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**NFC SPECIAL**

# DISCOURSE

## **NFC AT A CROSSROADS**

Revisiting Fiscal Federalism in Pakistan



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PAKISTAN INSTITUTE  
OF DEVELOPMENT  
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Discourse is a quarterly magazine from the Pakistan Institute of Development Economics. This issue of Discourse, titled “NFC at Crossroads: Revisiting Fiscal Federalism in Pakistan,” focuses on the National Finance Commission (NFC) Awards – a cornerstone of Pakistan’s fiscal federalism and one of the most significant instruments shaping the country’s governance and development trajectory. As Pakistan grapples with economic instability, rising fiscal pressures, and renewed calls for equity in resource sharing, the NFC once again stands at a defining moment.

This quarter’s issue brings together leading policymakers, scholars, and practitioners to critically engage with the past, present, and future of the NFC.

The contributions revisit the economic impact of successive Awards, reflect on the implementation challenges after the 18th Amendment, and analyze how ethnic and political cleavages continue to shape intergovernmental fiscal arrangements. Articles also delve into the enduring debate of provincial revenue mobilization and federal consolidation, offering fresh perspectives on how to balance equity, efficiency, and autonomy, along with offering innovation solutions.

Beyond the mechanics of fiscal distribution, the issue also broadens the lens to consider the unfinished agenda of empowering local governments, the incentives that underpin current transfer mechanisms, and the pressing need for institutional reforms. Importantly,

new ideas are put forward—such as incorporating climate considerations into future NFC frameworks and moving towards cooperative fiscal federalism that aligns national and provincial priorities.

Together, the contributions in NFC at Crossroads provide a comprehensive and timely analysis of Pakistan's fiscal contract. They highlight the risks of stagnation but also illuminate pathways for reform, underscoring the urgency of reshaping fiscal federalism to respond to evolving economic, social, and environmental realities.

As always, Discourse remains committed to fostering rigorous yet accessible dialogue that bridges academia, policy, and public interest. This issue presents analysis from some of the best minds in the field, bringing together authoritative voices who have long shaped the debate on fiscal federalism in Pakistan. Contributions from leading experts such as Dr. Kaiser Bengali, Dr. Aisha Ghaus Pasha, and Dr. Idrees Khawaja, among others, enrich the discussion with their deep insights, evidence-based perspectives, and forward-looking policy recommendations. Their work, alongside contributions from emerging scholars and practitioners, ensures that NFC at Crossroads captures both the historical depth and contemporary urgency of the subject. It is our hope that the debates and reflections presented here will inform policymakers and inspire broader engagement with one of the most critical challenges facing Pakistan today.

We hope you enjoy reading this issue of Discourse!



# TABLE OF CONTENTS



It's Time to Renew the NFC Award — For a Fairer, Stronger Pakistan - <b>Ahsan Iqbal</b>	01
The NFC Puzzle: Balancing Equity and Survival - <b>Dr. Nadeem Javaid</b>	04
Revisiting Fiscal Federalism in Pakistan - <b>Dr. Kaiser Bengali</b>	07
Fiscal Federalism in Pakistan: Economic Impact of the 7th NFC Award - <b>Dr. Aisha Ghaus Pasha</b>	14
Ethnic Cleavages and the Implementation of 18th Amendment - <b>Dr. Karim Khan</b>	20
Pakistan's Fiscal Trap: Breaking Free from Endless Consolidation - <b>Dr. Mohammad Ahmed Zubair</b>	25
Rethinking NFC - <b>Dr. Idrees Khawaja</b>	31
Why provincial revenue mobilisation central to the NFC Framework? - <b>Hina Shaikh</b>	35
Beyond the NFC Award: Pakistan's Unfinished Devolution to Local Governments - <b>Dr. Usama Ehsan Khan and Uzma Aftab</b>	39
Fiscal Resource Distribution: Criteria, Incentives and Institutional Mechanism. A Comparison between Neighbors - <b>Dr. Iftikhar Ahmad and Zahanat Hussain</b>	43
A Case for Climate-Centric NFC - <b>Moazz Manzoor</b>	50
Pakistan's Fiscal Federalism: From Stalemate to Solution - Charting a Cooperative Fiscal Future - <b>Saba Asghar Bhutta</b>	53
Speech of President of Reformistan on the 11 <sup>th</sup> NFC Award - <b>Dr. Nasir Iqbal</b>	57



# IT'S TIME TO RENEW THE NFC AWARD – FOR A FAIRER, STRONGER PAKISTAN

**Ahsan Iqbal**

Pakistan's federal system rests on a simple truth: every tier of government — federal, provincial, and local — must have the resources to fulfil its constitutional responsibilities. That principle comes alive through the National Finance Commission (NFC) Award, the constitutional mechanism for dividing federal tax revenues between the federation and the provinces. It is the lifeline of fiscal federalism — but today, it is frozen in time.

The 7th NFC Award, agreed in 2009 and implemented in 2010, was a milestone in our fiscal history. It emerged from hard-fought consensus, raised the provinces' share of the divisible pool

from 47.5% to 57.5%, and for the first time went beyond population as the sole criterion. It factored in poverty, revenue effort, and inverse population density, with special adjustments for Khyber Pakhtunkhwa's security costs and Balochistan's guaranteed share. It was a triumph for inter-provincial trust, and a step toward recognising that the poorest provinces needed fiscal space to catch up.

But it was never meant to be permanent. The Constitution's Article 160(1) requires the NFC to be reconstituted at least every five years to keep resource-sharing fair, relevant, and responsive. Fifteen years later, Pakistan is still running a

21st-century federation on a 2009 formula. In that time, our realities have shifted dramatically. Urbanisation has surged — from 36% of the population in 2009 to over 41% in 2024 — changing the shape of infrastructure and service delivery needs. Climate shocks have intensified, with the 2022 floods alone causing over US\$30 billion in losses, highlighting the need for stronger federal capacity to manage resilience and disaster recovery.

