



# THE DEADLOCK IN NATIONAL FINANCE COMMISSION AWARD

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**DISCUSSION PAPER ON THE DEADLOCK IN NATIONAL  
FINANCE COMMISSION AWARD**

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## INTRODUCTION

Pakistan's federal democracy is evolving; the 18<sup>th</sup> constitutional amendment, the passing of the 7<sup>th</sup> NFC Award and local government elections are some recent positive developments. However, while local government framework and the ensuing elections are fraught with problems, the NFC Award too is not backed by strong evidence. The NFC is seen to be marked with lacunas that causes delays and deadlocks in the passing of new awards; at the other end both vertical and horizontal revenue distribution is seen falling short of fairness while also lacking carrots and sticks to further revenue generation and to strengthen democracy at sub-national level.

Recognising these concerns, PRIME Institute undertook a project to provide independent research, advice and advocacy on NFC Award and its structure. The planned activities included dialogues at the federal and provincial level, a training workshop and conference in the capital, publication of papers and a final report.

It is believed that the ongoing FATA merger will create some facts on the ground towards the demand for a new NFC award; as will the final population census results, whenever they are announced by the new government. Ergo, the NFC Award was expected to be one of the top agenda items of the incoming government. This expectation was strengthened by the fact that within a month of taking office, Finance Minister Asad Umar wrote letters to the provinces to recommend members for the NFC at a time when his office had more pressing concerns, such as to go or not to go to the IMF to ease external account worries.

In light of this, the purpose of this short report is essentially to review the reasons behind the delay and deadlock towards the passing of the new NFC Award, and its possible solutions currently being proposed by various stakeholders. The report also briefly touches upon some ancillary topics such as the formula for horizontal distribution, tax assignments, tax reform, provincial tax collection, and fiscal federalism though only as a supplement to the main focus of discussion i.e. how to fix the delay or deadlock.

The scope of this report is not to provide a detailed or a unique solution for the deadlock but to develop an understanding of what a country-wide stakeholder consensus on the NFC might look like and where the fault lines exist; summarizing the critical points that require further deliberation and research. As such, therefore, the scope defines the limits of this paper.

The methodology adopted for this paper includes the analyses of various reports, papers, presentations, op-eds, and interviews published on the subject, followed by elite interviews with key stakeholders in the centre and in the four provinces, including policy researchers, leading economists, relevant federal and provincial government officials and key politicians. Their statements, unless made publicly, are not attributed in this report to respect the formal but candid nature of the conversation that was made possible on the condition of anonymity.

## FIXING THE DEADLOCK

Most of the discourse on the NFC before the passing of the 7th Award revolved around the need to have more criteria or indicators as the basis of sharing the divisible pool. The 7<sup>th</sup> Award met those demands and three other indicators<sup>1</sup> were added to the horizontal distribution formula, whereas the demand made by Sindh province that provinces should be given back the right to collect GST on services<sup>2</sup> was also met.

After the 7<sup>th</sup> NFC, the discourse moved – and in some cases strengthened – towards (a) how to end the deadlock; (b) how to link NFC with socio-economic objectives; (c) how to incentivise provinces for revenue generation; and (d) how to institutionalise the mechanism. This section looks at the reasons of the deadlock, summarises the points of consensus and points of disagreements among the stakeholders on the subject while flagging the lacunas in the existing framework that need to be fixed henceforth.

### What is the deadlock?

Before discussing the reasons behind the deadlock or the delay in the NFC award, it is pertinent to highlight that the federal government skipped the constitution of the 8th NFC award and directly constituted the 9th NFC. This is despite that according to Article 160 of the Constitution of Pakistan the NFC should be constituted every five years by the President of Pakistan<sup>3</sup>.

Based on our interaction with stakeholders, there are two broad set of reasons behind the deadlock or the delay in the award, (a) distributive and (b) technical, both of which are discussed below.

### Distributive reasons

Being a mechanism for intergovernmental transfers<sup>4</sup> between the centre and the provinces and between the provinces, it is no wonder that distributive reasons lie at the heart of the delay/deadlock over the NFC.

<sup>1</sup> In addition to population (82%), three other indicators were added namely: poverty (10.3%), revenue collection or generation (5%), and inverse population density (2.7%) – weights in parenthesis. The combined vertical share of the provinces were also increased from 46.25% to 56% in FY11 and 57.5% from FY12 onward.

<sup>2</sup> According to the 1973 constitution the right to collect GST on services rested with the provinces. However, the federal government had been collecting on behalf of provinces empowered through a notification. At the time of 7<sup>th</sup> NFC, Sindh's biggest demand was to get back the right to collect GST on service; the same was duly accepted. Today, all four provinces have set up their own revenue authorities to collect GST on service in their province.

<sup>3</sup> SPDC 2018-b: The tenure of the 7th NFC Award had completed in June 2015, upon which it was obligatory on the federal government to initiate deliberation on the 8th NFC Award. "However, instead of constituting the 8th NFC, federal government constituted the 9th NFC and the President issued Distribution of Revenues and Grants-in-Aid (Amendment) Order in June 2015. In fact, the order did not amend anything except endorsing the continuation of protected revenue for the province of Balochistan."

<sup>4</sup> According to Article 160(2), it shall be the duty of the NFC to make recommendations to the President on the following: (a) the distribution between the Federation and the Provinces of the net proceeds of the taxes mentioned in clause (3); (b) the making of grants-in-aid by the Federal Government to the Provincial Governments; (c) the exercise by the Federal Government and the Provincial Governments of the borrowing powers conferred by the Constitution; and (d) any other matter relating to finance referred to the Commission by the President. The taxes mentioned in clause (3) are: (i) taxes on income, including corporation tax; (ii) taxes on the sales and purchases of goods imported, exported, produced, manufactured or consumed; (iii) export duties on cotton, and such other export duties as may be specified by the President; (iv) such

Faced with tight budget constraints – more on which in the ensuing sections – the federal government has been demanding an allocation of 7 percent (to be deducted from the divisible pool prior to its division) for its expenditure on FATA, AJK and Gilgit-Baltistan as well as its spending on national security.

The provinces, however, do not agree with this demand on the premise that according to the constitution of Pakistan the responsibility of federal territories (FATA/AJK/GB) and defence spending lie squarely in the domain of the federal government. “This 7% (deduction) will continue to be the chief driver of the deadlock and delay in the NFC if the centre persists with this demand,” one provincial stakeholder said rather categorically, echoing the sentiments of his peers from other provinces.

The centralists argue otherwise, on the notion that Pakistan exists in the provinces. Keeping GB as a federal territory, for example, benefits the whole country and not just Islamabad. Likewise, all the provinces will benefit from security spending aimed to counter terrorism or any other security threat. Without getting in the normativity of the argument, however, the constitutional position cannot be ignored, which implies that without amending the constitution, the centre cannot deduct any money from the divisible pool for the said expenditures because these are the responsibility of the federal government.

A related problem, though not demanded by Islamabad yet, is how to deal with natural disasters of profound magnitude. What if there is a major earthquake or flood that wrecks human lives as well as socio-economic infrastructure in the provinces; how will the federal government finance that expenditure. Surely the federal government cannot leave the provinces to themselves in such an event. Yet it has no mechanism to get additional funds for spending on natural disasters, especially considering that the resource transfer between the centre and the provinces is asymmetric.

The 18<sup>th</sup> Constitutional Amendment has protected the share of the provinces: clause 3A of Article 160 states: 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. This clause added in the 18<sup>th</sup> amendment provides little incentive for the federal government to come to the negotiation table.

### **Technical reasons**

That the President must constitute the NFC “at intervals not exceeding five years” is clear under Article 160 of the constitution. But whether or not an award must be passed every five years; or what are going to be the rules of business that the commission has to follow; or how should the federation act if a new award is not passed; these and ancillary concerns are not clear to all stakeholders (who lack consensus on these affairs), save for very few who hold very strong opposing views.

