the challenges going forward. Chapter VI deals with grants as a mechanism to achieve national objectives and priorities. Chapter VII and VIII deals with conclusions and recommendations.

[3]International Monetary Fund, Pakistan: Staff Report for the 2011 Article IV Consultation and Proposal for Post-Program Monitoring.

II. Intergovernmental Fiscal Relations

2.1 Fiscal Decentralization

7. While the momentum for fiscal decentralization gained strength internationally in early 1990s, there had been some cautionary notes (Hommes, 1996; Tanzi, 1995; Prud'homme, 1995) saying that fiscal decentralization may lead to less than optimal results because: (i) taxpayers may have insufficient information or no political power to pressure local policy-makers to make resource-efficient decisions; (ii) local politicians may be more corrupt than national politicians or at least find themselves in more corrupting or rent seeking situations; (iii) the quality of national bureaucracies is likely to be better than local bureaucracies; (iv) technological chance and increased mobility may reduce the number of services that are truly "local" in nature; (v) local governments often lack good public expenditure management systems to assist them in their tax and budget choices; (vi) fiscal inequities may actually increase with decentralization; (vii) fiscal decentralization may limit the ability of the principal (the central government) to influence policy at the local level; and (viii) local governments may become captive of elites and political barons. This criticism has been countered by others (McClure, 1995; Oates 1995) while acknowledging that decentralization if done badly will cause problems.

8. The catalysts for deepening fiscal decentralization and rearranging fiscal relationship include collapse of national economies, desire to break-away from colonial fiscal arrangements, central governments' failures to secure national objectives, globalization of economic activities, and demonstration effect of other countries. The globalization is also influencing governance structures moving from unitary to federal form of government as indicated in Table 1.[4]

Table 1: Governance Structure—20th Versus 21st Century

20th Century	21st Century
▪ Unitary ▪ Centralized ▪ Centre Manages ▪ Bureaucratic ▪ Command and Control ▪ Input controls ▪ Top down accountability ▪ Internally dependent ▪ Closed and Slow	▪ Federal/ Confederal ▪ Globalized and localized ▪ Centre leads ▪ Participatory ▪ Responsive and accountable to citizens ▪ Results matter ▪ Bottom-up accountability ▪ Competitive

[4]. Anwar Shah, Fiscal Decentralization in Developing and Transition Economies: Progress, Problems, and the Promise, p.4, 1994

20th Century	21st Century
▪ Intolerance of risk	▪ Open and quick ▪ Freedom to fail/succeed

2.2. Principles of Intergovernmental Fiscal System

9. The intergovernmental fiscal system is based on four pillars: expenditure assignment, revenue assignment, intergovernmental transfers/grants, and subnational debt/ borrowing (Bird 2000). The economic principles developed by Ved Ghandi, Anwar Shah and Roy Bahl (1994) for designing or reforming the intergovernmental fiscal structure suggest assigning expenditure responsibilities on the basis of economic efficiency, fiscal equity, political accountability, and administrative effectiveness to determine whether a function can be better performed by the central government or any other level of government.

10. ***Assigning expenditure responsibilities***. Decentralization theory suggests that the central or national government should be responsible for those services whose benefits extend across the country (e.g. national defense); that generate spillovers across the country (e.g. monetary policy); that benefit from economies of scale (e.g. certain transportation networks); that are primarily income redistributable in nature (e.g. provisions for the elderly); and where uniform country-wide standards are expected (e.g. certain environmental standards). Subnational governments should be responsible for those services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service. Primary and secondary education, health care, local transportation networks, and care of the elderly are typical examples of such services.

11. ***Tax Assignment and Fiscal Autonomy*: Fiscal need principle** emphasizes that the revenue generation capacity should match expenditure responsibilities to ensure fiscal autonomy. The **efficiency in tax administration principle** suggests that taxes on mobile factor, (corporate and personal taxes) should be assigned to the national government and taxes on less mobile factors including piggybacking of federal taxes to subnational governments. The user fees or benefit-based taxes where the beneficiaries can be clearly identified and the costs correctly determined (water and sewage systems, recreational services, public transit, and solid waste disposal) may be assigned to local governments.

12. The general principles of rational assignment of taxing powers to different levels of government as listed in fiscal federalism literature (Oates 1972, Anwar Shah 1994, Bird 2000) are: (a) the tax base assigned to subnational governments should be immobile to allow local authorities freedom to vary rates without the base vanishing; (b) redistributive taxes should be assigned to the central government; (c) services provided by subnational governments should be financed through user charges and other local fees and taxes that are related to benefits (motor

vehicles fee, water charges, education or hospital fees, etc.); (d) taxes that are subject to important economies of scale in collection efforts should be centralized; and (e) taxes levied on tax bases that are unevenly distributed should be centralized. Traditional fiscal federalism prescribes a limited tax assignment for subnational and local governments. Generally, the local taxes are those (i) that are easy to administer locally; (ii) that are imposed mainly on local residents; and (iii) that do not raise problems of 'harmonization' or 'competition between local and subnational governments or local and federal governments. The user charges include (a) service fees (license fee, registration fee or cost reimbursement fee of services rendered); (b) public prices (sale of private goods and services—utility charges to admission charges to recreation facilities); and (c) specific benefit charges (fuel tax levied on road users, betterment tax). Global practices for assigning expenditure and tax responsibilities are indicated at **Annex A and B.**

13. ***Intergovernmental transfers:*** The revenue and expenditure assignments generate vertical and horizontal imbalances within intergovernmental finances. This requires intergovernmental transfers to correct these imbalances. It has led some rethinking on three long-accepted principles governing subnational taxation: (i) conventional model of tax assignment that tends to assign all significant revenues to federal governments is inappropriate for countries in which subnational or local governments account for a significant proportion of public sector spending; (ii) subnational VATs are possible and can become important source of subnational revenues, and (iii) property tax and user charges package is inadequate where local governments have major spending responsibilities in the social sectors.

14. ***Subnational Borrowings:*** Finally, the subnational borrowing that is justified for three primary reasons: (i) Intergovernmental equity: The benefit principle of taxation suggest that investment projects, infrastructure, education, and health, benefits not the present residents of a locality but also the future residents, therefore, the later should also contribute the cost of investments. For this purpose borrowing is justified (Oates 1992); (ii) Economic Development: borrowing is an appropriate tool in investing infrastructure projects to stimulate regional economy, generate employment opportunities and improve earnings level; (iii) Synchronizing Expenditure and Revenue Flows: Borrowings provide subnational governments an opportunity to smoothen out the mismatch between flow of revenues and expenditures. Since central government has the responsibility for stabilization policies, it must have full control over public debt. It is important that intergovernmental fiscal structure must also be concerned about efficiency, vertical imbalances, horizontal equity (fiscal capacity among regions), externalities, tax exportation, public management, responsiveness, and accountability for service delivery apart from other factors discussed above.[5]

[5]. Anwar Shah, The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Economies, pp. 5-21, 1994.

2.3 Intergovernmental Transfers—Design Challenge

15. The intergovernmental transfer system of a country can take different forms: sharing revenues and tax bases, and establishing conditional or unconditional grant system. The key factors in designing the intergovernmental transfers are: the size of the distributable pool, the basis for distributing transfers, and conditionality. Fiscal transfers to lower levels of government is justified for several reasons: (i) to equalize vertical imbalances; (ii) to equalize horizontal imbalances to address inter-regional differences; (iii) to correct for inter-jurisdictional spillovers; (iv) to off-set externalities, i.e. conditional grants for specific service can stimulate spending on that service because if left to local governments, they may under-spend on services where there are substantial external benefits (education and health); and (v) to correct administrative inefficiencies and cost of assessing and collection of taxes by the federal government.

16. It must be recognized that intergovernmental transfers designed to correct vertical or horizontal imbalances have redistributive implications. In this context, revenue adequacy and its growth over period, predictability, simplicity of transfer formulae and transparency, equity, incentive for sound financial management and resource mobilization at subnational levels become equally important. Therefore, appropriate design of intergovernmental transfer system entails four policy choices: (a) determination of the divisible pool; (b) distribution of resource pool across central and subnational governments; (c) measuring and correcting redistribution and equalization; and (d) subnational spending autonomy and the transfer instrument.

17. The transfer (divisible) pool can be determined in three ways: (i) it can be based on predefined taxes that can allow the pool to grow if it is tied to buoyant taxes; (ii) it can be linked with spending plans of subnational governments, either open-ended or closed-ended, which can lead to serious fiscal challenges if the subnational governments are extremely polarized preparing ambitious plans to get maximum resources; and (iii) it can be tied with annual budget decisions that gives national government maximum flexibility to respond to national fiscal conditions.