Meanwhile, the federal government's fiscal space has been squeezed to the breaking point. Under the current award, 57.5% of federal tax revenues go to the provinces before the centre spends a single rupee. Federal obligations have not shrunk in parallel; they have grown. Each year, over Rs. 150 billion is spent on Azad Jammu and Kashmir, Gilgit-Baltistan, the newly merged districts of KP, and Islamabad — none of which receive a share of the divisible pool. Another Rs. 716 billion goes to the Benazir Income Support Programme, even though social protection became a provincial responsibility under the 18th Amendment. Most critically, debt servicing now consumes over 80% of net federal revenues.

The consequences are stark. The Public Sector Development Programme — the engine for national projects like dams, highways, higher education, and power transmission — has shrunk from 2.6% of GDP in 2018 to just 0.8% in 2025. Many projects that bind the country together have stalled for lack of funds, while provincial development spending has risen from 59% of the national total in 2000 to 76% in 2025. In other federations, such as Canada, the federal government maintains strong fiscal space to fund equalisation payments, health transfers, and infrastructure, ensuring national standards. Pakistan's federation, by contrast, is increasingly starved of the means to invest in nation-building.

This fiscal squeeze is compounded by a governance gap. The 18th Amendment was a bold reaffirmation of federalism, devolving 17 major functions to the provinces. But most provinces never devolved these further to districts and local governments, as required by Article 140A. The result is provinces that have replicated the centre's centralisation — holding power and resources at the top while devolved sectors like education, health, agriculture, and population planning remain underperforming. Pakistan ranks 161st in education and 154th in health globally, despite the fact that provinces now control the lion's share of spending in these sectors.

Other federations avoided this trap. India mandates Finance Commissions at the state level to ensure transparent resource flows to local bodies. South Africa embeds constitutionally protected transfers to municipalities, linked to performance reporting. Pakistan must either empower functional, elected, and well-funded district governments, or open a national debate on creating more, smaller provinces for more manageable governance. Our four mega-provinces are an outlier globally — Afghanistan, with 44 million people, has 34 provinces; Türkiye, with 86 million, has 81; India has created 11 new states since 1947.

A deeper problem lies in the design of the 7th NFC Award itself. The 18th Amendment inserted a clause that the provincial share cannot be reduced below the 2009 level of 57.5%. This “non-flexibility” has frozen the formula and discouraged reform. With guaranteed revenues, provinces have little incentive to revisit the award or expand their own tax effort. The result is repeated deadlock in NFC negotiations and a formula increasingly out of sync with Pakistan's realities.

A renewed NFC Award must shift the focus from simply dividing revenues to sharing responsibility for results. Performance-based allocations could reward provinces that improve literacy, expand health coverage, strengthen population planning, mobilise provincial taxes, and invest in climate resilience. Federal transfers could be linked to active Provincial Finance Commissions that ensure funds reach local governments. Transparency benchmarks could make certain grants conditional on provinces publishing sectoral performance data.

The current population weight of 82% in the formula also distorts incentives. It penalises provinces that successfully control population growth, under-rewards governance quality, and ignores climate vulnerability and urbanisation pressures. Global practice points to a more balanced approach. India's 15<sup>th</sup> Finance Commission reduced the population weight to 15% for performance-based criteria, while Germany combines population with fiscal capacity and “need” factors like unemployment. Pakistan's NFC could reduce the population weight to around 60%, with the rest assigned to performance, environmental stewardship, and climate adaptation, and also earmark a share for AJK, GB, and ICT in the divisible pool.

Strengthening the federation's fiscal capacity is not about weakening provinces. It is about enabling the country to execute projects that no single province can undertake alone: strategic transport corridors like CPEC, cross-provincial energy grids, mega water storage projects like Diamer-Bhasha and Mohmand dams, high-speed rail, and cutting-edge research in higher education, nuclear, and space technology. Without resources, these remain paper dreams — and the whole nation loses.

Renewing the NFC Award will be politically difficult but is economically unavoidable. The next award must rest on three principles: equity, so that every citizen in every province has equal opportunity; efficiency, so that good governance and fiscal effort are rewarded; and evolution, so that our fiscal federalism adapts to a changing world. The Constitution gives us the framework. The data is ready. What remains is the political will.

The NFC Award is not just a financial formula; it is the bloodstream of our federation. It determines whether resources reach those who need them, whether governments can deliver, and whether Pakistan can meet its development goals. The 7th NFC Award was a landmark of its time. The 8th can be a game-changer — but only if we modernise it to meet today's and tomorrow's challenges. For a fairer, stronger, and future-ready Pakistan, the time to act is now.

Mr. Ahsan Iqbal is the Federal Minister for Planning, Development and Special Initiatives, the Deputy Chairman Planning Commission, and Chancellor of the Pakistan Institute of Development Economics.





# THE NFC PUZZLE: BALANCING EQUITY AND SURVIVAL

Dr. Nadeem Javaid

## THE ETERNAL QUESTION OF FEDERATIONS

Every federation wrestles with the same riddle: who gets what share of the national purse? This is never just arithmetic—it is about trust, fairness, and survival. In Canada, debates over oil revenues tested the union's strength; in India, the Finance Commission recalibrates transfers every five years; in Australia, horizontal equalization prevents states from falling too far behind.

Pakistan's answer to this puzzle lies in the National Finance Commission (NFC) Award—a landmark of our fiscal federalism. But what was once hailed as a milestone of political consensus now strains under new economic realities.

## WHEN BALANCE TURNS INTO IMBALANCE

The Centre today shoulders national obligations—defense, debt servicing, pensions, subsidies, climate adaptation—that exceed its fiscal capacity. Meanwhile, provinces, strengthened by the 18th Amendment, rely heavily on federal transfers yet underperform on their own revenue generation.

This imbalance is not academic. As Federal Minister for Planning Ahsan Iqbal recently highlighted, the Centre spent over PKR 700 billion on provincial responsibilities, leaving little room for vital national projects like Diamer Bhasha and Mohmand dams—essential for Pakistan's water and food security. A federation that cannot invest in shared futures risks undermining its own survival.

