



RETHINKING NFC

Dr. Idrees Khawaja

INTRODUCTION: THE TWO PILLARS, ONE TRAP

Stephen Levitt, in his popular book *Freakonomics*, discusses several examples of such systems or incentive structures that produced unintended poor outcomes, like teachers at a school correctly answering MCQs for their poor students to secure performance bonuses linked to students' grades. Using the population share to distribute the national financial resources among the provinces has

corrupted the incentive structure to such an extent that we cannot even obtain an accurate population count – the population censuses, just like the national elections, are often alleged to have been rigged in favour of one or the other province. In fact, the reason that the population census of 2022 was held just five years after the previous census was a tacit admission of the rightfulness of claims regarding the alleged rigged numbers of the 2017 census. Yet another instance of the incentive structure gone wrong, thanks to the NFC, is the Petroleum Development Levy (PDL).

The PDL, when introduced in Pakistan, was envisaged as a reserve to smooth the volatility in the local oil prices – when international oil prices are low, the consumers will be charged the PDL to build a reserve which will be used in times of high global prices to avoid passing on the entire increase to the consumers. As it is a levy and not a tax, the amount collected as PDL does not go into the divisible pool of funds meant for distribution among provinces as per the NFC Award. To ensure that the federal government does not have to share the proceeds with the provinces, the government continues to increase the PDL, which now constitutes close to 40% of the retail price of fuel oil.

A view has been doing the rounds that the 82 per cent population share in the NFC may be reduced significantly in favour of socioeconomic indicators like multidimensional poverty or just the lagged state of education and healthcare, etc. It is noteworthy here that if the population count can be manipulated to secure more funds, then the statistics on education and health can also be manipulated. How about having a distribution mechanism that does not require any kind of data? To this end, how about turning the present NFC structure on its head – instead of the federal government collecting most of the taxes and distributing these among the provinces, how about provinces giving to the Centre for the services that Centre performs for the entire country, like national defence, internal security, foreign affairs and more.

The tax bases, like personal income tax, corporate income tax and sales tax on goods, organically belong to the provinces; it's the Centre that has entitled itself to these tax bases by way of legislation. Most salaried individuals serve in provinces; therefore, the income tax payable on their income belongs to the province where they are employed. Similar logic applies to the income tax paid by entrepreneurs and corporates, as the businesses primarily operate in provinces. Most of the goods sold in Pakistan are sold in the provinces, thus the sales tax on goods also organically belongs to the provinces.

All the functions that the Centre performs are supposedly for the benefit of the entire population of the country. The Center must have money to perform these functions. With the NFC structure turned on its head, this is possible in two ways – the provinces should pay a certain sum out of the taxes that they collect to the Centre or the provinces and center can share the tax bases like income tax and sales tax on goods in a particular proportion –

enough to finance the needs of the Centre while accounting for the deficit financing (money creation) that the center can typically resort to. The system of sharing tax bases is easier to administer and politically more feasible as well, relative to the provinces collecting in the first place and then giving to the center. Under the sharing system any constitutional tier – center or the province – can be the collecting agency with the one level paying collection charges to the collector.

The advantage of sharing tax bases between the provinces and the center is that this system requires no data like the population count or data on poverty or other socio-economic indicators, like education and health. Thus, predefined sharing proportion of tax bases, will kill the perverse incentives to manipulate the data required for several kinds of planning and policy decisions, just to secure more funds.

The sharing system would attract criticism that, given the natural terrain and other circumstantial factors, not all provinces have the potential to generate significant tax revenue. Some provinces may not be able to generate enough to meet their own needs, let alone share with the Center. This could be the case in some provinces, even after recourse to tax bases like the income tax and the sales tax on goods.

The system of Have-Provinces giving to Have-not provinces prevails in countries like Canada. In Pakistan, one province giving to another may not be politically feasible; however, just as the rich pay more tax, sharing a percentage of a tax base meant for the Centre can be higher for the Have provinces relative to Have-not provinces. In the end, the central government should be collecting enough from all provinces put together to have sufficient funds at its disposal to help the Have-not provinces.

This might attract criticism that the Centre helping the lagging provinces will also generate perverse incentives. Here is a brief history that tells us that the development of Punjab, the largest province in terms of population, is essentially a state-led development. Now it is only fair that other laggard provinces should enjoy access to the state's resources.

Historically, state-led development has increased employment opportunities in some regions and districts, but not all. In late 19th-century India, the British, while aiming at revenue generation and exporting primary raw material from India to England, decided to increase India's agricultural production.