18. The distribution of pool across sub-national governments can take place in more than one ways: (a) transfer of all or some tax-revenues on the basis of collection from a geographical unit (derivation principle); (b) distribution is based on an objectively defined formula using some objective and quantitative criteria for allocation of pool of revenues [population (a straight per capita distribution), indicators of physical factors that may lead to costs of service of provision (land area, population density, urbanization), factors reflecting concentration of high cost population (percent of families living below the poverty line, percent of school aged children), and indicators of infrastructure needs (miles of paved highways, percent of household with

access to adequate water supply, infrastructure needs to support economic development), tax effort to provide some incentive to subnational and local governments to increase the overall level of revenue mobilization, level of average income in the local area, revenue potential, and balance between revenue raising capacity and expenditure needs], which ensures transparency and can meet many of the objectives of intergovernmental transfers but loses its overall effects if too many indicators are added to the formula; (c) cost-sharing on matching basis for expenditures incurred on priority activities; and (d) ad-hoc transfers at the discretion of granting government, which will lead to uncertainty, arbitrariness, and non-transparent allocations.[6]

2.4 An Overview of International Experiences

19. Many countries around the globe, developed, developing and transition, embarked upon fiscal decentralization by reassigning expenditure functions and devolving revenue sources to subnational and local governments. The stylized facts relating to fiscal decentralization from a cross country perspective are highlighted below:

(i) Relative importance of different levels of government in providing public goods and services is reflected in the size of governments measured in terms of expenditure to GDP ratio or subnational government spending to federal government spending. Federal governments spending range from 20% of GDP in Asia to 40% in European countries of OECD. The subnational share of total government spending is below 5% in Asia, ranges from 10 to 40% in Latin America, and from 12% to 60% in the OECD countries.

(ii) Subnational governments in Asia rely heavily on transfers from the center while federations (Austria, Canada, Switzerland, Germany, and United States) emphasize on local tax revenue mobilization whereas European countries including Australia mainly resort to intergovernmental transfers to finance subnational spending.

(iii) Intergovernmental transfers in many countries are formula driven, though newer for state-local revenue sharing in countries that are deepening their fiscal decentralization (India and Pakistan) and are constrained by data limitations.

(iv) Many countries with three levels of government distribute grant to lowest tier using a variety of formula methods based on different indicators: population size and poverty (Mexico), the value of real estate (Brazil), the balance between expenditure needs and fiscal capacity (Russia and China), and equal shares (India).

(v) Fiscal decentralization increases informational distance between the center and the decentralized subnational or local governments to which fiscal responsibilities are

[6]. Paul Smoke and Yun-Hwan Kim, Intergovernmental Fiscal Transfers in Asia: Current Practices and Challenges for the future, pp. 21-57.

devolved or delegated and makes it difficult for the federal government to monitor efficiency in expenditure management, revenue collection, and improvement in service delivery. Coordination failures in intergovernmental fiscal relations may encourage fiscal indiscipline.

The revenue sharing between the national and sub-national governments is at **Table 2** (next page) and countries experiences for revenue sharing and grants arrangements are at **Annex C.**

Table 2. Revenue Sharing Between National and Sub-National Governments

Country	Shared Taxes	Percentage	Criteria	Percentage	Transfer
Argentina	Value Added Tax (VAT) Income Tax Asset Tax Excise Tax Financial Service Tax Fuel Tax	53.90 48.70 49.00 49.00 49.00 53.00	Population Development Gap Inverse Population Density	65.00 25.00 10.00	5 %
Brazil	Income Tax Payroll Tax Tax on Industrial Products Taxes on Hydroelectricity and Minerals	21.50 66.70 21.50 45.00	Population Area Per Capita	Equal	2%
Colombia	All Federal Taxes Beer tax VAT	23.00 40.00 50.00	Population Equal Share	70.00 30.00	22%
India	Income Tax Excise Duties Estate Duties	28.00 28.00 28.00	Population Income Distance Method Index of Infrastructure Tax Efforts Fiscal discipline Area	25.00 50.00 - 7.50 7.50 10.00	28%
Indonesia	Royalties on Oil & Gas Forestry Royalties Motor Vehicle Tax Tax on land and area	100.00 35.00 100.00 81.00	Origin Origin Origin Origin	100.00 100.00 100.00 100.00	12%
Japan	Income Tax Liquor Tax	32.00 32.00	Collection	100.00	
Malaysia	Import & Excise Duties on oil Export Duties on Tin	30.00 10.00	Collection	100.00	3%
Mexico	Income Tax	17.35	Population Collection	50.00 50.00	
Nigeria	All Federal Taxes	31.50	Minimum Responsibility Population Social Development Factor Collection	40.00 40.00 15.00 5.00	
Philippines	All Federal Taxes Tax on Petroleum Product and Natural Resources	40.00 77.00	Population Land Area Equal Share Origin	25.00 25.00 50.00 100.00	

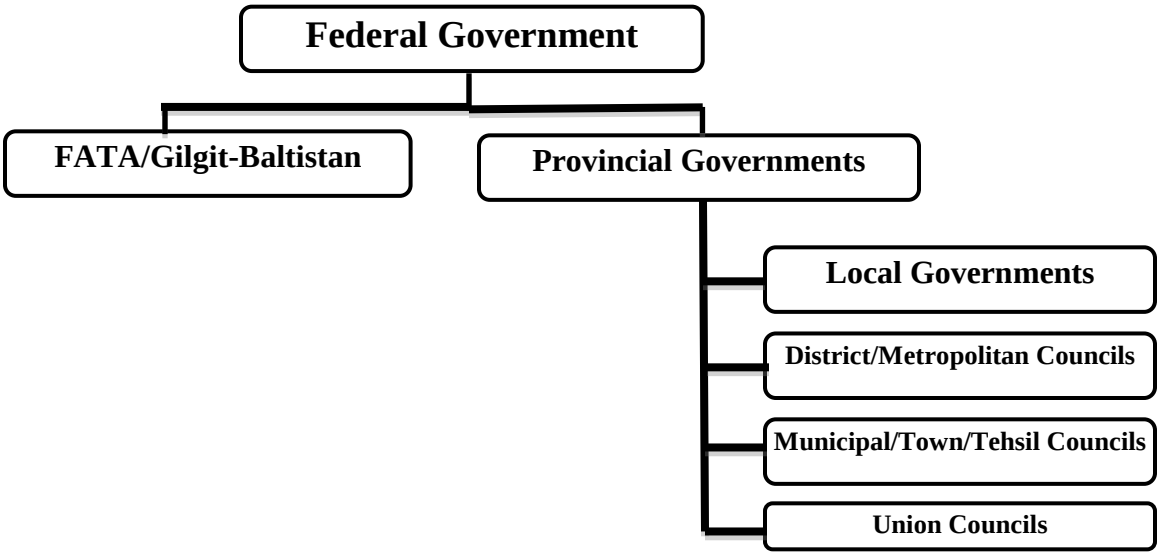
Sources: *The Reform of Inter-Governmental Fiscal Relations in Developing and Emerging Market Economies, The World Bank, Policy and Research Series 23; Sharing of India is extracted from the Report of 12th National Finance Commission, India*

III. Inter-Governmental Transfers in Pakistan

3.1. Governance Structure

20. Pakistan is a federation with three tiers of the government—the federal government, provincial governments and local governments (Article 140-A of the 1973 Constitution)—with constitutional division of functions between the federation (Federal Legislative List) and the provinces (all residuary functions), collaborative functions (Part-II of the Federal Legislative List), and statutory functions (Local Government Act). Post 18th Constitutional Amendment (2010), the governance structure is reflected at **Figure 1.**

Figure 1. Governance Structure of Pakistan



21. Although, the legislative distribution of functions conform positively to the assignment principles of fiscal federalism as explained above, the actual assumption of responsibilities tends to be more centralized. Higher level governments increasingly attempt to encroach not only upon lower level government responsibilities but also upon traditional private functions, despite devolution. The federal government extends itself in areas of shared responsibility or that belong to subnational governments, which, in turn encourages the subnational governments to venture into Local Governments jurisdiction; for example vertical programs or MNAs/Senators development programs represent attempts by higher tiers of government to influence the policy and behavior of lower levels of government by direct intervention.

22. The key constitutional institutions responsible for administrative and fiscal collaboration between the federation and the federating units are:

(a) **Council of Common Interest:** It administers all matters enlisted in Part-II of the Federal Legislative List. The Inter-Provincial Coordination Committee functions as an adjunct of this institution.

(b) **National Economic Council**: It is mandated to formulate plans in respect of financial, commercial, social and economic policies; and in formulating such plans it is, amongst other factors, required to ensure balanced development and regional equity and is guided by the Principles of Policy set out in Chapter 2 of Part-II.

(c) **National Finance Commission**: It is entrusted with distribution of resources (divisible pool) between the federation and provinces and among provinces.