## WHY THE CENTRE STILL MATTERS

The logic is straightforward: only the Centre can build dams that supply water across provinces, highways that knit the nation together, and climate defenses that shield all regions. Yet when the federal share of the divisible pool was cut from 56% to 42.5% in 2010, it created a stark mismatch between obligations and resources. Today, development has been pushed to the margins, while debt and defense dominate.

Other federations understood this risk early. Australia's Commonwealth government directly finances strategic water and energy projects. India's Centre runs flagship education and health schemes to ensure national cohesion. Pakistan, too, must restore the Centre's fiscal space if it is to drive transformation.

## PROVINCES: AUTONOMY WITHOUT ACCOUNTABILITY

The 18<sup>th</sup> Amendment delivered historic autonomy. But autonomy without responsibility is dangerous. More than a decade later, provinces still raise less than 1% of their GDP in taxes. The services sector contributes over 57% of GDP, yet provinces collect less than 0.5% in tax revenue from it. Agriculture income tax and property taxes remain grossly underutilized.

Worse, provinces themselves deny Provincial Finance Commission (PFC) Awards, leaving districts and local governments dependent on provincial handouts. This double centralization—provinces leaning on the Centre, districts leaning on provinces—creates a distorted fiscal pyramid where accountability is weakest at the grassroots.

The result? Provinces enjoy political space to spend but not the responsibility to raise. Citizens are left with weak schools, hospitals, and municipal services, while the Centre borrows heavily, squeezing out investment in national projects.

## RETHINKING THE NFC FORMULA: FROM POPULATION TO PERFORMANCE

The flaw of the NFC lies not in its vision but in its incentives. With population as the overwhelming criterion, it rewards size, not performance. Pakistan needs an evolved formula that encourages responsibility and resilience:

1. Prioritize human development – link part of transfers to improvements in education, health, nutrition, and gender equity.
2. Correct population incentives – current 2.6% annual growth may be inflated by the perverse incentive of larger shares for larger populations; the formula must encourage population control and responsible planning.
3. Reward revenue effort – provinces must be incentivized to tax agriculture, services, and property.
4. Incorporate climate resilience – reward investments in water management, forests, and adaptation.
5. Reserve a federal development share – protect funding for strategic national projects like dams, grids, and digital infrastructure.

This redesign would shift fiscal federalism from entitlement to effort, from consumption to investment.

## NFC AND PAKISTAN'S TRANSFORMATION AMBITION

Pakistan aspires to become a \$1 trillion economy by 2035 under the Uraan Pakistan initiative. But such ambitions demand bold, long-term investments. A fiscally crippled Centre and complacent provinces cannot deliver them.

Other federations show the way. In Germany, states co-finance federal programs, ensuring joint ownership of progress. Pakistan must, likewise, make fiscal federalism a ladder for growth, not a tug-of-war over shares.

## TOWARDS A NEW FISCAL CONTRACT

The way forward is political courage and cooperation. Provinces must recognize that a stronger federation ultimately strengthens them. The Centre must protect autonomy but insist on responsibility. Together, they must design a new fiscal contract that:

- Links transfers partly to provincial tax effort and service delivery.
- Guarantees a federal share for national projects.
- Strengthens intergovernmental forums for joint planning and monitoring.
- Empowers districts by ensuring provinces implement Provincial Finance Commissions.

## FROM DIVISION TO COLLABORATION

The NFC must no longer be seen as a contest of “who gets more.” Instead, it must evolve into a compact of shared responsibility and shared prosperity. If Pakistan truly seeks resilience and prosperity, fiscal federalism must become the foundation of collaboration, not competition.

In that lies the solution to the puzzle: equity for provinces, space for the federation, empowerment for local governments, and incentives for population stability.

Dr. Nadeem Javaid (SI) is a renowned academician and policy expert currently serving as the Vice Chancellor, Pakistan Institute of Development Economics.



BALANCE



# REVISITING FISCAL FEDERALISM IN PAKISTAN

**Dr. Kaiser Bengali**

The 7<sup>th</sup> NFC Award of 2010 was a landmark achievement; given that it was arrived at by consensus in the backdrop of decades of discord over centre-provincial fiscal relations. While the subject of apportioning resources is essentially political, there is always a large degree of overt economic rationale underlying the decision-making. The 7<sup>th</sup> Award was an accomplishment that was political, based on economic reasoning.

The need for apportionment arises from the fact of unequal development levels: vertical (i.e., in terms of different groups in the country) or horizontal (i.e., in terms of different regions in the country). The former acquires relevancy in the context of inter-jurisdictional imbalances if a marginalized group is concentrated in particular sub-national jurisdiction(s). The latter is a product of inter-regional imbalance in social and economic development. In most cases, the marginalization of a group or region is the result of historical political processes; thus, arises the need for redressal.

Most, if not all, countries in the world are faced with similar problems in varying degrees. Many attempt to address the situation with different forms of inter-governmental resource transfers; albeit, in the particular context of each country. Considerable international literature exists on the subject, dating back more than half a century. The earlier models are referred to as the First Generation Theories (FGT) and the latter ones as the Second Generation Theories (SGT)<sup>1</sup>. Inter alia, the former were propounded by Musgrave (1959), Oates (1972, 1999, 2005), and Musgrave and Musgrave (1984), and the latter have been put forward, inter alia, by Maite and Weingast (2003), Rodden et al (2003), Shah (2005), and Weingast (2007, 2009, 2013).

<sup>1</sup> A review of the two theories is available in: Iqbal and Sabir (2018). Strengthening Fiscal Federalism in Pakistan: The Way Forward, Social Policy Development Centre, Karachi

The essence of the First Generation Theories is that revenue collection is best performed at the national level, with fiscal transfers to sub-national levels for service delivery. The basis of this understanding is that factors of production, e.g., capital and labour, are mobile. As such, sub-national governments may tend to compete by offering lower tax rates; which can likely result in overall lower revenues. At the same time, FGT proponents argue that sub-national governments tend to better cater to the needs of local residents.