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*duties of exercise as may be specified by the President; and (v) such other taxes as may be specified by the President.*

At the one end, there are likes of Raza Rabbani, who in his capacity as Chairman Senate held out a ruling that it's a constitutional obligation to pass a new award every five years. Drawing on the language of the law, the original intent of the drafters of the 1973 Constitution and the Indian experience with intergovernmental revenue transfers, Rabbani gave the ruling that "immediately after the announcement of an Award, the President shall constitute the next NFC to give recommendations within its tenure"; and that the "NFC shall give its recommendations to the President well before the expiration of its tenure"<sup>5</sup>. Based on his reading of the constitution, Rabbani challenges the dominant view that the previous NFC award can be extended if consensus on a new Award is not reached.

The centralists oppose this view. They in fact argue that there is no deadlock at all. They argue that the constitution only demands that a commission be formed. If the commission has a unanimous recommendation, then it is moved to the president, if they don't have a unanimous recommendation then they need not send anything to the president. This argument is based on their reading of clause 4 of article 160 of the constitution that states:

*"As soon as may be after receiving the recommendation, of the National Finance Commission, the President shall, by Order, specify, in accordance with the recommendations of the Commission under paragraph (a) of clause (2), the share of the net proceeds of the taxes mentioned in clause (3) which is to be allocated to each Province, and that share shall be paid to the Government of the Province concerned, and, notwithstanding the provision of Article 78 shall not form part of the Federal Consolidated Fund."*

It is therefore argued that there is no deadlock at present because parties in the NFC, where the federal government has only one vote out of five, have not reached a consensus, and as such there is no obligation to reach the award. Implicit in this reading of the constitution is the view that previous award ought to be extended if consensus on a new award is not reached, because failing to extend the previous award beyond five years would lead to government shutdown for lack of revenue sharing arrangement.

The provincial stakeholders contend that meetings for the last round of the NFC were not being called by the federal government, and therefore the fault lies with the centre for causing delays in the passing of the award. However, some stakeholders contend that there is also an implicit consensus among provinces not to push for a new award, because "everyone is happy with the current arrangement".

Meanwhile, centralists argue that nothing prevents the provinces to call the NFC meetings; "it is not as if the provinces were sending notices to call the meetings and the centre refused to oblige". This goes back to the absence of explicitly laid out rules of business for the NFC, in the face of which it is up to the NFC itself to spell out its rules of business.

While it is the parliament that drafts the constitution and other laws, their interpretation lies in the domain of the Supreme Court. As far as the subject of

<sup>5</sup> Senate 2017

delays/deadlocks in the NFC is concerned, the Supreme Court has not been approached by either of the parties in question. Rather, there is a consensus among stakeholders not to approach the Supreme Court for constitutional interpretation to avoid unnecessary politicising of the issue. This begs the question how to fix the deadlock.

### **Key learning:**

- 1) *Vertical distribution is a bone of contention in terms of should provinces share the expenditure on security and federal territories. PGs are clear that they won't. Unless any of the two parties relax their positions, an award will not even be in sight, let alone passed. This learning is very clear.*
- 2) *While technical reasons / differences in constitutional interpretation are not cited as biggest problems, on further probing they appear as fundamental structural issues, albeit the matter is little researched*

### **How to fix the deadlock?**

For the centralists who maintain that there is no deadlock, there is obviously nothing to be fixed. They feel threatened by the demands to necessarily get a new award because they perceive those demands as a ploy to get more out of the federal government not only by way of increasing the share of provinces but also through reassignment / decentralisation of taxes – a subject that will be touched upon in later sections. “Do they want to destroy the federation,” said one centralist rhetorically.

Most other stakeholders who hold the view that a deadlock exists have no specific solutions to reduce the risks of delays / deadlocks in the passing of the NFC award. However, four proposals have been made requiring each requiring amendment in the constitution; neither enjoys a consensus within the community.

The first revolves around changing the National Finance Commission into a two-tier structure where the first tier comprises of technocrats who publicly release research-based proposals for intergovernmental revenue transfers, and the second tier comprises of politicians<sup>6</sup>. This is aimed at reducing the risks of deadlock by achieving transparency and bringing the matter to the attention of wider public; albeit it will not completely do away with the deadlock.

The second revolves around rolling out a legislation to regulate a variety of NFC matters including (a) having a timeframe to finalise the award; (b) hold public hearings; and (c) “some kind of mechanism” to handle the NFC deadlock and delays<sup>7</sup>. Details of this mechanism are not spelled out, but the idea is that the stakeholders, especially national and sub-national politicians, sit down to find a solution.

The third proposal is to increase the powers of the Senate and a constitutional amendment whereby if the NFC Award is not announced within five years, then the federal government should take permission from the Senate for extension of the award and Senate should have power to increase the share of provinces to one

<sup>6</sup> Shahid Kardar 2007; Idree Khawaja 2017

<sup>7</sup> Wajid Rana forthcoming

percent as a penalty for federal government's failure to pass a new award<sup>8</sup>. However, this proposal has not found traction on account of the fact that management of affairs between national and sub-national governments should be through amicable coordination rather than by stick.

The fourth proposal stems from a not-so-widely-shared belief that the "deadlock is a product of political stubbornness" rather than genuine mismatch of incentives or economic rationale. Consequently, it is proposed that instead of a recommendation by consensus, the NFC should recommend on the basis of majority, where if any four out of five governments recommend something, the fifth should concede in the interest of national unity<sup>9</sup>.

This view also does not find support among the stakeholders on two grounds: (a) agreement by consensus is seen to be a normatively superior in the affairs of intergovernmental revenue transfers; and (b) given Pakistan's history and hotly evolving politics, the fifth government who is to be forced into agreement in the interest of national unity may be made worse off by majority decision. This, especially considering that a political party may form three governments, and may have an ally in fourth, and thereby penalise whoever forms the fifth government.

### **Key learning:**

- 1) *There is no consensus on the solutions to fix either of the two broad reasons of the deadlock. But there is consensus that no one wants to rock the boat or add penalty clauses of any kind.*

### **Taxation: the heart of the matter**

That the federal government agreed to reduce its share in the divisible pool from 46.25 percent to 56 (and eventually 57.5 percent) in the 7<sup>th</sup> NFC Award is a matter that baffles many. But based on our interaction with the stakeholders, the federal finance bureaucracy was convinced to reduce its share in favour of the provinces on the promise that federal government would increase the size of the pie over a period of five years and thereby the centre would not feel tight budget constraints.

The 2010 NFC agreement stated: "*Federal Government and Provincial Governments should streamline their tax collection systems to reduce leakages and increase their revenues through efforts to improve taxation in order to achieve a 15% tax to GDP ratio by the terminal year i.e. 2014-15. Provinces would initiate steps to effectively tax the agriculture and real estate sectors. Federal Government and Provincial Governments may take necessary administrative and legislative steps accordingly*<sup>10</sup>".

While the agreement included a demand placed on provinces to effectively tax agricultural and real estate sectors, given that most buoyant tax bases were and still are in the federal domain, the bulk of responsibility of raising the tax-to-GDP ratio to 15 percent implicitly fell on federal government's shoulders. The tax-to-GDP, however, did not increase up to desired level, whereas the federal government's

<sup>8</sup> Senate 2017

<sup>9</sup> Zubair Khan, n.d.

<sup>10</sup> Federal and provincial coordination to this affect did not materialise; for brief on provincial taxation see subsection below

expenditures remained higher than expected leading to tight budget constraints. This eventually led to the point where the centre started demanding 7 percent prior deduction from divisible pool for its expenditure on security and federal territories.

The centralists oppose this view, saying that the NFC has to be re-looked at. "It's completely messed up. The federation cannot run under the current revenue shares. You are forcing the centre to go into a deficit and live on loans," according to Miftah Ismail, former finance minister<sup>11</sup>. In response to the critique<sup>12</sup> that the federal government failed to improve tax collection, Miftah shared the following ballpark calculations:

*"Total tax collection today would be around Rs 4000 billion. As a percentage of GDP, it's about 12.4 percent. Even if the tax-to-GDP was 15 percent, the total tax revenue would have been Rs 5100 billion. Roughly 58 percent goes to the provinces, that's about Rs 3000 billion, leaving only Rs 2100 billion for the centre, of which Rs 1700 billion are spent on debt servicing. Now you have to spend Rs 1100 billion on defence budget, and we are already into a deficit of Rs 700 billion. Now even if we shut all ministries and departments assuming all of them are not needed, you will have to spend on PSDP and pensions of about Rs 300 billion. The point is that you can raise the revenues to Rs 6000 billion, but you still can't balance the budget. This NFC award was fundamentally flawed."<sup>13</sup>*

Based on this reasoning, Miftah opined that "the centre is prone to macroeconomic instability after 7<sup>th</sup> NFC<sup>14</sup>" – a sentiment shared by the IMF<sup>15</sup> (see next sub-section for details). However, this line of reasoning often made by centralists does not appear tenable.