Canals were constructed to irrigate and cultivate Punjab's barren but fit-for-agriculture land. Farming and residential plots were allotted at throwaway prices to carefully selected agriculturists from the settled districts of India. These measures together came to be known as 'canal colonisation'.

The canal colonisation of Punjab led to migration to 'canal colonies' at a massive scale and caused the irrigated area in (United) Punjab to increase from three million acres in 1885 to 14 million acres in 1947 — an increase of 366 per cent. Ali Imran writes in *Punjab Under Imperialism: 1885-1947* that (Central) Punjab, which was a desert waste or at best a pastoral savannah, turned into one of the major centres of commercialised agriculture in South Asia.

The increase in employment opportunities in central Punjab was the obvious outcome of canal colonisation, where eight out of the nine canal colonies developed by the Raj were located. Moreover, thanks to migration, the population of Punjab also increased rapidly. For example, the population density of Lyallpur (now Faisalabad) increased from seven persons per square mile in 1891 to 301 in 1921 and 927 in 1998. The ginning factories, the Agriculture Research Centre and the railway workshop in Lyallpur all owe their origin to the lower Chenab colony that facilitated cotton-cropping in the region.

Yet another initiative of the then state that led to significant employment opportunities and migration was the establishment of the military headquarters of the Indian army in Rawalpindi. After the Afghan war of 1878, the British became obsessed with the Great Game and feared that Russia might invade India through Afghanistan. To deter the Russian threat, our coloniser decided to establish the military headquarters of the Indian army in Rawalpindi, as it was close enough to the full range of passes and yet too far away to be overrun in the first offensive.

The establishment of the headquarters turned the villages of Rawal into the city of Rawalpindi, the second largest in Punjab, next to Lahore. Moreover,

out of a total of six cantonments in Punjab, four were in the relatively small northern Punjab comprising Rawalpindi/Murree, Jhelum and Attock.

Cantonments have influenced the region's economy in several ways. Meant to serve as residential-cum-office spaces for the British officers, the provision of public goods was bound to be better in the cantonments than in the inner city. The strategic road-and-rail network constructed to connect cantonments was also used for commercial carriage and civilian transport. Similarly, the health and education infrastructure meant for soldiers was also available to civilians, and the construction within and around cantonments generated innumerable job opportunities. Hence, migration to Rawalpindi and the increase in population in and around cantonments did not come as a surprise.

As there was no NFC kind of institution in the colonial period, the state could choose on its own where to spend and how much. It is evident that canal colonisation, as well as the establishment of military headquarters and cantonments, involved massive expenditures — that more was spent in Punjab meant that less was available for spending elsewhere.

The NFC distributes a significant proportion (82 per cent) of national tax revenue based on the provincial share of the population, and Punjab, being the most populated province, draws the largest share. The increase in population in the province being sudden and owing to the development-cum-strategic ventures undertaken in the pre-Partition period, Punjab continues to be the beneficiary of the pre-Partition state-led development effort, by way of the current, larger allocations under the NFC.

The development effort undertaken during the British reign, though beneficial for the country, was meant to serve the interests of the Raj; an independent state must think differently. The principle of equity demands that development efforts of the state be spread all over the country to impact the majority, if not everyone.

People living in districts like Tharparkar do not enjoy the same opportunities as those residing in Karachi, Lahore, and Islamabad do. To provide a reasonable level of opportunities to the majority, development efforts, especially in the social sector, will have to be focused on the lagging regions of Pakistan.

A formula that distributes funds to the provinces primarily based on population share cannot ensure that enough funds will flow to, say, Chagai, Rajanpur, Kohistan, Tharparkar, former Fata and Gilgit-Baltistan. To provide opportunities for all a rethink and revisit is the need of the day.

It is high time that the nation focuses development efforts on such regions. But the current needs of the provinces and the Center must be met as well. A pragmatic solution could be to estimate the expenditures required to sustain the existing infrastructure and the administrative paraphernalia, both at the central and provincial levels.

Lagged regions like the tribal areas lack economic opportunities and have been safe havens for terrorists; once the nation sees the correlation between the lack of opportunities in a region and the safe havens for terrorists, it will not be difficult to find the money to spend to be spent on creating opportunities in the lagged regions, as the state has done historically for the now prosperous areas.

It goes without saying within the provinces too the flow of funds to the districts and regions should be based mechanism that serves the current funding needs of the districts/regions while leaving enough to alleviate the lagged development indicators of those left behind by the state.

Dr. Idrees Khawaja is an academican and researcher, having previously served as the Chief of Research at the Pakistan Institute of Development Economics