The essence of Second Generation Theories is that reliance of sub-national governments on federal transfers for delivery of public services amounts to de-linking tax and expenditure responsibilities – and accountability in expenditure decision-making. The absence of the linkage, it is argued, may tend to weaken sub-national incentive to tap potential local revenue sources; for example, also on account of local interest group pressure.

## DEVELOPMENT DIVIDE IN PAKISTAN

Inequality is pervasive in Pakistan: vertical and well as horizontal. There are regions that are relatively under-developed; however, marginalized population groups are not concentrated region-wise. The under-developed regions include the western provinces of Khyber-Pakhtunkhwa and Balochistan; Sindh exhibits a sharp urban rural divide and there are under-developed parts in Punjab as well<sup>2</sup>.

The inter-provincial development gap is indicated by the relative shares of agricultural and industrial endowments. Punjab and Sindh account for 80 percent of cultivable area and 90 percent of industrial establishments, respectively; compared to 20 percent and 10 percent, respectively, for Khyber-Pakhtunkhwa and Balochistan. This imbalance manifests in the respective revenue generation capacity of the provinces; thus, the case for inter-provincial resource transfers (see Table I).

There are important nuances to the above distribution. Sindh's lower share in cultivable area and number of industrial establishments, relative to that of Punjab, understates its true resource endowment. The province is home to the only two ports of the country and has large deposits of natural gas and coal; proving to be sizeable revenue bases. On the other hand, Balochistan too is mineral rich; however, the absence of supporting infrastructure – roads, water, etc. – has limited their exploitation – and, resultantly, the capacity to generate revenues.

## NATIONAL FINANCE COMMISSION

The National Finance Commission (NFC) is a constitutional body – vide Article 160 of the Constitution – that has to be constituted every 5 years and which is tasked to determine the respective shares of the federation and provinces out of specified federal tax revenues – vide Fourth Schedule of the Federal Legislative List Part I – referred to as the Federal Divisible Pool.

Table 1: Resource base by province

Provinces	Cultivable area <sup>1</sup>		Manufacturing Establishments <sup>2</sup>		Own-source Revenue <sup>3</sup>
	Million hectares	Share (%)	Nos.	Share (%)	000 Million Rs. Revised 2024-25
Punjab	12.65	57.5	32,580	76.5	915.2
Sindh	5.00	22.6	6,299	14.8	618.8
Khyber-Pakhtunkhwa	1.80	8.3	3,357	7.9	86.4
Balochistan	2.55	11.6	342	0.8	64.9
<b>Pakistan</b>	<b>22.0</b>	<b>100.0</b>	<b>42,578</b>	<b>100.0</b>	-

- Sources: 1. Government of Pakistan, Agricultural Statistics of Pakistan, 2005  
 2. Government of Pakistan, Census of Manufacturing Industries, 2015-16  
 3. Provincial Budgets 2025-26

<sup>2</sup> Under-development is high in Gilgit-Baltistan and Kashmir as well; however, the two territories are not constitutionally part of Pakistan. As such, they are not parties to the National Finance Commission.

The basis for resource distribution between the federation and provinces and between provinces is the Federal Divisible Pool. Over the years since NFC was constituted in 1974, the composition of the Divisible Pool has changed, as shown in Table 2. The process began with the 1st NFC in 1974 with a 20:80 distribution of vertical shares between the federation and the provinces, with the Divisible Pool including three taxes - Income & Corporate Tax, Sales Tax, and Export duties. The 4<sup>th</sup> NFC in 1991 enlarged the Divisible Pool by adding Central Excise Duties, but retained the federal-provincial distribution ratio at 20:80. The 6<sup>th</sup> NFC in 1997 further enlarged the Divisible Pool by adding Import Duties, but drastically reversed the federal-provincial distribution share to 63:37.



**Table 2: History of Composition of Federal Divisible Pool**

Award	Year	Federal-Provincial Share (%)	Taxes (included in Divisible Pool)
1 <sup>st</sup>	1974	20 : 80	Income & Corporate Tax Sales Tax Export duties
4 <sup>th</sup>	1991	20 : 80	As above + CED
6 <sup>th</sup>	1997	63 : 37	As above + Import Duties
Presidential Order	2006	52.5 : 47.5	As above
7 <sup>th</sup>	2010	42.5 : 57.5	As above

In other words, the 6<sup>th</sup> NFC raised the federal share from 20 percent to 63 percent and the provincial share was reduced from 80 percent to 37 percent. The rationale for this shift was explained by the following: Import Duties constituted the major revenue source for the federal government – single largest tax revenue source, accounting of one-quarter of tax revenues – and its inclusion raised the size of the Divisible Pool significantly. Resultantly, provincial revenues increased in absolute terms despite the reduction in its share. The composition of the Divisible Pool has since remained the same; however, the federal-provincial distribution was changed to 52.5:47.5 in 2006 and to 42.5:57.5 in 2010.

## 7<sup>TH</sup> NFC AWARD

The 7<sup>th</sup> NFC Award, concluded in 2009-10, was historic on three counts.

One, it changed the long-standing single criterion – population – formula for (horizontal) distribution between the provinces to a multiple-criteria – population, revenue, backwardness and population density

– formula.

Two, it reversed the (vertical) federal-provincial ratio to 42.5 – 57.5.

And three, it devolved GST Services to the provinces, as stipulated in the Constitution.

The introduction of the multi-criteria formula changed the inter-provincial shares as shown in Table 3. Accordingly, the shares of three provinces – Sindh, Khyber-Pakhtunkhwa and Balochistan – increased at the expense of Punjab. However, Punjab's loss was compensated by the sizeable enlargement of the provincial pool by virtue of increase in the (vertical) provincial share to 57.5 percent.