First, the *raison d'être* of the NFC is not macroeconomic stability; nor is it ensuring public service delivery by sub-national governments (and accountability thereof), even though it has implications on both. The purpose of intergovernmental transfers is to meet the fiscal needs of the population spread across the country together with a sense of equalisation that demands that citizens living in different geographical regions with differing capacity to raise own revenues, should be able to enjoy "at least minimum amount of public services" and possess the revenue needed to provide the minimum amount of public services<sup>16</sup>. Moreover, macroeconomic stability is the job of the federal government and not the job of subnational governments and therefore the NFC should not be primarily seen with the lens of macroeconomics.

Second, the federal government's total revenue comprises of tax revenues net of transfers, as well as non-tax revenues. The latter are retained, more or less, completely by the federal government, excluding some small straight transfers<sup>17</sup>. Third, while the combined federal transfers (from the divisible pool, straight transfers and grants) as a percentage of total federal revenues (tax and non-tax) rose from 38

<sup>11</sup> BR Research 2018-b

<sup>12</sup> Hafiz Pasha 2018: *The actual ratio was significantly lower at 11% of the GDP in 2014 -15, implying a big short fall of 4% of the GDP. From 2009 -10 to 2014-15, federal tax revenues increased annually by 14% whereas Provincial tax revenues showed significantly faster increase of 27% annually, especially after the levy of the sales tax on services. As such, the Federal fiscal effort has been disappointing, contributing thereby to a larger deficit. In fact, the NFC Secretariat in the Federal Ministry of Finance projected earlier that the Federal fiscal deficit should have come down to 4% of the GDP by 2014-15*

<sup>13</sup> BR Research 2018-b

<sup>14</sup> BR Research 2018-b

<sup>15</sup> Tasneem Alam & Tokhir Mirzoev 2017

<sup>16</sup> Raghav Sharma n.d.

<sup>17</sup> Hafiz Pasha 2018

percent to 50 percent in FY11 - the immediate year after the 7<sup>th</sup> NFC award - it eventually tapered to 44 percent by FY17<sup>18</sup>. Ergo, lower straight transfers and grants have partially offset the effect of increase in transfers from the divisible pool.

Fourth, critics observe a federal encroachment of provincial functions that has increased the size of the centre's budget. "Currently, there are as many as 41 divisions in the federal government, many of which are contrary to the spirit of the 18<sup>th</sup> Amendment". The federal government also continues to run development programs in the areas of health, population planning, etc. when it should it need only have a coordinating role in these areas as these have become provincial subjects after the 18<sup>th</sup> Amendment.

There is no publicly available study that shows that the said 41 divisions should be completely disbanded at the centre, and they are significantly responsible (being material expenditure amounts) for Islamabad's tight budget constraints. But the notion that higher share of provinces in the 7<sup>th</sup> NFC Award is the biggest cause of financial problems for the federal government has been proven wrong by a recent study. The study<sup>19</sup> proves that "shortfall in FBR revenues affected the provinces more than the federal government" and that the biggest cause of higher federal budget deficit is the tremendous growth in federal government's current expenditures.

Granted that "FBR revenue shortfall, along with higher federal transfers to provinces caused a slight deviation in the budget deficit", but "it is the higher than projected current expenditure that caused the growth in the budget deficit"<sup>20</sup>. It is pertinent to note however that one of the reasons why federal government's expenditure increased was the great flood of 2010, an expenditure borne by the federal government, even though the floods caused damage in regions under the domain provincial governments. This goes back to the question of expenditure responsibility on natural disaster raised in earlier section.

Lastly, apropos to Miftah's ballpark calculations mentioned above, it is true that the federal government currently spends roughly one-third of its annual budget each on defence and debt servicing. But in absence of detailed fiscal analysis, it should not be a forgone conclusion that spending on defence and debt servicing will remain at current proportions (relative to budget outlay) even when the federal government is able to raise its tax revenues.

The increase in tax revenue should *ceteris paribus* result in lower need for debt and accordingly lower spending on debt servicing. Likewise, while defence spending may remain at current proportions for a few years to invest in any latent genuine needs that are currently unmet due to tight budget constraints, it is counter intuitive to expect that defence spending will be permanently fixed at one-third of the federal budget even when Islamabad's revenues rise toward its full potential.

<sup>18</sup> Hafiz Pasha 2018

<sup>19</sup> SPDC2018-b

<sup>20</sup> SPDC2018-b

That said, stakeholders agree that the responsibility, efficiency and judiciousness of federal and provincial expenditure will be a hotly deliberated subject in the next round of the NFC.

### **Provincial taxation:**

In 2017, the IMF echoed the voice of centralists when it flagged that “although federal tax revenue has increased substantially in the past several years, incentives for the federal government in raising additional revenue may have become skewed toward revenue areas outside of the divisible pool of tax resources shared with the provinces” because the centre feels a disincentive to raise more taxes since nearly 58 percent goes to the provinces. In addition, provincial incentives to raise revenue may have been diminished by increased availability of revenue from the divisible pool.

There is some truth to this observation. At the one end, the federal government has started finances through GIDC and the petroleum levy both of which do not form part of the divisible pool. Moreover, in Punjab for example, efforts were being made to realise the potential of urban property tax in the years leading up to the 7<sup>th</sup> NFC Award. However, as soon as it became apparent that the new NFC award would result in substantially larger transfer of resources from the divisible pool, the motivation for property tax reforms was lost and the plans were shelved. Thus, “at least in the short term, the new award has had a dampening effect on the revenue effort in Punjab, a critical sub-national entity”<sup>21</sup>.

However, it could be argued that provinces found another source, GST on services, which was politically less difficult than urban property taxes and agriculture income taxes. The share of provincial own tax revenue in the total tax revenue remained around 4 percent on an average during 2000-01 and 2010-11<sup>22</sup>. “After the 7<sup>th</sup> NFC when the GST on services was handed back to the provinces, “a clear upward trend was observed after which the provincial share increased from 3.7 percent (2010-11) to 7.7 percent”. This debunks the myth that provinces have not increased their own revenues.

In terms of the provinces’ failure to realise the potential agricultural income tax (AIT), there are a few pertinent points to be made. There is no denying that AIT collection by provinces is poor; it is estimated about 1-1.5 percent of agriculture GDP as against the tax paid by manufacturing sector (about 26% of manufacturing GDP). This leads to problems of inequity. However, contrary to popular perception according to which the revenue potential of AIT ranges between Rs250-300 billion, the actual potential of AIT is estimated to be very low, ranging between a country-wide total of Rs40-60 billion<sup>23</sup>, varying according to different assumptions. Albeit one study puts the AIT potential at Rs114 billion in Punjab for FY14<sup>24</sup>, implying that country wide AIT potential may be about Rs200 billion. While there is no consensus

<sup>21</sup> Jjaz Nabi & Hina Shaikh 2010

<sup>22</sup> SPDC2018-a

<sup>23</sup> Pildat2011-a

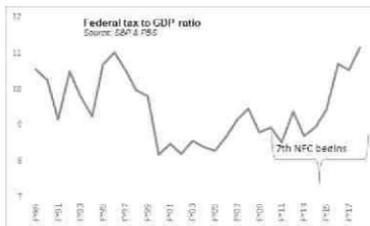
<sup>24</sup> Anjum Nasim & Hanid Mukhtar 2016

on the actual potential of AIT, the provinces need to start reforming the AIT framework to ally the genuine concerns of inequity.