23. The Principles of Policy in the Constitution defines the broader framework for resource spending (Articles 29 to 40 of the Constitution), the key principles include: (i) defense, (ii) promoting with special care, the educational and economic interests of backward classes or areas; (iii) enabling people of different areas through education, training, agricultural and industrial development and other methods to participate fully in all forms of national activities including employment in the services of Pakistan; (iv) providing for all citizens within the available resources of the country facilities for work and adequate livelihood; and (iv) reducing poverty in the income and earnings of individuals, including persons in the various classes of the service of Pakistan. These provisions of the Constitution reflects the responsibility of the State to focus on the welfare of every citizen irrespective of the place of residence of these citizens that necessitates rendering equal services to all and development of backward areas.

3.2. Constitutional and Statutory Position

24. The intergovernmental fiscal relations in Pakistan are governed by Articles 160-167 of the Constitution. The National Finance Commission, comprising federal and provincial finance ministers and four non-official members one from each province, constituted every five years under Article 160 is entrusted with the mandate of devising the revenue sharing arrangements between the federal government and the provinces and among the provinces. The Commission follows the "Unanimity Rule"—the federal and provincial governments must agree on its recommendations before the President of Pakistan approve the Order (NFC Award). 18th Constitutional Amendment has provided additional safeguards that (i) "the share of the provinces in each Award of National Finance Commission shall not be less than the share given to the Provinces in the previous Award" and (ii) the Federal and Provincial Finance Ministers shall monitor the implementation of the Award and lay such report before the Parliament. The fiscal relations between the provinces and local governments are regulated through the Local

Government Acton the recommendations of Provincial Finance Commission constituted in each province.[7]

25. The "divisible pool" i.e. the revenue sources available for share has been specified in the Constitution [Article 160 (3)]. The President on advice of the Prime Minister can add revenue sources (export duties, excise duties, and other taxes) to the divisible pool while notifying the establishment of the Commission. Extract of relevant provisions relating to divisible pool under the Government of India Act and various Constitutions are at **Annex-G.**

26. Post 18th amendment Constitutional arrangements for intergovernmental fiscal arrangement limits the space available for negotiations a new Award. The "Unanimity Principle" more often stalls the fresh Award. Generally, the NFC proceedings are dominated by: (i) vertical resource sharing; (ii) criteria for horizontal resource distribution among the provinces; (iii) outstanding Net-Hydel Profit dues of KPK; (iv) formula for Gas Development Surcharge; and (v) fiscal equalization grants. The challenges and issues facing fiscal decentralization and intergovernmental transfers in Pakistan include the following:

(i) Tax Assignment and Fiscal Autonomy

(ii) Determination of the divisible (transfer) pool and transfer design

(iii) Revenue sharing arrangements between three levels of government: formulae, criterion, weightage assigned to each criteria, transfer mechanism, grants (discretionary, conditional and unconditional) and determining expenditure needs using historical expenditure level as the base adjusting the base annually by an appropriate index, average expenditure per capita as the standard, etc.

(iv) Vertical and Horizontal imbalances and fiscal equalization

(v) Status of institutional framework responsible for distribution of resources: should they continue as at present or should they be autonomous and quasi-judicial, or should they be a permanent body or constituted after every five (three) years.

(vi) Institutional considerations including accountability measures such as performance indicators, auditing and monitoring systems; capacity building at each level of governments.

(vii) Transfer of Grants: Conditional or Unconditional or development grants

[7]Local Government Act, 2013 while under Local Government Act 2010 in case of Balochistan

3.3. Intergovernmental Transfers under NFC Awards

27. The intergovernmental transfers between the federation and subnational governments in Pakistan have been regulated by the NFC Awards, seven since 1951 and the proceeding for the ninth Award are in process. The history of various National Finance Commission is at **Table 3.**The NFC constituted in 1979 (2nd NFC), 1985 (3rd NFC), 2000 (6th NFC), and 2015 could not finalize their recommendations. The revenue sharing arrangements and the assigned share transferred to provinces under each of the Awards in Pakistan are reflected at **Table 4.**

Table 3. Chronology of NFC Awards

Serial No.	Name	Status
First	**NFC Award 1974**	**Conclusive**
Second	NFC Award 1979	Inconclusive
Third	NFC Award 1985	Inconclusive
Fourth	**NFC Award 1991**	**Conclusive**
Fifth	NFC Award 1995	Inconclusive
	NFC Award 1997	**Conclusive**
Sixth	NFC Award 2002	Inconclusive
DRGO	Interim Award 2006	President's Order
Seventh	**NFC Award 2010**	**Conclusive**
Eighth	NFC Award 2015	Inconclusive
Ninth	NFC Award 2020	Inconclusive so far

Table 4: Revenue Sharing between Federation and the Provinces Under Various NFC Awards (Percent)

Tax Heads	Niemeyer Award 1937[1]	Raisman Award 1951[2]	NFC 1962	NFC 1964	NFC 1970	1st NFC 1974	4th NFC 1990	5th NFC 1996	Interim Award 2006	7th NFC 2009
Shared Taxes										
Income & Corporation Tax	50	50	50	65	80	80	80	37.5	46.25[5]	57.5[6]
Wealth Tax[4]	-	-	-	-	-	-	-	37.5	-	-
Sales Tax	-	50	60	65	80	80	80	37.5	46.25	57.5
Custom Duties	-	-	-	-	-	-	-	37.5	46.25	57.5
Capital Value Tax[4]	-	-	-	-	-	-	-	37.5	46.25	57.5
Central Excise on tea/betel nut	-	50	60	65	80	-	-	-	-	-
Export Duty on Cotton/Jute	62.5	62.5	100	65	80	80	80	37.5	-	-
Excise Duty on tobacco	-	50	60	65	80	-	80	-	46.25	57.5
Excise Duty on Sugar	-	-	-	-	-	-	80	-		-
Federal Excise Duties	-	-	-	-	-	-	-	37.5	46.25	57.5
Taxes on Capital Value of Immoveable Property	-	-	100	100	100	-	-	-		
Estate and Succession Duties for agriculture land	-	-	100	100	100	-	-	-		
Straight Transfers										
Excise duty on Natural Gas	-	-	-	-	-	100	100	100	100	100
Royalty on Natural Gas	-	-	-	-	-	100	100	100	100	100
Surcharge on Natural Gas	-	-	-	-	-	-	100	100	100	100
Royalty on Crude Oil	-	-	-	-	-	-	100	100	100	100
Hydel Profits	-	-	-	-	-	-	6 bn	6 bn	6 bn	
Subvention/Special Grant (Rs in Million)										
NWFP	10	12.5	-	-	-	100	200	3310	27.75 bn	
Baluchistan	-	-	-	-	-		100	4080		
Sindh	10.5[3]	-	-	-	-	-	700	-		
Punjab	-	-	-	-	-	-	1000	-		
Fiscal Transfers as % of Federal Tax Revenue		12.8	23.1	27.0	33.4	29.8	35.3	41.3	45-50%	60.0%

Source: *Statutory Orders issued from time to time*

1. Governor General Order 3 of 1949
2. Governor General Order 23 of 1953
3. Subvention was later suspended as financial conditions improved
4. Wealth Tax and Capital Value Tax have since been abolished.
5. The provincial share during first year of Award was 41.5 percent and gradually increased to 46.25 percent
6. The Provincial share during the first of Award was 56 percent and increased to 57.5 percent in second year

28. The criterion for horizontal sharing of revenue is at **Table 5.** The principle of allocating a portion of revenue on collection basis was recognized in the initial awards, 100% of sales tax under Raisman Award and 30% of sales tax under 1962 Award. However, revenues continued to be distributed to the provinces on population basis from 1970 to 1996 NFC Awards and changed under 7th NFC Award (2009).

Table 5. Criteria for Horizontal Revenue Sharing

Award	Taxes	Sharing Criteria (Weight)
Raisman 1951	Sales Tax Income Tax and Excise Duties Export Duties	Collection (100%) Pre-Assigned Shares (100%) Pre-Assigned Shares (100%)
NFC 1962	Sales Tax	Collection (30%) Pre-Assigned Shares (70%)
NFC 1964		Pre-Assigned Shares (100%)
NFC 1970		Population (100%)
First NFC 1974	All Taxes	Population (100%)
Fourth NFC 1990	All Taxes	Population (100%)
Fifth NFC 1996	All Taxes	Population (100%)
Interim Award 2006	All Taxes	Population (100%)
Seventh NFC 2009	All Taxes	Population 82.0% Poverty/Backwardness 10.3% Revenue Generation/Collection 5.0% Inverse Population Density 2.7%

Various Statutory and President's Orders

29. Shares assigned to each of the provinces under different Awards are at **Table 6** indicating a close relationship between revenue share and population share. Under Raisman Award, both Punjab and Balochistan got the share lower than they were entitled to on the basis of population while Sindh and KPK (then NWFP) got higher shares then their population shares primarily because Sales Tax was assigned to respective province on 100% collection basis. The pre-assigned share of Punjab was lower than its population share while that of the other provinces was higher under NFC Award 1970. Nevertheless, the shares almost exactly match the population share from the 1974 Award and onwards. The shares of all provinces changed under NFC Award 2009 because of shift in criteria for horizontal revenue sharing.