<b>Indicators</b>	<b>Weights (%)</b>	
• Population	82.0	
• Poverty/Backwardness	10.3	
• Revenue Collection/Generation	5.0	
• Inverse Population Density	2.7	
<b>Share of provinces changed:</b>	<b>From:</b>	<b>To:</b>
• Punjab	57.3%	51.74%
• Sindh	23.7%	24.55%
• Khyber-Pakhtunkhwa	13.8%	14.62%
• Balochistan	5.2%	9.09%

The fiscal standing of the provinces was further strengthened by the transfer of General Sales Tax (GST) on Services to the provinces. However, the inter-provincial effect was not uniform; given the varying services sector economic bases of the provinces. Accordingly, Punjab and Sindh benefitted disproportionately, relative to Khyber-Pakhtunkhwa and Balochistan.

## CURRENT ISSUES

The Constitution mandates the NFC to be formed every 5 years and a fresh Award to be enacted. However, it is now a decade and a half since the NFC Award of 2010 and three Commissions – 8<sup>th</sup>, 9<sup>th</sup> and 10<sup>th</sup> – have lapsed without result. Needless to say, there are voices for changes and a debate is under way; with the centre and provinces positioning themselves at different points.

### The centrist case

The 7<sup>th</sup> NFC is under attack. The principal argument, herewith, is that the high (vertical) share accorded to the provinces has compromised federal finances; with the federal government unable to bridge its budget deficit. As is apparent from Table 4, the federal government's Net Revenue Receipts just about covers Interest Payments and Pensions (and not entirely), with no resources even for Defence and Civil Government.



<b>Table 4: Overall Resources and Expenditure Revised Estimates: 2024-25</b>			
(in billion Rs.)			
<b>Resources</b>		<b>Expenditure</b>	
Tax Revenue,	11,900	Interest Payments	8,945
Non-Tax Revenue	4,902	Pensions	1,014
Gross Revenue Receipts	16,802	Defence	2,181
Less Provincial Share	(6,997)	Running of Civil Government	886
<b>Net Revenue Receipts</b>	<b>9,805</b>	<b>Essential Expenditure</b>	<b>13,826</b>

Source: Federal Budget in Brief 2025-26

Prima facie, the centrist case is compelling. There is, however, a counter argument in defence of the 7<sup>th</sup> NFC. The counter case is that the 18<sup>th</sup> Amendment of 2010 – in abolishing the Concurrent List – had effectively transferred nearly 40 items to the provinces. Accordingly, it was expected that the Ministries, Divisions and Attached Departments related to these items will be disbanded, merged or scaled down, so as to effect expenditure savings.

This, it is said, the federal government has failed to do; resulting in the corresponding failure to reduce superfluous government expenditure. Rather, federal Current Expenditure has registered disproportionate growth even in real terms; averaging annual growth at 16.4 percent per annum over the period 2011-2014, while the average inflation rate over the same period was 10.5 percent<sup>3</sup>. In other words, federal Current Expenditure has grown at more than 1.5 times the inflation rate.

## The 7 percent proposal

The centrists have, however, maintained their stance; but face a constitutional barrier. The 18<sup>th</sup> Amendment added Clause 3A in Article 160 of the Constitution, which places a bar on reduction of the (vertical) share of provinces, as determined in the previous Award. Accordingly, the federal Finance Minister placed an alternative proposal at the meeting of the 9<sup>th</sup> NFC to allocate 7 percent of the Federal Divisible Pool to the centre, prior to the distribution according to the 7<sup>th</sup> NFC formula. The proposal was unanimously rejected by the provinces.

## Aiming at provincial ‘failures’

The centrist drive case for securing a higher share of the resources has turned to attempts to undermine provincial political standing. Two lines of ‘attack’ are:

1. provinces are riding on the back of federal resource generation efforts and have failed to mobilize own-source revenues; specifically, agricultural income tax and urban property tax, and
2. provinces have failed to effect devolution to the local government level to improve service delivery.

Both are moot points. However, the primary centrist objective of attaining a revision of the NFC sharing formula is likely to remain unachieved, even if the cases against the provinces are established.

## A provincial case

The demand for the NFC to convene and draw up a fresh Award is the most forceful from Khyber-Pakhtunkhwa<sup>4</sup>. Share of population is one of the four criteria in the 7<sup>th</sup> Award and the latest population data available in 2010 was from the 1998 Population Census. Accordingly, Khyber-Pakhtunkhwa’s population share was recorded at 13.4 percent. Moreover, FATA was a separate (federal) entity in 2010. Its merger with Khyber-Pakhtunkhwa in 2028 raised its population share to over 16 percent. Accordingly, Khyber-Pakhtunkhwa is deemed to suffer losses post-2018 on account of its lower posting of population size.

<sup>3</sup> Calculated from: Government of Pakistan, Economic Survey, various issues

<sup>4</sup> The province’s name was NWFP at the time of the 7<sup>th</sup> Award in 2010

## Case for equity

The NFC debate has all along been one of ‘who gets how much’. It is time perhaps to move on to deliberating on adopting NFC allocations as a tool to forward social goals – and one such goal can be a less regressive tax regime.

Taxes impose a burden on those taxed. The burden can be proportionate to income or proportionately higher or lower relative to income. The burden is termed as incidence and is designated as progressive if the burden of the tax is higher on the rich and regressive if it is higher on the poor. Generally, direct taxes, i.e. taxes on income, wealth, property, etc., are said to be progressive and indirect taxes, i.e. sales taxes, customs duties, excise duties, etc., are said to be regressive. A tax regime that is progressive is said to be equitable and fair relative to one that is regressive.

In Pakistan’s case, about 40 percent of federal tax revenue is accrued from direct taxes and 60 percent from indirect taxes. However, over two-thirds of income tax is collected in advance as withholding tax and is, in effect, indirect in nature. Thus, if the withholding tax component is excluded, the effective share of direct taxes falls to less than 15 percent, with the effective share of indirect taxes rising to over 85 percent.