Given its politically sensitive nature, both the centre and the four provinces desired to be on the same page on this subject. Soon after the 7<sup>th</sup> NFC, provincial finance ministers met and agreed to make a policy paper on the subject of AIT. The task to write that paper was given to Sindh, and within nine months of the 7<sup>th</sup> NFC award, the policy paper was prepared and shared with other governments. However, no further action was taken. We are informed that the federal government was given the job of coordinating and facilitation on this subject. The federal government had made an inter-ministerial committee on this but as such there hasn't been any further development on the subject since. Be that it may, considering that the AIT is a provincial domain, nothing should prevent the provinces to move in that direction.

A related problem is that failure to realise AIT is enabling tax evaders to mask their non-agri income as farming income and thereby evade taxes. However, as such there is no publicly available estimate of the quantum of non-agri income or taxes thereof being masked under the shadow of agriculture income.

As far as the argument of the centre's disincentive to increase tax revenues post 7<sup>th</sup> NFC is concerned, it is important to note that the centre had not been consistently raising its revenue sharply before the 7<sup>th</sup> NFC that gave out huge transfers to the provinces (see graph below). Au contraire, the growth in GST in services after its reversion to the provinces shows provinces can perhaps do a better job at tax collection.



Another counter argument is that if provinces get only a small percentage of revenue from the divisible pool, they have low marginal incentives to foster local economic prosperity. If, for instance, the centre keeps 75 percent of the revenue and transfers 25 percent to the province, then the province has little incentive to foster growth in economic sectors that fall in its domain that in turn can help raise the centre an extra billion of revenues.

When subnational governments have higher fiscal incentives to foster economic growth at subnational level, they are more likely to create conditions that will foster growth. In such an arrangement some provinces may get richer than others, but since the amount kept by the centre will also have grown with growth in subnational economy, the centre would be in a position to transfer more resources to the poorer provinces.

Be that as it may, the stakeholders who are concerned about provinces own tax revenues demand that indicators like provincial tax effort, or provincial fiscal discipline should be made one of the basis of horizontal sharing formula<sup>25</sup>.

Another proposal talks about disbursing 75% of the divisible pool without any condition, with the remaining linked to provincial fiscal reform progress<sup>26</sup>, whereas some propose a matching fiscal transfer as an incentive to sub-national governments to increase their revenues. The latter, for example, could take the shape of the centre giving 10 paisas per every extra rupee that provinces collect on their own above a certain threshold. Another specific proposal is to allow the provinces to piggy back income and corporate tax between the ranges of 0.5 to 1.0 percent to improve their base<sup>27</sup>. Others propose that instead of the federal government collecting taxes and then making fiscal transfers to provincial governments, provincial governments should collect taxes and then transfer the rest to federal government<sup>28</sup> after keeping their share.

It is not the scope of this paper of evaluate each proposal, but it is pertinent to highlight that the stakeholders lack consensus on any of these proposals. This is mostly because each of these proposals seem be untenable one ground or another. For instance, transfers from divisible pool cannot be made conditional on fiscal performance because that can penalise the people who reside in the provinces, and because the NFC is not a framework for macroeconomic stability. There should be other mechanism or instruments for macroeconomic stability such as perhaps having a fiscal coordinating body comprising of technical government staff, housed within the Council of Common Interests that has the power to make binding fiscal decisions.

Similarly, matching fiscal transfer (10 paisas proposal above) may not work if the federal government faces tight budget deficit constraints. Provinces could increase their own revenues and yet post budget deficits leading to higher combined national fiscal deficits. Likewise, reversing the responsibility of tax collection appears to be untenable because that would implicitly create fiscal claims between provinces, whereas in a federation, provinces have a claim on the centre and not on each other.

Regardless, in the criticism of provinces, it is often ignored that for about 70 percent of aggregate national expenditure, the federal government collects over 90 percent of total tax revenue collected in Pakistan, because it enjoys the most buoyant bases under the existing tax assignments. The provinces, by contrast, collect less than 10 percent of total national revenue but account for nearly 30 percent of total expenditures. In FY16, provincial share of general government expenditure was 35 percent, but it collected 8 percent of national fiscal revenue<sup>29</sup>.

<sup>25</sup> *PIDE 2012; Pasha 2015; Aisha n.d.*

<sup>26</sup> *Ashfaq Hasan 2015*

<sup>27</sup> *Wajid Rana forthcoming*

<sup>28</sup> *Idrees Khawaja 2017*

<sup>29</sup> *SPDC 2018-a; Tasneem Alam & Tokhir Mirzoev 2017*

**Key learning:**

- 1) *Taxation lies at the heart of the matter. Except for centralists all stakeholders agree that federal government should raise its tax revenue. Centralist argue that no matter how it raises the revenue, it will always face tight budget constraints because of current vertical distribution arrangement. Prima facie, that argument doesn't hold, but detailed fiscal analysis hasn't been presented by either side.*
  - a. *This suggests that in the next round of NFC negotiations the responsibility of expenditure, and its efficiency and judiciousness at both federal and provincial level will be one of the main items of discussion*
- 2) *Provinces have been criticised for failing to grow their own revenues, despite sharply increasing collecting on GST on services. The revenue potential of AIT and property taxes is little, and little researched.*

**Negotiations: the missing link**

There is a consensus among stakeholders that one of the major stumbling blocks towards the passing of an award is the failure to hold regular meetings and start the negotiations in an environment that is not marked with an air of mistrust. As discussed earlier in the sub-section on technical reasons of the deadlock, the NFC meetings were not held periodically; the provinces expected the federal government to call in the meetings, which it didn't; whereas the centralists argue that nothing prevents the provinces to call in a meeting.

In such an environment, negotiations let alone the successful passing of an award would prove to be impossible; after all meetings and discussions are the first steps towards removing the deadlock. The federal government's decision to constitute the 9<sup>th</sup> NFC without constituting the 8<sup>th</sup> NFC and without giving the reasons thereof is

**Learning from 7<sup>th</sup> NFC award:** *A host of factors are attributed to the successful passing of the award. First, is the hard-nosed deal-making nature of the then banker turned Finance Minister Shaukat Tarin. Second, Tarin had convinced a rather sceptical federal finance bureaucracy to allow the increase in share of provinces on the basis that federal government would increase its revenues sharply. In fact at the time the 7<sup>th</sup> NFC was being finalised, a Ministry of Finance team was drafting a revised GST/VAT law that was to be presented to the parliament by December 2009.*

*Third, factor that helped towards a unanimous decision was the federal government's promise at the outset that whichever province will be at a loss, the centre will compensate it. Historically it always used to be such that parties would first decide the vertical shares first, and then decide the horizontal distribution. This meant that once provinces would get the money from the centre, Punjab would have no interest in discussing the horizontal distribution because all the money that could be extracted from the centre had already been extracted. In 7<sup>th</sup> NFC, Sindh had insisted that first the provinces should agree on horizontal distribution before an agreement is reached on vertical distribution. Accordingly, when because of the multiple criteria Punjab emerged to be losing revenues, the NFC calculated Punjab's loss, which was then compensated by decrease in the federal government's share provincial under vertical distribution.*

*Fourth, to reduce the tensions and air of mistrust, the federal government the following key steps: (a) it resolved the long unaddressed concerns of Khyber Pakhtunkhwa related to hydel power; (b) it also resolved the pending concerns of Baluchistan relating to Sui gas; (c) it accepted Sindh's demands to allow provinces to collect GST on services as per the constitution; and (d) it reduced FBR's cost of tax collection (an amount which is deducted from the divisible pool) from 5 percent of the tax collected to the 1 percent which is the actual cost of collection. Finally, while there was no involvement by political leaders on the technicalities of the award or the day to day negotiations, the then President Asif Ali Zardari had given a clear sense of direction that the government wanted an Award.*

also not helpful because it creates an air of mistrust<sup>30</sup>.

The mistrust today is of much lesser magnitude than at the time of the 7<sup>th</sup> NFC, but there are a few bones of contention. For instance, the capital gain tax on real estate is a provincial subject since the 18<sup>th</sup> Amendment, being a part of the residual list. Yet the federal finance ministry under former finance minister Ishaq Dar had rolled out a capital gain tax on real estate. This especially irked Sindh that was working on CGT on real estate in consultation with the World Bank where the plan was to implement those taxes in a gradual phased-out manner.