Table 6. Pre-Assigned Shares of the Provinces under Various Awards

Province	**Raisman 1951**	**NFC 1961-62**	**NFC 1964**	**NFC 1970**	**NFC 1974**	**NFC 1990**	**NFC 1997**	**NFC 2009**
Punjab	59.39 (63.58)	–	–	56.50 (62.23)	60.25 (60.10)	57.87 (57.87)	57.88 (57.88)	51.74 (57.36)
Sindh	24.14	–	–	23.50	22.50	23.29	23.28	24.55

Province	Raisman 1951	NFC 1961-62	NFC 1964	NFC 1970	NFC 1974	NFC 1990	NFC 1997	NFC 2009
	(18.71)			(20.45)	(22.62)	(23.29)	(23.28)	(23.71)
NWFP	15.32 (14.10)	–	–	15.50 (14.01)	13.39 (13.40)	13.54 (13.54)	13.54 (13.54)	14.62 (13.82)
Balochistan	1.15 (3.61)	–	–	4.50 (2.31)	3.86 (3.88)	5.30 (5.30)	5.3 (5.3)	9.09 (5.11)
Total	**100**	**–**	**–**	**100**	**100**	**100**	**100**	**100**

Figures in brackets are population shares according to the last Census conducted prior to the Award.

3.4. Straight Transfers

30. In addition, the 1991 NFC Award embodies the principle envisioned in Article 161 of the Constitution which provides for transfer of royalty on natural resources to the province of origin by including surcharge of natural gas and royalty on crude oil. Concurrently, the Council of Common Interest while approving the Water Sharing Accord 1991 acknowledged the right of the provinces on Net Hydel Profits generated from hydro-electricity as provided under Article 161 (2) of the Constitution. The province wise straight transfers are at **Table 7**.

Table 7. Straight Transfers to the Provinces

Province	Straight Transfers
Punjab	Excise duty on Natural Gas Royalty on Natural Gas and Crude Oil Surcharge on Natural Gas (share of net proceeds assigned to provinces) Net Hydel Profit on Electricity administered by Federal Government in the province
Sindh	Royalty on Crude Oil Excise duty on Natural Gas Royalty on Natural Gas Surcharges on Natural Gas
KP	Net Hydel Profit on Electricity administered by Federal Government in the province Excise Duty and Royalty on Natural Gas Royalty on Crude Oil cise Duty and Royalty on Natural Gas Transfers Surcharge on Natural Gas
Balochistan	Excise Duty and Royalty on Natural Gas Transfers Surcharge on Natural Gas

Source: *Various Statutory and President's Orders*

31. The structure of provincial revenues **(Table 8)** indicates an increasing dependency of the provinces on federal tax assignment transfer accounting for 83.4% in FY2008/09 and 83.3% in FY2014/15 (last year of 7th NFC Award) up from 79.1% in 2001/02, of provincial revenue resources. The increase reflects three elements: (i) 1% of the divisible pool to KP on account of War on Terrorism; (ii) Constitutional protection to baseline share of Balochistan; and (iii) change

in vertical revenue sharing increasing share of the provinces. The federal transfers as percentage of GDP **(Table 9)**, which showed an increasing trend until 1995-96 and then started declining with the exception of 1999-2000 because of sluggish growth in revenues, substantially enlarged during interim Award and 7th NFC, demonstrating trends in fiscal decentralization. The provincial own receipts remained stagnant for most part of the NFC sharing arrangements under 1973 except after 7th NFC Award because of devolution of GST on Services to the provinces. Punjab, Sindh, and KPK have shown improvement in provincial own receipts.

32. While the provinces have generally been assigned non-buoyant and narrow-based tax, lack of political will to improve provincial tax collection, political compromises for tax adjustment, the economic and political complexities of taxing provincial revenue bases, and weak tax administration have prevented the provinces from realizing full revenue potential of several of buoyant and potentially broader tax bases assigned to them. Agriculture income, property tax and motor vehicle tax are the three potentially important tax bases available to the provinces but the revenue yield from agriculture income tax is only a fraction of its potential.

Table 8: The Structure of Provincial Revenues

(Percent)

	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan	Total
1984-85					
Federal Tax Assignments	45.9	61.6	32.7	60.8	47.7
Provincial Taxes	14.0	23.7	6.2	2.8	13.3
Non-Tax (Incl. Grants)	40.1	14.7	61.1	36.4	39.1
o/w Grants	23.9	0.0	52.2	29.5	25.3
Total	100.0	100.0	100.0	100.0	100.0
1990-91					
Federal Tax Assignments	65.0	75.6	44.4	59.4	62.9
Provincial Taxes	12.3	12.7	3.6	1.8	9.9
Non-Tax (Incl. Grants)	22.7	11.6	52.0	38.8	27.2
o/w Grants	9.9	0.0	43.0	34.9	16.0
Total	100.0	100.0	100.0	100.0	100.0
1998-99					
Federal Tax Assignments	76.6	77.0	52.2	69.0	72.00
Provincial Taxes	14.6	14.5	5.0	1.7	11.70
Non-Tax (Incl. Grants)	8.8	8.5	32.8	29.3	16.30
o/w Grants	0.0	0.0	13.20	27.1	4.90
Total	100.0	100.0	100.0	100.0	100.00
2001-02					
Federal Tax Assignments	77.4	66.2	63.2	58.4	79.1
Provincial Taxes	9.8	12.1	5.4	2.2	9.0
Non-Tax (Incl. Grants)	12.8	21.7	31.4	39.4	20.9
o/w Grants	3.5	6.6	13.0	18.6	7.4
Total	100.0	100.0	100.0	100.0	100.0
2009-10					
Federal Tax Assignments					83.4
Provincial Own Receipts	66	36	7	3	16.6

	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan	Total
Total					100
2014-15 (last year of 7th NFC)					
Federal Tax Assignments	84.6	77.0	87.0	95.4	83.3
Provincial Own Receipts	15.4	23.0	13.0	4.6	16.7
Total	100.0	100.0	100.0	100.0	100.0

Source: *Federal and Provincial Budget Documents and Finance Accounts*

Table 9: Revenue Transfer to the Provinces

Year	GDP (In billion rupees)	Percentage of transfers To GDP
1985-86	514	6.60
1986-87	572	7.26
1987-88	675	7.60
1988-89	770	6.90
1989-90	856	6.14
1990-91	1021	6.19
1991-92	1211	7.24
1992-93	1341	7.04
1993-94	1573	7.19
1994-95	1882	7.06
1995-96	2141	6.94
1996-97	2457	6.23
1997-98	2678	5.97
1998-99	2913	5.79
1999-00	3562	6.36
2000-01	3923	5.22
2001-02	3727	5.00
2002-03	4146	5.44
2003-04	4534	5.38
2009-10	14,249	4.31
2014-15	29,598	7.0

Source: Federal Budgets and Economic Survey of Pakistan

IV. An Analysis of 7th National Finance Commission Award

33. NFC Awards up to 1991 (Fourth Award) in Pakistan followed "gap-filling" approach assessing the revenue receipts and expenditures based on actual numbers of the provinces and

recommended non-plan deficit. This approach encouraged the provinces to understate the predicted growth of their tax receipts and overstate their expenditures and future commitments widening their deficits. The Fifth NFC Award adopted new approach based on (i) National Resource Picture (ii) inclusion of all federal taxes, and (iii) constitutional subvention for the two backward provinces, Khyber Pakhtunkhwa and Balochistan.

34. As mentioned above, NFCs constituted in 2000 and 2005 remained inconclusive. The Sixth National Finance Commission was constituted on July 22, 2000 but met for the first time in July 2001. After comprehensive deliberations spanning over a period of more than one year, it came too close to finalizing the Award in September 2002 except for difference of opinion on the criteria for distribution of GST in lieu of Octroi and Zila Tax (Sindh insisted on maintaining the existing distribution arrangements and NWFP arguing for distribution on population basis) and uncapping of hydel profit and payment of outstanding claims. It was then decided to pend the Award until the elections and induction of an elected government. The reconstituted Commission, notified on November 13, 2003, held 6 meetings but could not reach a consensus in formulating an Award. It got stuck not only on vertical distribution (provinces demanding 50 percent share) but also criterion for horizontal distribution of the divisible pool share as each province was sticking to its position discussed below.