Collection of indirect taxes is relied upon as it is relatively administratively easy and politically low cost. Levy of direct taxes is politically problematic and the government even went to the extent of abolishing Wealth Tax. In other words, Pakistan’s tax regime is regressive and burdens the poor significantly more than the rich (see Kazi (1984), Malik and Saqib (1989), SPDC (2004), Refaat (2008), Ara and Ahmed (2022), Ara (2023).

The objective of ensuring that the tax structure targets certain higher socioeconomic goals can be achieved partly by correcting the currently skewed balance between direct and indirect taxes. This objective requires that the federal-provincial tax sharing mode provides the Centre with the incentive to prioritize direct tax collection over indirect taxes

The basic proposal is for the direct and indirect taxes components in the Divisible Pool to be treated separately; with the Centre retaining 80 percent of direct taxes and provinces retaining 80 percent of indirect taxes. Calculations have shown that this dual formula does not change the current ‘take home’ for the centre or provinces.

Dr. Kaiser Bengali is a renowned economist with over 40 years of experience in teaching, research, and policy advice. He has served in key positions, including as Advisor to CM Sindh and as the first head of BISP.



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# FISCAL FEDERALISM IN PAKISTAN: ECONOMIC IMPACT OF THE 7<sup>TH</sup> NFC AWARD

**Dr. Aisha Ghaus Pasha**

The National Finance Commission (NFC) Award has the spotlight in national discourse again. Fiscal federalism in Pakistan remains a cornerstone of the country's political economy, as it governs intergovernmental transfers between the federation and the four federating units. The Constitution of Pakistan requires that the NFC be constituted every five years to reevaluate the efficacy of revenue sharing in the light of evolving regional disparities and economic challenges, and announce a new award. The reality is this has not happened because of the political dynamics.

Historically, the division of financial responsibilities became structured with the promulgation of Pakistan's first constitution in 1956. Since the separation of East Pakistan, there have been only four conclusive NFC Awards (1974, 1991, 1996, 2009) in addition to a Distributional Order 2006.

This implies that only four NFC Awards were announced with consensus of all the federating units during a period of over 50 years (1974 to 2025).

After the NFC Award 1974, two attempts were made for the revision in inter-governmental transfers but these were unsuccessful. The much-awaited NFC Award then materialized in 1990-91. This was followed by the NFC Award 1996 for a period of five years (1996-97 to 2001-02), but remained in practice till 2005-06. In 2006, a distribution order from the President of Pakistan replaced the NFC Award 1996. In 2009 the 7<sup>th</sup> NFC Award was conclusively approved by revising the formula of sharing of resources. A new award was due in 2014, but three NFCs have since been constituted without culmination of an award.

As compared to Pakistan, in India, 15<sup>th</sup> NFC Award is currently operative. The regularity in consensus building is probably because the fiscal need and thereby the shares of federating units in India are determined by technical assessment of a team of experts. In Pakistan, however, the NFC secretariat neither has the mandate nor the capability to do a similar analysis and political dynamics determine the award, limiting chances of consensus.

## THE 7<sup>TH</sup> NFC AWARD

The 7<sup>th</sup> NFC Award has been cited as a landmark development in Pakistan's fiscal history. It was a major step towards provincial financial autonomy. It significantly increased the provincial share of the divisible pool from 47.5% to 56% in the first year, and 57.5% thereafter. This shift was aligned with the 18<sup>th</sup> Amendment (2010), which devolved Concurrent List functions to the provinces. Also, it provincialized Sales Tax on Services and enhanced straight transfers to strengthen provincial tax and revenue base.

To address inter-provincial disparities, for the first time, the award incorporated multiple criteria to distribute the divisible pool beyond population, including the following: population (82% weight); poverty and backwardness (10.3%); revenue collection and generation (5%); and, inverse population density (2.7%). This was a manifestation of a spirit of accommodation among the federating units, enhancing national cohesion and unity.

It exhibited sensitivity to the special situations of the smaller provinces- Khyber- Pakhtunkhwa and Balochistan- by giving them a share respectively for being the frontline province in the war against terrorism and backwardness.

In annexure, the Award also presented projections of public finance over the tenure of the Award-federal and provincial revenues and federal and provincial current and development expenditure. This was done to bring in an element of performance into discussion on NFC transfers to inculcate positive fiscal behavior (higher own source revenue, control over expenditure and better PFM systems).

In summary, the 7<sup>th</sup> NFC Award was designed to strengthen the provinces, reduce regional disparities and improve the fiscal state of the country through higher revenue mobilization, prudence in development spending and avoidance of profligacy in current expenditure by both the tiers of the

government. Through a significant enhancement in provincial revenues, it bought a paradigm shift in the development framework whereby provinces had the lead in the development of the country through improvement in the sectors which were the constitutional responsibility of the provincial governments. A strengthened NFC Secretariat was to monitor the overall finances of all tiers of the government.

## FISCAL IMPACT OF THE 7<sup>TH</sup> NFC AWARD

The 7<sup>th</sup> NFC Award had substantial fiscal, economic and political implications for Pakistan's federation. Focusing first on the fiscal impact, it strengthened provincial autonomy by allocating more federal resources to the provinces. Federal transfers as a percentage of federal tax revenues increased from 37% in 2009-10 to 62% in 2010-11. Overtime the federal government has developed non-sharable revenue sources, reducing this percentage to 57%. Nonetheless, the NFC Award empowered the provinces to develop and implement their own policies in line with regional priorities, presumably with a focus on social sectors.

A major criticism of the post-2009 NFC arrangement is the limited fiscal space left for the federal government, which is struggling to meet its own expenditure obligations, including debt servicing, defense, and national-level development projects. While true, three important dimensions also need to be highlighted: first, this would not have been the case if federal government would have increased the tax to GDP ratio to 15% of the GDP, in line with the NFC projections as bulk of the fiscal base is still with the federal government.