Or take the case of the federal government plans to reduce the size of divisible pool by reducing GST on petroleum products and filling its revenue gap by means of petroleum levy. While the move is constitutional, it does create an air of mistrust among the parties. Likewise, Baluchistan is concerned about the CPEC outlay in her lands. They feel that by being deprived of adequate CPEC outlay in the provinces, the province is being deprived of revenue transfers that Baluchistan could have gotten on the basis of revenue collection & generation from the activities spilling over from CPEC spending in the province.

Clearing the air of mistrust is one of the key reasons behind the successful passing of the 7<sup>th</sup> NFC. And this time would be no different, if the national and sub-national governments desire major changes in the award. To that end, as an example as one stakeholder put it, "if the centre really wants the provinces to contribute towards security funding then instead of demanding an allocation prior to the divisibility of the divisible pool, perhaps it can make up a security plan for each of the province and invite the provinces to the negotiation table. The point being that there is a way to start negotiations instead of starting with all or none approach". Alternatively, if stakeholder consensus is any guide, the centre could get a new award simply by endorsing the existing arrangement, while incorporating changes stemming from new facts on grounds such as FATA merger, population census and other datasets that feed into the horizontal distribution mechanism.

### **Key learning:**

- 1) *There is a consensus that negotiations without an air of mistrust is the missing link; the parties should keep on talking where deadlock on one of the items on the agenda should not prevent discussion on other items.*
- 2) *There is a consensus that if the centre doesn't want full-fledged negotiations, it can get a new award just by incorporating updated datasets in the current formula, and that provinces will likely agree to that*

### **LINKING NFC WITH SOCIO-ECONOMIC OBJECTIVES**

In light of devolution a host of economists, policy researchers, donors and think tanks<sup>31</sup> demand that the NFC should be linked to socio-economic objectives

<sup>30</sup> *There is a legacy of mistrust between federal and provincial governments. For example; prior to 1997 the share of provinces in divisible pool was 80 percent. In 1997, two taxes - import duty and excise duty - were added to the pool and provincial share was reduced 37.5 percent under that argument that by adding these two taxes provinces will get more money. Initially, provinces did get more money under divisible pool transfers but as revenue from import duties started reducing under the WTO, a fact that federal government knew too well at the time of the Award (and provincial government didn't), transfers to provinces dried.*

achieved by the provinces. Because there is no instrument available under the current NFC framework that enables the federal government to influence the absorption of its fiscal allocations in provinces in pursuit of broader national developmental objectives<sup>32</sup>, various proposals have been made to link the NFC with improvements in socio-economic objectives.

For instance, it is argued that the horizontal distribution formula should also include other aspects such as “lag in infrastructure/investment”, “income difference”<sup>33</sup> and “inverse of area under irrigation”<sup>34</sup>. However, more emphasis is laid on the notion that the NFC process should integrate multi-dimensional poverty index and/or the human development index to assess the impact of increased expenditure at sub-national level by linking fiscal equalisation with socio-economic objectives<sup>35</sup>. Or that the next NFC should include an explicit set of social outcomes that provinces will need to achieve within education, health, provision of safe drinking water etc. by the end of the tenure of the award. If halfway outcomes are not met, transfers should be adjusted or withheld<sup>36</sup>.

It is also proposed to explore a mechanism to channel subnational/local governments’ expenditures towards meeting national objectives (PRSP, SDG) either through formula for distribution of resources or institutionalizing conditional grants for meeting clearly defined objectives/targets. Another specific proposal talks about changing the divisible pool such that non-tax revenue become a part of it, and then distributing the non-tax revenue portion of provincial revenues directly to districts based on the socio-economic performance of the districts<sup>37</sup>.

More recently, in their address to the Senate Standing Committee on Planning and Development, senators from Balochistan and Khyber Pakhtunkhwa demanded that instead of population the distribution of taxes under the NFC should be based on poverty, backwardness and other socio-economic indicators to develop the left-behind regions<sup>38</sup>. Here is the exact quote of Senator Shahzeb Durrani: “instead of considering population to distribute national resources under the NFC Award, it should be on the basis of development.”

These concerns are understandable considering that by most estimates the provincial governments are “bursting from the seams” since the 18<sup>th</sup> amendment because they have so much money. It is also understandable because against the responsibility of social service delivery that lies primarily with the subnational governments, the actual and perceived social outcomes (health, education, etc) achieved by provinces are rather poor even though eight years have passed since the 18<sup>th</sup> amendment and the 7<sup>th</sup> NFC. Lastly, it is no denying that strategies adopted for fiscal transfers do have implications on human development outcomes.

<sup>31</sup> However, federal and provincial government officials disagree with such ideas on the premise that the centre has no constitutional right to meddle in purely provincial affairs

<sup>32</sup> Zubair Shahid 2015

<sup>33</sup> Muzafar Said 2015

<sup>34</sup> Proposal made in PRIME’s NFC consultative forums

<sup>35</sup> Marc-André Franche 2015

<sup>36</sup> Sakib Sherani 2015

<sup>37</sup> Kaiser Bengali forthcoming

<sup>38</sup> Business Recorder 2018

However, as much attractive as these ideas might look like, they are untenable. Contrary to the consensus among policy wonks, there seems to be a consensus on this untenability among federal and provincial government officials (former or current) as well as economists hired as consultants by these governments. Three main reasons account for it.

First, after the 18<sup>th</sup> amendment the centre has no constitutional right to meddle in affairs that are purely provincial. At the most the federal government coordinate or perhaps nudge by offering some conditional matching grants outside the transfers made under the divisible pool.

Second, the NFC is not a forum to reward efficiency of governance, performance or anything to that affect; it is a forum to meet the needs of the people of Pakistan and to mitigate the differences between sub-national governments with a sense of equalisation that demands that citizens living in different geographical regions with differing capacity to raise own revenues, should be able to enjoy at least minimum acceptable amount of public services and possess the money needed to provide the minimum amount of public services.

Instead, it is the electoral process and/or other institutions and instruments of accountability that should reward or penalise the governments. It is up to the voters to decide the socio-economic choices of their province and the performance of governments thereof. The people of any province should not be penalised because of poor performance by their government.

Lastly, doing away with population as the main basis of distribution is not tenable because the majority of the people of Pakistan live in areas that are better developed. In the 7<sup>th</sup> NFC, the centre compensated for the loss that Punjab accrued by reducing the weight of population in the horizontal distribution formula. While no official statistics have been made public, it is estimated that if the weight of population was to be brought down to 78 percent or lower in the last award, then even Sindh would have had to be compensated for the loss in federal transfers from the divisible pool. And further reduction in centre's share under vertical distribution to compensate for Sindh's loss would have left Islamabad fiscally much weaker<sup>39</sup>. Population being an important proxy for fiscal needs, it must be kept in mind that if we try to correct the interprovincial disparities created over decades in a very short period, it will retard the economic growth of advanced provinces, which in turn can reduce national tax revenues.

A related question that is being asked pertains to the allocation of 1 percent of net proceeds of the divisible pool to Khyber Pakhtunkhwa, given its role as a frontline province in the war on terror. The question is how long will that allocation continue<sup>40</sup>, especially now that Pakistan has made recognisable gains in the war on terror. Second, what was that compensation exactly for; whether it was to compensate for

<sup>39</sup> BR Research 2018-c

<sup>40</sup> The 7<sup>th</sup> NFC had allocated it for each year of the award period; but with no new award, the previous award continues thereby allocating KP that amount every year

tax loss due to war's impact on KP economy; or it was for higher security/police spending by provincial law enforcement agencies; or was it for spending on poverty, health, education etc because of war's impact on the lives of residents of the province. Each may have different implications for the life of that allocation.

### **Key learning:**

- 1) *Linking the NFC with socio-economic performance (inputs or outputs) is attractive but does not enjoy consensus, not even among centralists*

## **INSTITUTIONAL MECHANISM**

There seems to be an agreement on the notion that compared to Germany, Canada and Australia, Pakistan has a relatively modest set of intergovernmental institutions<sup>41</sup>. There are also concerns about the effectiveness of the existing institutions, such as the CCI and the NFC secretariat. For instance, in the case of CCI, some argue that the CCI or NEC should have the powers to bind provinces to achieve required fiscal surpluses; or that a provincial fiscal and debt limitation act be introduced to curb provincial borrowing<sup>42</sup>. In the case of NFC secretariat, there is a growing emphasis on the need to strengthen and professionalise the NFC secretariat comprising of full time professionals<sup>43</sup> - a view that enjoys wide consensus among stakeholders.