35. Consequently, the President approved the Distribution of Revenues and Grants-in-Aid (Amendment) Order (DRGO) 2006 which differs from previous Awards in three ways: (a) it introduced a variable share of provincial governments in the divisible pool ranging from 41.50 percent in FY2007 to 46.25 percent in 2010-11; (b) it introduced two divisible pools- one totally based on sole criteria of population for horizontal distribution and the other used distribution of 1/6th of the sales tax on new shares of the provinces in lieu of abolished Octroi and Zila Tax; and (c) grant-in-aid for all the provinces not based on any criteria.

36. The 7th NFC Award introduced structural changes in the resource distribution including:

(1) Correcting the long-standing vertical imbalance against provinces and increasing the provincial share in the divisible pool substantially from 45 percent in FY2010 to 56 percent in FY2011 and 57.5 percent from FY2012 onwards;

(2) Criteria for horizontal distribution changing from population as sole basis to multiple factors. i.e. population (82 percent), revenue collection/generation (5 percent), backwardness (10.3 percent) and inverse population density (2.7 percent) to accommodate long standing demands of Sindh, KP and Balochistan respectively;

(3) Reduction in federal government's collection charges from 5 to 1 percent thereby enlarging the divisible pool;

(4) Allocating additional one percent of net proceeds of the divisible pool to KP recognizing its role as a frontline province against war on terrorism;

(5) Transfer of GST on services collected in the Central Excise mode to the provinces in straight transfer mode and devolving GST on Services to the provinces;

(6) Providing constitutional protection to share of the provinces specially that of Balochistan in the NFC Award;

(7) Constituting NFC Monitoring Committee under the Constitution to meet biannually to monitor the implementation of the Award; and

(8) Resolution of chronic issues such as Gas Development Surcharge (demanded by Balochistan) and Net Hydel Profit (KP demand) transferring Rs. 20 billion and Rs. 110 billion, respectively.

With substantial resource transfers from the divisible pool **(Table 10)**, the fiscal position of the provinces strengthened vastly but weakened the federal government which has to deal with debt-servicing, defense, development, and subsidies in addition to running the federal government which are 4.2 percent, 3.6 percent, 2.5 percent, 1 percent and 1.5 percent of revenues/GDP plunging the federal government into perpetual fiscal deficit.

Table 10. Resource Transfer in Pakistan

Year	Revenue as % of GDP	Revenue Transferred to Provinces as% of GDP
1990s	17.1	7.0
2000s	13.9	5.2
2004-05	13.8	5.4
2009-10	14.0	6.2
2014-15	14.3	6.8
2015-16	15.0	7.0

37. **Table 11** indicates that the total federal transfers less of straight transfers has increased in FY2015 post-7th NFC Award by 132 percent over the last year (FY2010) of Interim Award 2006. Federal transfers to sub-nationals has increased over time. Secondly, there is less vertical as well as horizontal inequities have been addressed to a large extent encouraging fiscal equalization. However, socio-economic disparities across provinces still persist. Horizontal distribution is largely based on population that limits the financial capacity of two smaller provinces to meet their assigned roles and responsibilities. The poor planning, distorted priorities, skewed spending on infrastructure in large cities and misallocation of resources are also largely responsible for persistence of these disparities not only inter-provincial but also intra-province.

Table 11. Share in Total Transfers by Provinces

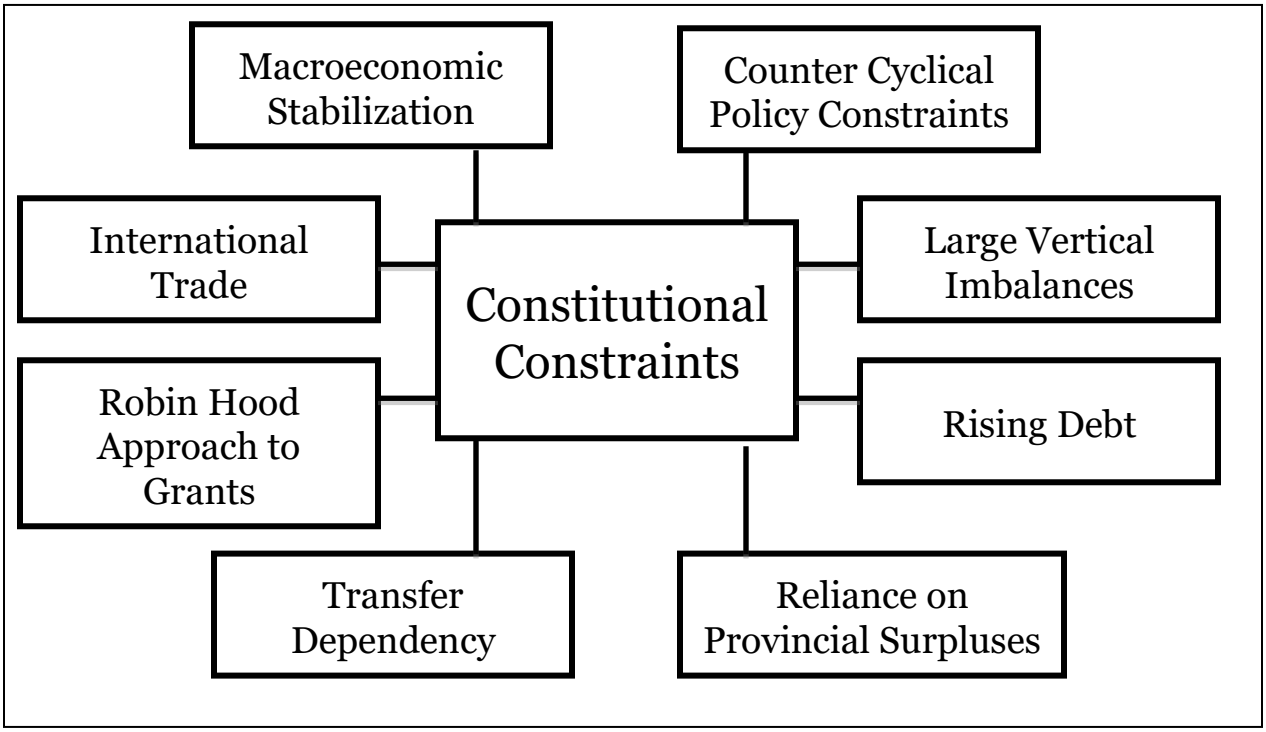
Period	Total Federal Transfers in Rs. billion	Punjab %	Sindh %	KP %	Balochistan %
1990-91 Pre 1990 NFC	33.8	55.3	24.0	12.7	7.9
1991-92 Post 1990 NFC	65.8	45.1	23.9	19.0	12.0
1996-97 Pre 1996 NFC	139.4	51.3	24.9	15.9	7.9
2001-02 Post 1996 NFC	139.7	57.8	23.3	13.5	5.3
2009-10 Post 2006 Order	615.0	53.0	24.9	14.9	7.2
2014-15 Post 7th NFC Award	1429.6	50.3	23.9	15.9	9.9
Per Capita Resource Transfer PKR		**9,767**	**11,224**	**12,810**	**21,555**

Source: *NFC Reports of various years.*

V. Challenges Going Forward

38. The provinces had been weary of the whole process of NFC because of their experiences under NFC Awards of 1991 and 1997 when the actual federal transfers stayed far below the projections and strained the development progress for almost fifteen years. It was for these reasons that the NFC Awards of 2000 and 2005 remained inconclusive and finally the President of Pakistan had to notify DRGO (Interim Award 2006). The experience was not much different than the previous Awards except that share of the provinces gradually increased which became the basis for hard bargain by the provinces. The political understanding between the two main political parties in power in 2009 to transfer larger chunk of the divisible pool to the provinces weakened the federal government resulting into perpetual high fiscal deficit. Despite huge resource transfers, the socio-economic indicators continued to be low as these provinces could not plan for determining the right priorities and judicious use of additional resources. The priority remained infrastructure which is visible with high rent seeking. Sharing of borrowing limits with the sub-nationals on the strength of their Provincial Consolidated Funds added to their resource flow and encouraged imprudent fiscal behavior in some provinces. The too fast and too soon fiscal decentralization has created many challenges for the federation (**Figure 2)**.

Figure 2. Challenges Caused by Too Fast Fiscal Decentralization



39. The Federal Government is no longer interested in bringing an early closure to finalize the next NFC Award. The provinces are demanding further increase in their share in the divisible pool from current 57.5 percent to 70 percent. The Federal Government feels very strongly that given its fiscal position, there is hardly any fiscal space to be shared with the provinces. Instead, the Federal Government is persuading the provinces to allocate 7 percent of the gross-divisible pool before determining the vertical share of the federation and the provinces, for Federally Administered Tribal Area (FATA), Azad Jammu and Kashmir and Gilgit-Baltistan (4 percent), and national security (3 percent). The provinces are hedging against any federal attempt to reduce their share under any pretext and are endeavoring to protect existing multiple criteria for horizontal distribution and pushing for increase in their vertical share. Therefore, no party is interested in early resolution of this logjam in NFC. It seems that the current stalemate will also end up making the current NFC Award as inconclusive unless the political environment changes dramatically.