Second, the federal government did not cut the growth in its current expenditure through structural reforms in pensions, debt management, PFM and devolution as envisaged in the 18<sup>th</sup> Constitutional amendment. And lastly, the sharper reprioritization required in the federal development expenditure was not fully undertaken whereby the development spending throw-forward continues more or less unabated while provincial subjects are part of federal development portfolio. Provinces in the post 18<sup>th</sup> Amendment era were gearing up to take on the devolved functional responsibility, especially the larger provinces, but effective devolution never realized.

All in all, the feeble state of federal finances is a combined consequence of the above-mentioned factors which can principally be attributed to political economy dynamics, lack of capacity, indifference to transformational reforms and weak systems.

Turning now to provincial finances, the resource mobilization story is somewhat similar and shows lack of policy and effort consistency. Federal tax transfers (excluding straight transfers, which are part of provincial income collected by the federal government, as per Article 161 of the Constitution) as percentage of provincial revenue receipts increased from 72% in 2009-10 to 82% in 2010-11. It decreases to 75% by 2017-18, indicating growing provincial financial self-sufficiency.

The trend reverts thereafter and in 2024-25 its stands at 77%. This pattern is also demonstrated by the increase in provincial revenue to GDP ratio from 0.7% in 2009-10 to 1.4% by 2017-18 and then to a decline to 1.1% currently. Some broad tax bases are under the provincial fiscal domain—services, immovable property and agricultural income. It is imperative that Provinces mobilize resources from these tax bases to promote growth, development and social welfare.

On the expenditure side, combined expenditure on education and health which was 1.7% of GDP prior to the award increased to 2.8% by 2017-18 and thereafter declines to the current level of 1.8%. The aspiration about a big boost to spending on these two sectors, which directly benefit the masses, was not realized. Since the public sector development pendulum has shifted to the provinces, they need to make their spendings more efficient, value based, strengthen their financial management systems to make the spending more transparent and reprioritize development to maximize growth and wellbeing of the provincial residents.

In sum, higher and equitable resource mobilization is essential to improve the state of public finances in Pakistan. This requires political will, policy consistency and strengthening of the tax apparatus at both the federal and provincial level. Digitalization, data sharing and coordination between the two tiers of government can facilitate this. Also, expenditure reforms, sharper development prioritization and improved expenditure efficiency is crucial to ensure that outcomes are commensurate with the increase in expenditure—a feature largely missing in both tiers of government.

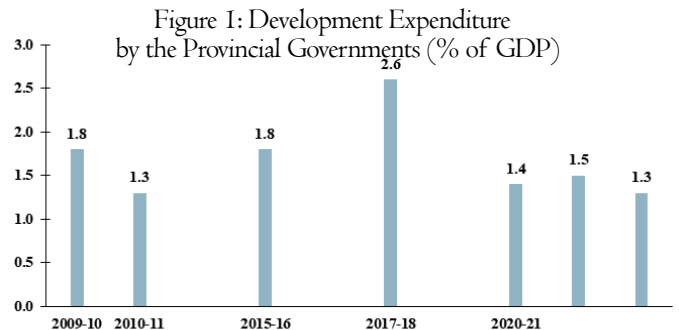
We turn now to the broader economic impact of the 7<sup>th</sup> NFC Award.

## ECONOMIC IMPACT OF THE 7<sup>TH</sup> NFC AWARD

The vertical and horizontal sharing formula in the 7<sup>th</sup> NFC Award were derived with the underlying focus on the broader economic impact of the Award. There were two dimensions of the economic impact. The first focus was on promoting the economic growth process and thereby achieving a higher GDP growth rate. This was to be facilitated, first, by higher development spending by the provincial governments, especially on the social sectors and growth promoting physical infrastructure. This would facilitate faster human capital formation and reduce the physical constraints to growth.

The second impact was expected to be a larger and stronger law and order set-up to tackle terrorism and crime (1% of Gross divisible pool was given to KPK for being the frontline province against war on terror). This would reduce risk perceptions of private investors and thereby raise the overall level of investment in the economy.

Therefore, the first empirical question is whether the 7<sup>th</sup> NFC Award led to a higher level of development spending by the four provincial governments. The answer is that, as shown in Figure 1, a peak was attained in 2017-18 at 2.6% of the GDP, but it has since declined by over 1% of the GDP.



Likewise, the trend in the overall GDP growth rate has been inconsistent. It increased to 6.1% by 2017-18 and thereafter declined. Therefore, post 7<sup>th</sup> NFC Award, there has not been a steady and significant increase in economic growth as highlighted in Table I. There has, in fact, been a small decline in recent years.

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Period	Percentages
2004-05 to 2009-10	3.7
2009-10 to 2014-15	3.5
2014-15 to 2019-20	3.4
2019-20 to 2024-25	3.4

The other economic impact that was envisaged under the 7<sup>th</sup> NFC Award was to achieve a big reduction in regional disparities among the provinces. Consequently, as highlighted above, poverty/backwardness and Inverse population density were included in the horizontal sharing formula to facilitate a process of catching up by the two relatively backward provinces of Baluchistan and Khyber-Pakhtunkhwa. The first criterion was to enable a larger share of transfer to a province with a higher incidence of poverty. The second criterion reflected the higher unit costs of provision of services in a province with lower population density.

The consequence was the following ratio in per capita NFC transfers in 2010-11, the first year of the Award.

Province	Share in NFC Transfers (%)	Share of Population (%)	Ratio of per capita Transfer to National per capita Transfer
Punjab	50.45	54.28	0.929
Sindh	23.94	23.30	1.027
Khyber-Pakhtunkhwa	16.03	16.78	0.955
Baluchistan	9.58	5.64	1.698
<b>Total</b>	<b>100.00</b>	<b>100.00</b>	

Therefore, the award gave a higher per capita transfer to Sindh because of its relatively large contribution to federal tax revenues. Despite being relatively less developed the province of Khyber-Pakhtunkhwa received a lower per capita transfer in relation to the national average because of a relatively low contribution to federal tax revenues and above average population density. Punjab and Baluchistan received the appropriate level of per capita transfers.