Some stakeholders, however, extend that stream of thought into a two-tier structure, where in the first tier there is an independent agency whose members are chosen without regard to provincial affiliation, and the second tier comprises of political nominations similar to the current NFC. It is proposed that the first tier should comprise of a body of experts who are apolitical appointments of the body and have access to funds at their disposal for research. Their job shall be to make recommendations about the composition of divisible pool, and how to share the pool. Their recommendations are to be made public; debated in seminars and in the media. These measures are aimed at addressing transparency concerns which in turn is hoped to reduce the deadlock risks. The second tier shall be an inter-governmental forum marked by political appointees by respective governments. The forum may or may not accept the recommendations of the first tier, but must give reasons thereof, and must consider the ideas flowing from public debate<sup>44</sup>.

In so far as strengthening of the NFC secretariat is concerned, there is consensus among stakeholders that it should be done on urgent basis. The secretariat is presently a single-person office - a joint secretary in the Q-block who looks at it often alongside with side responsibilities. Unlike the case of the CCI in the case of which the constitution demands the establishment of a permanent secretariat, there is no such requirement in the case of the NFC. However, as such nothing stops the national and sub-national governments to set up NFC and PFC secretariat comprising of experts from economics, public finance, and law, to be housed within their finance ministries. Along with the body of experts, the secretariat should have

<sup>41</sup> Leslie Seidle 2012

<sup>42</sup> Ashfaque Hasan 2015

<sup>43</sup> Ashfaque Hasan 2015; Aisha n.d.

<sup>44</sup> Shahid Kardar 2007; PIDE 2012; Idrees Khawaja 2017

centralised data sets<sup>45</sup>, whose services are jointly used by national and sub-national governments. There is a consensus that federal and provincial statistical bodies ought to be strengthened to ensure timely available and reliable macro-and-socio-economic data, including subnational sectoral GDP and poverty estimates, to enable better analysis by the NFC secretariat.

However, as far as the two-tier structure is concerned, most stakeholders especially those in the government and those have consulted for the government, have strong reservations against the proposal. It is seen as an academic view with no political backing because it may “undermine the political will”. “Tomorrow if the politicians decide something else, their decision could be criticised for not following what the so-called experts said – and at the end of the day the NFC is and should remain political,” one senior economists explained echoing the concerns of many government officials. “I don’t think the two-tier model will work because that model hinges on public debate and transparency which is good on paper but the moment it becomes public, it stands at the risk of becoming politically charged and acrimonious and people start playing to gallery,” cautioned another.

Institutional arrangements for intergovernmental transfers isn’t a hotly researched topic in fiscal federalism. But research by Anwar Shah, who is the most cited scholar in this field, lends credence to the concerns raised above.

Based on his study of diverse institutional arrangements in various federations across the world, he maintains that the independence of technical apolitical institutions, as is the proposed tier-one, is overrated “because norms and standards for equalization should not be separated from political decision-making”.

He also highlights that such arrangements fall prey to agency problems in an attempt to find and maintain their relevance, whereas the attempt to appear completely independent makes them a victim of analysis paralysis by adding too much complexity, leading to costly and impractical solutions that may not have political backing.

Moreover, there is a question of who is to monitor the so-called independence of such an institution who biases may be difficult to understand behind the web of technicalities and complexities. A case in point of weak capacity to understand even basic technicalities of intergovernmental transfers was the 1997 award, where the provinces didn’t have the capacity to understand that post-WTO import duties would be slashed sharply leading to lower revenues from the divisible pool.

“By comparison, intergovernmental fora to engage in political bargaining in search of simpler and feasible solutions to reduce transaction costs for country.” It also places great premium on simplicity and “rough justice”. Institutionalized political bargaining

<sup>45</sup> *The absence of various national and sub-national data does not get highlighted as a pressing concern at the outset. However, it eventually surfaces when negotiations begin or if anyone wants to do detailed analysis to provide actionable intelligence to be used as the basis of intergovernmental transfers or negotiations. Periodic sub-national GDP; unit cost of delivery of various public goods in various jurisdictions; revenue potential of various tax heads in various jurisdictions; these and many other relevant datasets are missing from the discourse leaving no or weak reference points for decisions and their analysis.*

is the strength of inter-governmental forums and is likely to result in a compact political consensus on equalization standards<sup>46</sup>.

### **Key learning:**

- 1) *Two-tier structure is also considered attractive but does not enjoy consensus. Albeit the strengthening of NFC secretariat is widely agreed upon, especially to address the data constraints for meaningful evidence-based negotiations*
- 2) *Existing intergovernmental forum is seen as optimal framework to hammer out vertical and horizontal distribution*

## **BORROWING AND REVENUE ASSIGNMENTS**

According to Article 160 (2c), it shall be the duty of the NFC to make recommendations pertaining to the exercise of the borrowing powers by the federal and provincial government as conferred by the constitution. However, this subject is hardly touched upon in the NFC Awards, nor has it mainstreamed into the NFC discourse<sup>47</sup>.

The 7<sup>th</sup> NFC also didn't make any recommendation pursuant to Article 160 (2c) except for emphasising that both governments would develop and enforce mechanisms for maintaining fiscal discipline through legislative and administrative measures. This is despite the fact that the drafters of the 18<sup>th</sup> Amendment, working separately but simultaneously with the NFC, were heading towards the enhancement of the borrowing power of the provinces. The 18<sup>th</sup> amendment added a clause (clause 4) to Article 167 that states: "A Province may raise domestic or international loan or give guarantees on the security of the Provincial Consolidated Fund within such limits and subject to such conditions as may be specified by the National Economic Council".

The addition of this clause is read as if the borrowing powers of provincial governments have been enhanced considering that National Economic Council (NEC) has appropriate representation of the provinces<sup>48</sup>. Moreover, that provinces in Pakistan can now raise external loans unlike the Indian arrangement where it is the Union Government that has the powers to raise external and internal loans, whereas her State Governments can only incur internal loans<sup>49</sup>. Here an important gap in the law deserves to be highlighted i.e. the federal Fiscal Responsibility and Debt Limitation (FRDL) Act 2005 does not contain any provision specific to provincial government<sup>50</sup>.

Following the addition of clause 4 to Article 167, Punjab has drafted the provincial fiscal discipline and debt limitation act, whereas Sindh is also in process of drafting a

<sup>46</sup> SPDC 2018-b; UNDP 2013

<sup>47</sup> Most of the NFC discourse revolved around horizontal distribution formula before the 7<sup>th</sup> NFC. After the 7<sup>th</sup> NFC, the discourse has evolved towards linking socio-economic objectives & provinces own revenues with the NFC, and broader aspects of fiscal federalism. A recent exception to this trend is SPDC 2018-b where the subject of borrowing is discussed in detail.

<sup>48</sup> SPDC 2018-b

<sup>49</sup> SPDC 2018-a

<sup>50</sup> SPDC 2018-a

similar law in consultation with the World Bank. In light of these developments the subject of borrowing powers can be expected to become of part of the next round of NFC negotiations, even if an award to that affect is not eventually passed.

Be that as it may, some pertinent questions need to be answered on this subject, and as such there seems to be little research let alone consensus on the provincial borrowing and its implications. These questions include, for instance: (a) who will bear the cost of borrowing, especially in case of defaults if any; (b) what rules and institutions should be framed to ensure sustainable external debt at national level; (c) should provinces be allowed to issues domestic bonds, such as munis; (d) because any external loan to be obtained by provinces has to passed through the EAD under federal government, what kind of rules should be framed to ensure de facto equity and fairness in the borrowing powers of the provinces; and (e) should borrowing-based federal non-current expenditure be also spent in provinces in light of the NFC sharing formula.

The last point warrants further elaboration. Allocation of debt in the spirit of horizontal sharing formula isn't the only subject that might gain traction in the NFC henceforth. Lately, another notion gaining attention is that spending by federal government, developmental (such as federal PSDP) or current expenditure (such as electricity subsidy), should also reflect the spirit of the NFC. This is despite the fact that revenue distribution does not have specific legal implications over how the centre distributes its own spending across the provinces<sup>51</sup>. One of the underlying premises behind the demands that NFC sharing formula should serve as a guiding light for all other spending, is the observation that federal-provincial specific purpose transfers are ad hoc and primarily used for agency functions or to advance political objectives<sup>52</sup>.