VI. Grants as a Mechanism for Achieving National Objectives

40. Many countries in a federal system utilize the mechanism of unconditional and conditional grants as alternate channels or as supplement to fiscal transfers. The general purpose unconditional grants are meant to fill resource gap (subvention to KP and Baluchistan during fifth Award). The conditional transfers to sub-national and local governments are advocated (i)

to ensure certain minimum standards of services across jurisdictions; (ii) to pursue higher level government objectives (either on matching or non-matching basis; and (iii) to address inter-jurisdictional spillovers of benefits (conditional matching transfers). Khushal Pakistan, Tameer-e-Pakistan, Education Sector Reforms, matching ratio transfer for Social Action Program, are the cases in point. However, federal-provincial specific purpose transfers in Pakistan have been adhoc and primarily used for agency functions or to advance political objectives. The program of matching grants for resource mobilization under1991 and 1997 NFC Awards was also ill conceived. It primarily rewarded richer jurisdictions. Its non-disbursement on one pretext or the other, to provinces which exceeded the target, tarnished the credibility of this incentive.

41. The federalist approach assumes that the funds flow to responsible political bodies with least interference in local expenditure choices but with sufficient accountability. Nevertheless, when the national government uses local governments in executing national policies and achieving national objectives, such as primary education and health coverage, it is desirable to have conditional transfers. The conditional grants are used in many countries with federal structure. At times, the national governments also provide grants for financing infrastructure for two reasons: (a) some local infrastructure may involve significant externalities; and (b) such projects may supplement national development programs. The examples in point are Khushal Pakistan or Tameer-e-Pakistan and On Farm Water Management Program. However, the specific purpose grants need close monitoring and evaluation and should require the subnational and local governments an adequate investment and maintenance plan and user charge policy, where applicable; selection of sites for investment should be through a systematic process accounting for need, capacity, and economic evaluation rather than political clout. Generally, the literature supports matching grants for infrastructure development rather than general purpose grant for developing ownership and maintenance.

42. With devolution of spending functions and fiscal decentralization, it is important to develop a mechanism to channel subnational and local governments' expenditures towards meeting national objectives (Poverty Reduction Strategy Paper and Millennium Development Goals targets) either through formula for distribution of resources or institutionalizing conditional grants for meeting clearly defined objectives/targets. Such targeted programs include employment generation, health, education, and poverty reduction. It will require making grant criteria very transparent to avoid any subsequent frictions and availability of additional resources with national and subnational governments for providing additional resources to lower level of government.

VII. Conclusions

43. The conclusions emerging from the preceding discussion on fiscal decentralization in Pakistan and international experience are summed up as follows:

(i) The key challenges to devolution in Pakistan includes: (i) overlap with federal and provincial governments and lack of jurisdictional clarity in assigned expenditure responsibilities; (ii) vertical programs of the federal and provincial governments undermining the planning and budgeting and ownership of local governments; (iii) absence of mechanism to develop complementarity between national objectives and priorities and subnational and local governments programs; (iv) absence of three years awards.

(ii) Intergovernmental fiscal relations in Pakistan are complex because of smaller number of provinces of which one is larger in terms of population, other is huge in area, the third is relatively backward, and fourth has high economic and business activities.

(iii) The intergovernmental fiscal structures are based on expenditure assignment, revenue assignment, intergovernmental transfer/grants, and subnational borrowings.

(iv) Assigning expenditure responsibilities to a level of government is based on economic efficiency, fiscal equity, political accountability, and administrative effectiveness (Annex-A) whereas assigning taxing powers to a level of government is based on mobility, re-distribution of a tax, economies of scale, and tax base (even or uneven) with user charges for services assigned to local governments (Annex-B). The correction of consequential vertical and horizontal imbalances needs intergovernmental transfer system. The subnational borrowings are justified for intergovernmental equity, economic development, and synchronizing expenditure and revenue flows.

(v) The key factors in designing the intergovernmental transfers are: the distributive pool, distribution formula, conditionalities, if any. Divisible pool can be determined on the bases of predefined taxes, spending plans of subnational governments, or annual budget decisions. The distribution of divisible pool across sub-national governments can be on derivation basis (counter equalizing), objectively defined formula, matching basis, and adhoc transfers.

(vi) Subnational governments across the globe mostly rely heavily on intergovernmental transfers in a federal system whereas some use local tax revenue mobilization as subnational governments are generally assigned more expenditure functions than can be

financed from revenue sources allocated. Most fiscally decentralized countries practice formula driven intergovernmental transfers (Table 2).

(vii) Legislative distribution of powers in Pakistan conforms positively to the assignment principles of fiscal federalism; the actual assumption of responsibilities tends to be more centralized with higher level of government encroaching upon lower level government responsibilities, often defended on grounds of superior institutional capacity at higher level of government that impairs accountability and financial discipline, weakens local government and leads to poor efficiency in service delivery.

(viii) Recognizing vertical imbalances because of assigned spending responsibilities and taxation authority to federal and subnational governments, the 1973 Constitution provides revenue sharing mechanism (divisible pool having element of equalization) and institution (NFC). Similar arrangements have been made for sharing between subnational and local governments under Local Government Act 2013 (PFCs).

(ix) Assigning one buoyant tax to each of the lower level of government, as generally argued on the grounds of better fiscal responsibility and autonomy to provinces, increases regional disparities as fiscal capacities of provinces and districts are diverse, which affects service delivery adversely. It is evident from the collection of GST on Services.

(x) There is a consensus on formula based horizontal revenue sharing. However, the difference of opinion on criterion and weightage for each criterion in the proposed formula (Punjab stands for population alone criteria, Sindh for revenue collection, KP for backwardness, and Balochistan for inverse population density) existed which had been resolved under 7th NFC Award for the reasons mentioned below.

(xi) Population alone basis provides equal per capita transfers to all units but is neutral to inter-regional differences in the fiscal capacity and cost differentials for service delivery across provinces. As income of the provinces become more and more equal, the convergence to population basis is easy. Using revenue collection as one of criterion for horizontal revenue sharing suffers from many shortcomings: treatment of revenues collection on imports, determining the origin of sales tax on goods produced and consumed, locational effect of income and corporate tax, origin of capital invested in developing a federating unit, and likelihood of increasing the vertical imbalance. It was done away with in India since 5th NFC and Percy Committee opposed it as early as in 1932. Area and lag in infrastructure index tend to reflect cost disadvantages in providing services. Given two-third area of one province, inappropriate weight associated with Area indicator would tilt the bias in favour of that province. Therefore, inverse population density is more rational criteria to neutralize cost advantages. Fiscal effort criterion for

horizontal revenue sharing arrangements rewards revenue performance of a provinces showing higher tax revenue per unit of tax base gets. However, the fiscal effort needs to be measured in relation to tax potential of a province, which in absence of reliable data is not possible. The ratios of total own revenue to total revenue expenditure or total own revenues to total expenditures tend to increase regional inequalities because of lower fiscal capacity of KP and Balochistan, therefore, revenue balance, defined as ratio of revenue receipts to revenue expenditure, can be used as proxy for improvement in fiscal performance. The use of income distance method (distance of per capita income of a province from highest income province) measures absolute resource gap needed to provide public services at equal standards across provinces but suffers from two constraints in Pakistan: highest income province may not get any share and non-availability of regional GDP. The former constraint can be removed by taking weighted average of per capita income of two highest income provinces to measure distance from that benchmark income.

(xii) The risk associated with existing revenue sharing framework is the unilateral changes by the federal government in tax rate, tax concessions, and tax exemption resulting into unforeseen consequences for overall revenue collection and equalization.

(xiii) The existing system of revenue sharing between national and subnational does not allow federal government to influence provinces' expenditure priorities to achieve national objectives (social and economic sectors).

(xiv) Revenue sharing arrangement under Provincial Finance Commissions are constrained by (a) treating of all jurisdictions alike (city district government, large urban districts, and small rural district, each having a different local services menu); (b) distribution of resources on expenditure needs overlooking different fiscal capacities of various local governments; (c) transfers do not fully match with expenditure responsibilities leading to vertical imbalances; (d) weak accountability of local governments to local taxpayers as the major transfers come from the provincial and federal government, providing incentive to neglect local revenue raising and focusing more on provincial distribution criteria.; and (e) least focus on enhancing efficiency and equity and to provide for responsible and accountable governance.