### **Revenue reassignment:**

Another agenda that is likely to be a part of next NFC negotiations is the question of revenue reassignment. Generally, it is the notion that federal government shouldn't encroach on provincial tax bases<sup>53</sup>. Specifically, Sindh has been demanding that GST on goods should be given to the provinces<sup>54</sup>. This demand seems to stem from the argument that depriving provinces of the right to levy sales tax on goods is a constitutional flaw. "Provinces had that right pre-independence. The Constituent Assembly took that right in 1948 with the promise to give it back as soon as the centre's financial position improved<sup>55</sup>".

While a constitutional change in reassignment of GST on goods is not on the cards, Sindh is asking the centre to issue a notification allowing the provinces to collect this tax and give it back to the centre, without asking for a say in tax policy. Sindh's position is that she will be able to collect more revenue under this tax head, as it did so in the case of GST on services. Sindh proposes that if a province is able to meet

<sup>51</sup> *Umbreen Fatima & Anjum Nasim 2013*

<sup>52</sup> *Wajid Rana forthcoming*

<sup>53</sup> *Aisha n.d.*

<sup>54</sup> *GoS 2015*

<sup>55</sup> *Huzaima Bukhari and Ikramul Haq 2016; and information gleaned from PRIME's NFC consultative forums*

or exceed Islamabad's revenue collection target from that province, then it should be allowed to retain some part of it as an incentive for good performance. Sindh may also be willing to share that incentive with Khyber Pakhtunkhwa and Balochistan to compensate for their lack of tax base.

These proposals, however, lack support from the stakeholders consulted for this report. Lack of support for this proposal stems from the argument that Pakistan is a federation and, by virtue of it, the provinces have claim on the centre but not on each other. Khyber Pakhtunkhwa and Balochistan, for instance, cannot be left waiting that Sindh or Punjab collect more taxes then they will get their money.

Another proposal making rounds is to revise the divisible pool, where the non-WHT direct taxes are subtracted from the pool, and federal government's non-tax revenues are added to offset the loss of revenues for provincial governments. In addition, agricultural income tax is given to the centre via a constitutional amendment and made a part of the divisible pool. Removal of non-WHT direct taxes from divisible pool is aimed at giving federal government the incentive to collect more taxes and keep it, and thereby improve inter-personal equity, whereas giving agricultural income tax to the centre is aimed at giving federal government the incentive to resolve the tax shelter problem and thereby improve inter sectoral equity<sup>56</sup>.

However, like other proposals surrounding revenue reassignments, this proposal too lacks consensus. This is not only because most stakeholders are not comfortable with the idea of tax reassignment at this stage, but also because reassigning non-tax revenues to provinces may make them susceptible to the volatility non-tax revenue collection<sup>57</sup>.

### **Key learning:**

- 1) *Negotiations on borrowing of the provinces - its scope, modalities etc – will likely be on the discussion table in next round of discussions provided the centre is interested in having full-fledged discussions. So might, albeit to a lesser degree, provincial shares in federal spending on borrowed money. How should both look like? Various proposals have been making rounds, but there is no consensus, nor is their publicly available research or position papers*
- 2) *Revenue reassignment is an even more difficult agenda, not only because most non-provincial stakeholders are not comfortable with it, but also because of the likely strong resistance by the centre*

### **THE BIGGER PICTURE**

There is no single neat equation that can be used to distribute fiscal, political and public goods in a manner that is perfectly just and as such beyond criticism. Federations come in various shapes, sizes and forms each with unique set of

<sup>56</sup> Kaiser Bengali forthcoming

<sup>57</sup> Non-tax revenue includes sale of government licenses (such as telecom license), privatisation, SBP profits and so forth.

historical and cultural factors. Consequently, they differ widely in the way they distribute fiscal, political and public goods across the tiers of government that exist in their respective countries, resulting into a wide variety of experiences in efficient and equitable distribution.

Within the narrow area of tax assignment for instance, a host of criteria influences decision making: (a) efficiency of the internal common market; (b) national equity; (c) administrative costs; and (d) fiscal need. Likewise, there are various criteria that can be used for horizontal distribution of revenues: (a) expenditure need (which includes indicators like population, or demographic change); (b) equity (such as backwardness, income distance, inverse per capita income, poverty, infrastructure distance); (c) efficiency/performance (such as fiscal contribution, tax effort, fiscal self-reliance); and (d) fiscal disability (such as forest cover).

In practice, however, these criteria are more like guiding principles that have substantial room for subjectivity and open to varying judgements depending on the level of government; historical, political and cultural realities; level of economic and political development; disparity in development of sub-national government; national priorities; and so forth. A perfect tax assignment and method of distribution is an elusive exercise, which lends emphasis on the view that national and sub-national governments must keep negotiating and giving research assignments to public and private organisations to help towards evidence-based negotiations and thereby reduce subjectivity.

At its heart this debate is about whether or not Pakistan's federal structure can and should be evolved towards what can be classified as second-generation fiscal federalism framework (SGFF). Unlike the first-generation fiscal federalism framework (FGFF), where it is assumed that "public decisionmakers are benevolent maximizers of the social welfare", SGFF assumes that "economic policy is not decided by benevolent social planners, but by government officials, usually with „at least“ one eye to their re-election prospects<sup>58</sup>." Consequently, whereas FGFF emphasizes the importance of transfers by national government for mitigating vertical and horizontal imbalances to sub-national units, SGFF approach emphasizes the importance of incentives generated by sub-national tax generation for fostering economic growth in sub-national regions.

The FGFF is "a vision of fiscal federalism where the federal government is largely responsible for maintaining macroeconomic stabilization and providing an efficient level of national public goods in conjunction with sub-national governments<sup>59</sup>." It maintains that decentralization of taxes is prone to generating tax wars among sub-national governments, due to inter-jurisdictional competition that would be self-defeating and result in a reduction in taxation.

The SGFF is a vision where subnational governments that are empowered to raise a substantial portion of their own revenue become more accountable to citizens, to

<sup>58</sup> Barry Weingast 2006

<sup>59</sup> SPDC 2018-b

provide the services they want, and to be less corrupt<sup>60</sup>. This of course rests on assumption that institutions of accountability exist at sub-national levels – either via media or via public institutions such as auditor general, NAB, lawmakers' oversight committee etc in the case of Pakistan.

Seen in this light, the future of the NFC in particular, and fiscal federalism in general in Pakistan is a battle of world views; those who believe that public decisionmakers are benevolent social planners, and those who believe that decisions are deeply influenced by re-election prospects. With the return of democracy in Pakistan with different political parties gaining strong hold in different provinces, the latter seems to be the logical step forward. However, this debate between FGFF and SGFF has not gathered momentum in policy or political circles, albeit the balance of opinion tilts toward the FGFF with very few stakeholders demanding a reassignment of taxes including reassignment to or sharing of some major taxes based with provincial and local governments.

In Pakistan major tax bases are assigned exclusively to one level of government or the other. Moreover, the highest yielding taxes such as sales and income taxes and custom duty are assigned to the federal government. "In many federations, in contrast to Pakistan, such taxes are co-occupied by the two levels of government, so both are able to obtain revenues from them independently."<sup>61</sup>

Tax assignment in Pakistan prefers efficiency in tax administration and uniformity of the tax regime over provincial and local fiscal autonomy and accountability. Hence, provincial and local governments are hugely dependent upon revenue transfers from higher levels of government to finance their own expenditures.

According to a recent estimate, "the federal government collects over 90 percent of total revenue collected in Pakistan, while it accounts for some 70 percent of aggregate national expenditure. The provinces, by contrast, collect less than 10 percent of total national revenue but account for nearly 30 percent of total expenditures"<sup>62</sup>. In FY16 provincial share of general government expenditure was 35 percent, but it collected 8 percent of national fiscal revenue<sup>63</sup>.