(xv) The determination of fiscal needs and formula driven horizontal distribution of resources requires accurate data, which is missing on many aspects: regional GDP, district level poverty, disease burden and health conditions, education, economic and community services, fiscal capacity, gender, urban and rural needs for services, and determination of baselines for the purpose of development grant and fiscal equalization to bring backward areas/regions close to national standards. It is an imperative that timely, reliable and comprehensive data is generated for the formula(s) to work. In fact the design of formula(s) will be constrained in the short term due to unavailability of data having acceptable attributes.

VIII. Recommendations

44. The policy recommendations based on the above discussion are listed as under:

(a) **Jurisdiction Overlap:** Fiscal Decentralization and Inter-Governmental transfers require clarity in spending responsibilities between different levels of government to avert jurisdictional overlap and to curb the tendency of assuming lower level government functions by the higher level of government, for effective accountability.

(b) **National Finance Commission/Provincial Finance Commissions:** Existing institutional mechanism and composition of NFC and PFCs may be retained as their structures are more viable for evolving a political consensus. However, these institutions need to be strengthened either through permanent Secretariats manned by professionals or making some research institution adjunct to these Secretariats for research on various issues for informed discussion and decision-making (For detailed argument, see **Annex-D).**

(c) **Determination of actual vertical and horizontal imbalances** in Pakistan requires development of a scientific method to ascertain fiscal needs and fiscal capacity of subnational and local governments. Pending that, fiscal needs and capacity may be assessed using weighted average cumulative growth rates of actual provincial revenue and expenditure during 1991-92 to 2014-15 to bring the receipts and expenditures of benchmark year (say 2014-15) at par, which then may be projected on the basis of agreed growth rates for receipts and expenditures over next five years.

(d) **Rationalizing the Divisible Pool:** Since the divisible pool now includes all taxes for sharing with the provinces, the existing size may continue. The argument for including surcharges in the Pool may impair federation's capability to discharge its obligations with respect to debt servicing, defense, and development.

(e) **Sharing of the Pool:** The pool may be shared in the ratio of 42.5: 57.5 (all inclusive) between the federation and subnational governments. Therefore, the savings from grants and funds transferred to the provinces arbitrarily in the pretext of development schemes must be preserved to finance the needs of FATA, Gilgit-Baltistan, and AJK.

(f) The Federal Government and the Provinces must endeavor to converge on replacement of existing General Sales Tax with single-tier Value Added Tax to simplify tax structure as well as to increase the revenues.

(g) Federal Government may explore some Non-Tax Avenues to enhance its revenues as relying on provincial surpluses to achieve fiscal deficit target is highly risky and amenable to various vulnerabilities as the Federal Government has instrument to bind the provinces in this regard except moral suasion.

(h) Existing (2009) revenue sharing framework provides reasonable degree of fiscal equalization and has facilitated convergence of per capita revenues; it is proposed to be retained. .

(i) NFC must continue to be constituted every 5 years and meet to review Horizontal Distribution Criteria for making necessary adjustments in population based on Census and other adjustments needed following thorough research.

(j) **Multi-Indicators Formula:** The current horizontal distributional factors viz. Population, Backwardness, Revenue Collection/Generation, Inverse Population Density may be considered for expansion to include Inverse Demographic Change and Income Distance in the formula. Once the Regional Gross Domestic Product data becomes available, Income Distance may also be added as one of criterion. Backwardness should be comprehensively measured either on the basis of Human Development Index (life expectancy, primary education, and primary healthcare) or Multi-Dimensional Poverty Index (MPDI) which will require database to determine the benchmark. It will need to commission a technical study to evaluate the implications of various scenarios as the inclusion of above criterion in the formula could make the intergovernmental transfer system complex without achieving fiscal equalization, if designed poorly. The guiding objectives of any formula must be fiscal equalization, convergence of regional income, bringing all provinces at par with national standards, and stimulating revenue effort and expenditures to achieve national priorities. The same holds true for PFC Awards.

(k) Following options are suggested subject to detail technical study examining each option:

Option I P (60%) + MPDI (7%) + RG (5%) + IPD (3%) + IDC (10%) + ID (15%)

Option II P (70%) + MPDI (7%) + RG (5%) + IPD (3%) + IDC (10%) + ID (5%)

Option III P (75%) + MPDI (7%) + RG (5%) + IPD (3%) + IDC (5%) + ID (5%)

where

P = Population

MPDI = Multiple Dimensional Poverty Index

RG = Revenue Generation

IPD = Inverse Population Density

IDC = Inverse Demographic Change

ID = Income Distance

(l) The Public Sector Development Program (PSDP) and its components and its components may be analyzed to determine its effect: equalizer or dis-equalizing to ensure its judicious distribution across provinces to correct regional disparities to bring them all close to national standards.

(m) **Provincial Taxes and Piggybacking:** The provincial own revenues have been stagnant at 0.6 percent of the GDP for quite long. The political will to mobilize local resources, both at the subnational and local levels, is quite weak and needs special efforts. The additional revenues can be tapped by exploiting the full potential of Agriculture Income Tax, Property Tax, Motor Vehicle Tax, matching the user charges to cost of services, and plugging the leakage by reinvigorating the revenue administration in the provinces, which will promote greater provincial fiscal autonomy. The provincial governments must plan to optimize the potential of their taxes and improve their tax administration. The provinces may be allowed to piggyback income and corporate tax between the ranges of 0.5 to 1.0 percent to improve their base.

(n) **Compliance to National Priorities:** With devolution of spending functions and fiscal decentralization, it is important to develop a mechanism to channel subnational and local governments' expenditures towards meeting national objectives (Sustainable Development Goals targets and other priorities) either through formula for distribution of resources or institutionalizing conditional transfers out of divisible pool for meeting clearly defined objectives/targets.

(o) **Golden Rule for Borrowings:** It is proposed that borrowing powers of the provinces may be linked with development needs and laying upper limit for each of the province depending on their fiscal capacity.

(p) **Urban-Rural Gap:** The PFCs Award, though already factoring for backwardness in formulae for revenue sharing between subnational and local governments need to review urban-rural gap and human development indicators in each district for providing sufficient weightage to bridge the gap and bringing all districts at par during a predetermined period and Awards allocation to districts may be regulated accordingly. Else, the Provincial Governments should develop conditional grant mechanism to address these problems.

(q) **Legislation to avoid Delay in Awards:** NFC could not finalize its Awards in 1979, 1985, 2002 and 2007. The 9th Award has already been delayed by two years. Likewise, the final PFCs Award have not been notified by the provinces since elections under Local Government Act 2013. There is a need to develop some legal and institutional mechanism to circumvent this phenomenon. Article 160 (4) of the Constitution does provide room for legislation. It is proposed to legislate to regulate NFC matters in terms of (i) qualifications of such other persons, (ii) nominating private persons other than non-official members, (iii) time frame for finalizing recommendations, (iv) public hearings, (v) summoning of reports, documents, and experts, (vi) broad principles for sharing of revenues between federal and provincial governments; and (vi) a mechanism to handle

stalemate or impasse in NFC that allows finalization of the Award within the prescribed time frame. Similar arrangements may be provided for PFC in the Local Government Acts.

(r) **Fiscal Responsibility and Debt Limitation Law:** The Provincial Governments may be encouraged to design Provincial Responsibility and Debt Limitation Law and these laws, both for the federal and provincial governments, must include penal clauses for breach of limits prescribed or to be prescribed in the Laws.

(s) **Public Financial Management Law:** Federal and Provincial Governments must frame Public Financial Management laws as required under Articles 79 and 119 of the Constitution to strengthen financial management and discipline their finances.

(t) **Development Discretionary Grants:** The proposed PFM Law may bar announcing and sanctioning of all development discretionary grants or earmarking funds in the budget for Parliamentarians/Members of the Provincial Assemblies.

(u) **Role of Legislature in Budget Making:** The proposed Law may provide for enhancing the role of legislature in budget making and to strengthen the legislative oversight, particularly by the Public Accounts Committees.

(v) **Local Government Tiers:** The number of Local Government tiers may be reduced to only two tiers and also create Special Purpose Districts for economizing the cost of services, moving towards phasing out rural-urban distinction. Local Governments must be empowered with strengthening their capacities in governance and administration and strict accountability.

(w) **Provincial Finance Commission and Local Government Commission:** The provinces must activate PFCs to finalize the provincial awards and Local Government Commissions.

(x) **Independent NFC and PFC Secretariat:** The federal and provincial governments may establish independent NFC and PFC Secretariats manned by professionals and experts in Fiscal Decentralization and Inter-Governmental Transfers for research in (i)International Best Practices and Recent Trends in Fiscal Decentralization (ii) Rationalizing the Divisible Pool (Federal, Provincial); (iii) Fiscal Capacity and Fiscal Equalization of Provinces; (iv) Revenue Sharing Formula and Borrowings Limit; (v) Incentives Demographic Change; (vi) Fiscal Accountability and Fiscal Performance; and (vii) all other related matters.