Despite this there is a hesitance towards discussing how Pakistan can graduate towards SGFF. This hesitance perhaps stems from a sense of regret over the manner in which devolution was rolled out. In addition to problems discussed earlier, some of other issues that were left undressed at the time of devolution include the following.

The biggest critique is that the devolution of fiscal resources was not synchronized with the strengthening public financial management frameworks at the provincial level. This is indeed true. Most stakeholders interviewed for this report flag the weak capacity at provincial level. However, a valid counter argument is that slow progress

<sup>60</sup> Barry Weingast 2006

<sup>61</sup> Zubair Khan 2003

<sup>62</sup> Ibid

<sup>63</sup> Tasneem Alam & Tokhir Mirzoev 2017

on devolution may have stalled the process given the inertia, and the underlying tilt towards centralisation, especially in the context of Pakistan's history of civil-military relations.

In a recent paper, the IMF flagged another concern over the non-binding nature of the decisions made by the Fiscal Coordination Committee (FCC) comprising of provincial and federal finance secretaries, to synchronize policy coordination and budget implementation.

The third critique pertains to the provinces' failure to devolve fiscal and political autonomy to local level. The 18th amendment had declared local government as the third tier of government by adding section 140A to the constitution, which states that "each province shall, by law, establish a local government system and devolve political, administrative and financial responsibility and authority to the elected representatives of the local governments."

While each province has the discretion to draft its own local government system, all the four local government laws have provisions to establish provincial finance commissions for the award of revenue at sub-national level. However, so far only two provinces have announced PFC award. The purpose of fiscal decentralisation was to improve service delivery, and that vision, it is argued, cannot be achieved without taking devolution to its logical conclusion by giving fiscal and political autonomy to local governments.

However, the notion that further political and fiscal devolution is what's needed for furthering democracy and improving accountability needs to be taken with caution. Despite repeated attempts of local government, new leadership has not emerged, not at least noticeably, from any of the local government experiments. Research suggests that those who get elected at local level, whether under military's version of local government or civilian, essentially belong to the same power structure that exists at upper tiers of government. This debunks the view that local government is the nursery of new leadership and of democracy.

Moreover, while citizen empowerment, accountability and transparency are seen to be attractive reasons for devolution to the third tier of government, devoid of reality, evidence suggests that the same has not been true in Pakistan. For example, the site construction of a new village road or a new well is not based on the collective will of villagers; it is based on the will of the feudal who is also a local government leader and whose family is a part of upper tiers of government.

Likewise, the ideals that local government leads to accountability and transparency has to be reconsidered in Pakistan, in light of the fact that Pakistan has not even achieved accountability and transparency even at federal level, nor does the media, a key institution of accountability, focusses on sub-national issues at provincial level, let alone issues that concern the third tier of government.

**Key learning:**

- 1) *The discussion on the NFC cannot be separated from a detailed discussion on how Pakistan wants to imagine its fiscal federalism framework, including reassignment of taxes and further fiscal and political devolution to the third tier of government.*

**CONCLUSION & RECOMMENDATIONS**

The purpose of the NFC is to allocate financial resources to sub-national governments, so they can meet their needs of public expenditure on their respective populace. However, aside from needs, equalisation is also important part of the NFC. The principle of equalisation demands that citizens living in different provinces with varying capacity to raise own revenues should be able to enjoy a minimum acceptable of quality and quantity of public goods for which they need to have to the financial resources to be able to provide for those public services. This was the spirit behind the decision to include poverty and inverse population as part of set of criteria that formed the basis of distribution in the now-continuing 7<sup>th</sup> NFC Award.

These principles are also the reason why the framers of the 1973 constitution decided against the idea of having a permanent formula for distribution of intergovernmental revenue transfers. Instead it proposed for a committee to sit down every five years that can reevaluate the formula in light of the changing socio-economic conditions in the country that may necessitate constant adjudgment of the basis of transfers.

Moreover, raising backward provinces to minimum acceptable level of development is not the only reason for continuous improvement in the formula for revenue transfers. The promotion of healthy competition among sub-national governments, especially vis-à-vis economic growth, higher tax effort and expenditure efficiency is also one of the objectives of intergovernmental revenue transfers.

Because of the complex and evolving nature of the basis of intergovernmental transfers, there is no single neat equation that can be used to distribute fiscal, political and public goods in a manner that is perfectly just and as such beyond criticism. It's a journey that requires continuous research and negotiations.

In Pakistan federalism has only recently started to take roots following the 18<sup>th</sup> Amendment, 7<sup>th</sup> NFC, the passing of local government laws in provinces, however, deficient those laws may be. To ensure that it continues to move in that direction, provinces will have to up their ante in both research and advocacy to resist the centralist hangover in Islamabad that demand a roll back of devolution.

However, evidence backed debate and discussion on the subject remains a challenge in the absence of timely availability of reliable and widely acceptable macroeconomic and socio-economic datasets at both national and provincial level for effective analysis of policy choices and decisions thereof. Local level data is even more sketchy creating hurdles in actionable analysis of revenue and expenditure performance of sub-national governments.

In this backdrop, the following is an itemised list of learnings of this study on the subject of the NFC:

- Vertical distribution is a bone of contention towards the passing of the new NFC award. The centre demands that provinces ought to share the expenditure on security and federal territories, and hence demands an allocation for the same prior to the divisibility of the divisible pool. Provincial governments are clear that there is no constitutional or even normative requirement to do so. Unless any of the two parties relax their positions, a new award, save for continuation of old arrangement, may not be in sight.
- Technical reasons / differences in constitutional interpretation of the extendibility of the NFC award are not immediately cited as biggest hurdle behind the current NFC deadlock. However, upon further inquiry with stakeholders, difference of opinion and lack of consensus on constitutional interpretation eventually emerges as a fundamental structural problem. Although this subject is little researched, or deliberated, no stakeholder wants to rock the boat by going to the Supreme Court for constitutional interpretation. Nor do most stakeholders agree with the suggestions to add penalty clauses of any kind to force an NFC agreement.
- Taxation lies at the heart of the matter. Except for centralists all stakeholders agree that federal government should raise its tax revenue. Centralist argue that no matter how it raises the revenue, it will always face tight budget constraints because of current vertical distribution arrangement. Prima facie, that argument doesn't hold, but detailed fiscal analysis hasn't been presented by either side. This suggests that in the next round of NFC negotiations, the responsibility of expenditure, and its efficiency and judiciousness at both federal and provincial level will be one of the main items of discussion. There has been criticism against provinces for failing to grow their own revenues, despite sharply increasing collecting on GST on services. However, the revenue potential of AIT and property taxes is little, and also little researched.
- There is a consensus that negotiations without an air of mistrust is the missing link; the parties have to keep on talking. The first step therefore is to start the negotiation, and then continue at it. On that note, there is also a consensus that if the centre doesn't want full-fledged negotiations, it can get a new award just by incorporating updated datasets in the current formula, and that provinces will likely agree to that.
- Linking the NFC formula with socio-economic performance (inputs or outputs thereof) is attractive ideal but does not enjoy consensus, not even among centralists.
- A two-tier institutional structure to finalise the NFC award is also considered attractive, but the idea does not enjoy consensus. Existing intergovernmental

forum is seen as optimal framework to hammer out vertical and horizontal distribution. Albeit the strengthening of NFC secretariat is widely agreed upon, especially to address the data constraints for meaningful evidence-based negotiations. Likewise, there is consensus that federal and provincial bureau of statistics ought to be strengthened and made autonomous to ensure timely and reliable availability of macro-and-socio economic data.

- Negotiations on borrowing of the provinces - its scope, modalities etc – will likely be on the discussion table in next round of NFC discussions provided the centre is interested in having full-fledged discussions. So might, albeit to a lesser degree, provincial shares in federal spending on borrowed money. How should both look like? Each may have some idea, but there is no consensus, nor is their publicly available research or position papers on the subject. This is the kind of research that a strong NFC secretariat can conduct periodically.
- Rearrangement of revenue reassignments is an even more difficult agenda, not only because most non-provincial stakeholders are not comfortable with it, but also because of likely very strong resistance by the centre
- A discussion on the NFC cannot be separated from a detailed discussion on how Pakistan wants to imagine its fiscal federalism framework, including reassignment of taxes and further fiscal and political devolution to the third tier of government.

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