Annex-A

Expenditure Assignment in Federal Systems

Country	Defense	Foreign	Int. Trade	Industry & Agriculture	Education	Health	Law & Order	Highways	Irrigation	Social Welfare	Environment	Air & Rail
Argentine	F	F	F	F, S, L	F, S, L	F,S, L	F, S	F, S	F	F, S	F, S	F, S
Australia	F	F	F	S, C	S	F, S	F, S	F, S		F, S	F, S	F
Austria	F	F	F	F !	F, S	C !	F, S	F, S		F, S	F, S	F
Canada	F	F	F	C	S	S	S	S		F, S	F,S	F, S
Brazil	F	F	F	F, S	F, S	F, S	F, S	F, S	F	F, S	F, S	F
China	F	F	F	F, S, L	F, S, L	S, L			F			F
Germany	F	F	C !	C !	S	C !	C !	F		C !	C !	F C!
India	F	F	F	F, S	F, S, L	S, L	S	F	F	F, S	F, S	F
Indonesia	F	F	F	F	F, S, L	F,S, L	S, L	F	F	S, L	F	F
Japan	F	F	F	L	F, L	F, L	L	L		F, L		
Malaysia	F	F	F	F, S	F	F, S	F	F	F	F, S	L	F
Mexico	F	F	F	F	F, S	F, S	S, L		F		F	F
Nigeria	F	F	F	F, S	F, S	S, L	F	F,S, L	F		F, S	F
Pakistan	**F**	**F**	**F**	**F, S, L**	**F, S, L**	**F,S, L**	**F, S**	**F, S**	**F, S**	**S,L**	**F, S**	**F**
Philippines	F	F	F	F	F, S, L	F	S, L	F	F	F, S, L	F	F
Russian Fed	F, S	F	F, S	F, S, L	F, S, L	F,S, L	S, L	F,S, L	F	F, S, L	F, S	F,S
Switzerland	F	F	F	S	S	S	F, S	F, S		C !	C !	F

Country	Defense	Foreign	Int. Trade	Industry & Agriculture	Education	Health	Law & Order	Highways	Irrigation	Social Welfare	Environment	Air & Rail
Thailand	F	F	F	F	L	L	L	L	F	L	F	F

Source: *Anwar Shah, The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies and Literature on Fiscal Decentralization*

Legend:
F = Federal
S = State/Province
L = Local Government
C = Concurrent power
! = Federal legislation administered by States/Provinces

Annex-B

Tax Assignment in Federal Systems

Country	Custom	Income & Corporate	Estates	GST	VAT	Excise	Property	User Fees	Residual
Argentine	F	F	F	F, S, L	F	S, L	S,L	S, L	S
Australia	F	F	F	S	F, S	S	L	L	S
Austria	F	F	F		F !	F, S	C !	F, S	F, S
Canada	F	F	F		C	S	S	S	S
Brazil	F	F	F		F		L	S, L	S
China	F	F, S, L		F, S, L	F	F, S	S, L	F, S, L	
Germany	F	F	C !		C !	S	C !	C !	F
India	F	F, S	F	F, S		F, S, L	F, S, L	F, S, L	F
Indonesia	F	F		F	F	F	F	F, S, L	
Japan	F	F	F		L	F, L	F, L	L	L
Malaysia	F, S	F		F		F, S	S, L	S, L	
Mexico	F	F	F	F	F	F	L	F, S, L	
Nigeria	F	F	S	S		F, S	L	S, L	
Pakistan	**F**	**F**	**F**	**F**	**N/A**	**F, S**	**S, L**	**S, L**	**S,L**
Philippines	F	F		S		F, S	L	S, L	F
Russian Fed	F	F	F, S		F, S	F, S	S,L	S, L	
Switzerland	F	F	F		S	S	S	F, S	F, S
Thailand	F	F				F, L	L		F

Source: *Anwar Shah, The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies and Literature on Fiscal Decentralization*

Legend:
F = Federal
S = State/Province
L = Local Government
C = Concurrent power
! = Federal legislation administered by States/Province

Annex-C

Taxation Authority of Each Level of Government in Pakistan

S.No	Federal Government	Provincial Government	Local Governments
a.	Customs including export duties	Tax on agriculture income	Education Tax
b.	Income and Corporate tax	Tax on Profession, trades, Callings, employment	Health tax
c.	Income and Corporate tax	Motor vehicle tax	Tax on Vehicles other than Motor Vehicles
d.	General Sales Tax on goods	GST on Services	Local rate on Lands
e.	Surcharge on Petroleum	Registration, Transfer of Immoveable Property	Fees of Schools, Colleges, and Health Facilities
f.	Wealth Tax (abolished)	Stamp duties	Fees for Services rendered
g.	Capital Value tax (abolished)	Abiana, Social, Economic and Community Services Fee	Toll of new roads and bridges within district limits
h.	Estate duty (abolished)	Land Revenue	Local Sales tax on Services
i.	User charges on federal subjects	Tolls on provincial highways	Tax on transfer of immoveable property
j.		Excise duties on alcoholic liquors, opium and other narcotics	Property tax
k.		Entertainment Tax	Fees on advertisement
l.			Fees for fairs and shows
m.			Fees for building plans
n.			Fees for Licensing
p.			Entertainment Fees
			Fees for Licensing of professions and vocations
q.			Market Fees
			Registration Fees

Source: *The Constitution, Islamic Republic of Pakistan 1973, Provincial Governments Budget Books, Local Government Act, 2013*

Annex-D

A Case for Independent NFC!

The stalemate in resolving the Sixth NFC Award is raising the argument for an independent Finance Commission to be established outside government control on the pattern of India where the Commission is constituted under the Finance Commission (Miscellaneous Provisions) Act, 1951 comprising a Chairman and four members selected from amongst persons who have experience of public affairs, knowledge of accounts, wide experience in financial matters and in administration, or have special knowledge of economics and members qualified to be or have been judges of the high courts. The Commission there acts as a quasi-judicial body having powers of civil court to summon anybody or seek any government document. As opposed to this, the NFC in Pakistan comprises of interested parties who act as pleaders, judges and adjudicators and, therefore, cannot be rational. This argument necessitates having a close look at the evolution of existing formula driven distribution of resources between the Union and the States in India. The literature [Govinda Rao and Nirvikar (2000), B.P.R.Vithal and M.L.Sastry (2001), and Amaresh Baghchi (1995)] suggests the following:

(a) the National Finance Commission is constituted by the President every five years;

(b) the Commission's approach consists of assessing overall requirements of the center and states to determine the volume of resources available to the center for transfer, and required by individual states, projecting states' own revenues and non-plan current expenditures, distributing assigned taxes broadly on the basis of origin, distributing shared taxes, and making up the deficit between projected expenditures and revenues after tax devolution with grants, popularly known as "gap-filling" approach, practiced in Pakistan till 1988 that increased the financial indiscipline in the provinces and widen the consolidated fiscal deficit;

(c) the "Gadgil formula" that forms the basis for distribution of resources was approved by the National Development Council represented by all States in 1969 and has been modified from time to time in terms of weightage assigned to different indicators by the Indian NFC; and

(d) sharing of central taxes (personal income tax and union excise duties) was on a tax-by-tax basis whereas custom duties and corporation tax was not shared until 2000. However, the 80th amendment in the Indian Constitution in May 2000 has mandated that net proceeds of all Union taxes and duties, except the central sales and consignment taxes, surcharges on central taxes and duties, and earmarked cesses are

now distributable between the center and the states, already adopted by Pakistan in 1997.

2. The working of these Commissions, their design of the transfer system, and the approach and methodology have come in for criticism (i) mainly relating to attempts to restrict the scope of the Finance Commissions through the Presidential terms of reference; and (ii) on approach and methodology employed by the Commission and the equity and incentive consequences of the transfer scheme evolved by them.

3. This clearly reflects that no matter what is the composition or status of the NFC, there has to be a political consensus on the basic principles for devising a revenue sharing formula to smoothen all irritants. This issue cannot be resolved administratively, especially in an environment of tense political polarization. Secondly, India has 28 States and it would be difficult to gather the Union and 28 States for revenue sharing process, which is time consuming. It is for administrative convenience that quasi-judicial Commission is constituted in India. However, the recommendations of each NFC in India are debated in each State and Union legislatures to develop political consensus before these are approved and notified by the President of India. Even in other countries, the revenue sharing is carried out through legislation, which requires political consensus. Therefore, the argument of independent finance commission may not be tenable. However, there is a need for permanent administrative body adjunct to the NFC in Pakistan to carry out all the leg work and research required to channel discussion and enable the Commission to take informed decisions.

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