The methodology and estimates of the Gross Regional Products (GRPs) of the Provinces have been taken from Bengali (1999) and Pasha (2020). They have been used to extrapolate the size of the four provincial economies up to 2024-25. The estimated average growth rates of the GRPs of each province are presented in Table 3 for different periods. The results reveal that the range of provincial growth rates was 2.5% points in the decade prior to the 7<sup>th</sup> NFC Award. This range declined to 1.4% points from 2009-10 to 2024-25.

Therefore, there appears to have been some success in achieving an equalization of provincial GRP growth rates. However, this has happened at a time when the national GDP growth rate has declined somewhat. The Gini coefficient of regional income equality has also declined from 0.102 in 2009-10 to 0.092 in 2024-25.

**Table 3: Growth Rates of the Gross Regional Product of the Provinces**

	1999-2000 to 2009-10	2009-10 to 2024-25
Punjab	4.2	3.6
Sindh	5.0	3.1
Khyber-Pakhtunkhwa	5.1	4.1
Balochistan	2.6	2.7
<b>Pakistan</b>	<b>4.4</b>	<b>3.9</b>

The final impact that is examined is the change in the Human Development Index (HDI) of the provinces. The UNDP Pakistan Human Development Report of 2020 has estimated the HDI of

the Provinces for 2006-07 and 2018-19 respectively. The separate index values of education, health and income per capita have also been highlighted.

The HDI values of each Province is presented in Table 4.

**Table 4: HDI by Province**

	2006-07	2018-19
Punjab	0.527	0.572
Sindh	0.529	0.574
Khyber-Pakhtunkhwa	0.491	0.546
Balochistan	0.470	0.473
<b>Pakistan</b>	<b>0.529</b>	<b>0.570</b>

The cumulative increase in the HDI has been the highest in Khyber- Pakhtunkhwa because of significant progress on all three fronts of education, health and income. Baluchistan has shown only marginal improvement in the HDI, with actually a fall in the health index. Overall, the level of inequality among the four Provinces has only marginally improved.

To sum up, the economic impact of the 7<sup>th</sup> NFC award has perhaps not been as strong as envisaged. The GDP growth shows an inconsistent trend. This perhaps is due to a number of negative factors including COVID-19, floods and increased external vulnerability due to low foreign exchange reserves leading to stabilization measures at the cost of growth. However, there has been some success in reducing regional disparities, with Khyber-Pakhtunkhwa beginning to catch up with the two more developed provinces of Sindh and Punjab. However, Baluchistan continues to remain a visibly backward Province.

## WAY FORWARD: REVISITING THE REVENUE SHARING ARRANGEMENTS

The analysis in this paper tries to demonstrate that multiple other major factors are behind the current malaise in public finances in Pakistan -it is not the NFC award. Having said that, it is also important to accept that intergovernmental fiscal relations have to alter in the light of the developing fiscal trends. Some suggestions are given below:

The 18<sup>th</sup> Amendment to the Constitution ensures that the share of the provinces in the award is not reduced. Any downward change in vertical transfers is, therefore, unlawful and indeed undesirable. Also, as the TORs of the last uncompleted NFCs implied, provinces financing purely federal

functions is undesirable as it can lead to a moral hazard situation whereby the federal government has no hesitation in indulging in over spending. The solution is proper handing over of the 18<sup>th</sup> amendment functional responsibilities to the provinces, that is, full implementation of the 18<sup>th</sup> amendment, in letter and spirit.

Federal government should step out of all provincial function, restructure its ministries and Divisions, limiting itself to only regulatory functions where required. Likewise, provincial governments should not seek funds for devolved functions which should be accompanied with an amicable solution of all outstanding 18<sup>th</sup> amendment issues (like transfer of workers welfare funds). Provinces, especially the smaller provinces, need to be administratively strengthened and systems set to ensure quality service delivery. Better coordination between federal and provincial governments will minimize duplication and inefficiencies. The National Economic Council will have to play an effective role to ensure service delivery across regions, subnational ownership of and adherence to national policy goals and fulfillment of international commitments, like the SDGs and the IMF program.

Turning to the NFC formula, it does not incentivize provinces to improve their tax collection or efficiency in public spending. A performance-based element could improve transparency, accountability and promote healthy competition among provinces to improve fiscal responsibility. Currently, horizontal distribution is based on four criteria: population, poverty and backwardness, contribution to federal revenue generation and inverse population density. To encourage own resource generation, growth in own revenue mobilization can perhaps be the fifth criterion. To reward provinces for improving social sector outcomes, indicators based on international institutions assessment, like HDI can be used to give grants for better performance. Such changes will make the award somewhat dynamic in character and outcome oriented.

Our analysis indicates that the divisible pool transfers are not as fiscally equalizing as required. There is perhaps a case for some alteration in weights of criteria- some increase in poverty and some reduction in revenue generation. The latter can be diverted to incentivize own resource mobilization, as discussed above.

To keep revenue sharing equitable, relevant and reflective of underlying fiscal realities, the

arrangements have to be reviewed and altered after the constitutionally mandated period of five years. The probability of ensuring this will rise if the NFC award is based on technical assessment of fiscal need, as is the case in India. The NFC Secretariat needs to be strengthened for this purpose and to effectively monitor fiscal trends of the federation. It should serve as a data and policy hub, which should not only keep the federal government and the parliament informed but also share information with the provinces.

Also, by generating cash surpluses the provinces are, in effect, contributing to financing the budget deficit and thereby curtailing debt expansion. The current arrangement is, however, inconsistent and unpredictable. The provinces should reflect their commitment to the federal government in their expenditure management strategy to minimize disruption in their development activities.

Finally, there is a need to institutionalize regular dialogue among the federal and provincial governments through an empowered inter-governmental Fiscal Council to coordinate budgets, spending priorities, economic reforms and taxation issues, in particular, strife for integration and harmonization of the sales tax on goods and services. A Finance Secretaries committee currently exists for discussion on fiscal matters but a formal, institutionalized forum, supported by the NFC secretariat, can perhaps be more effective.

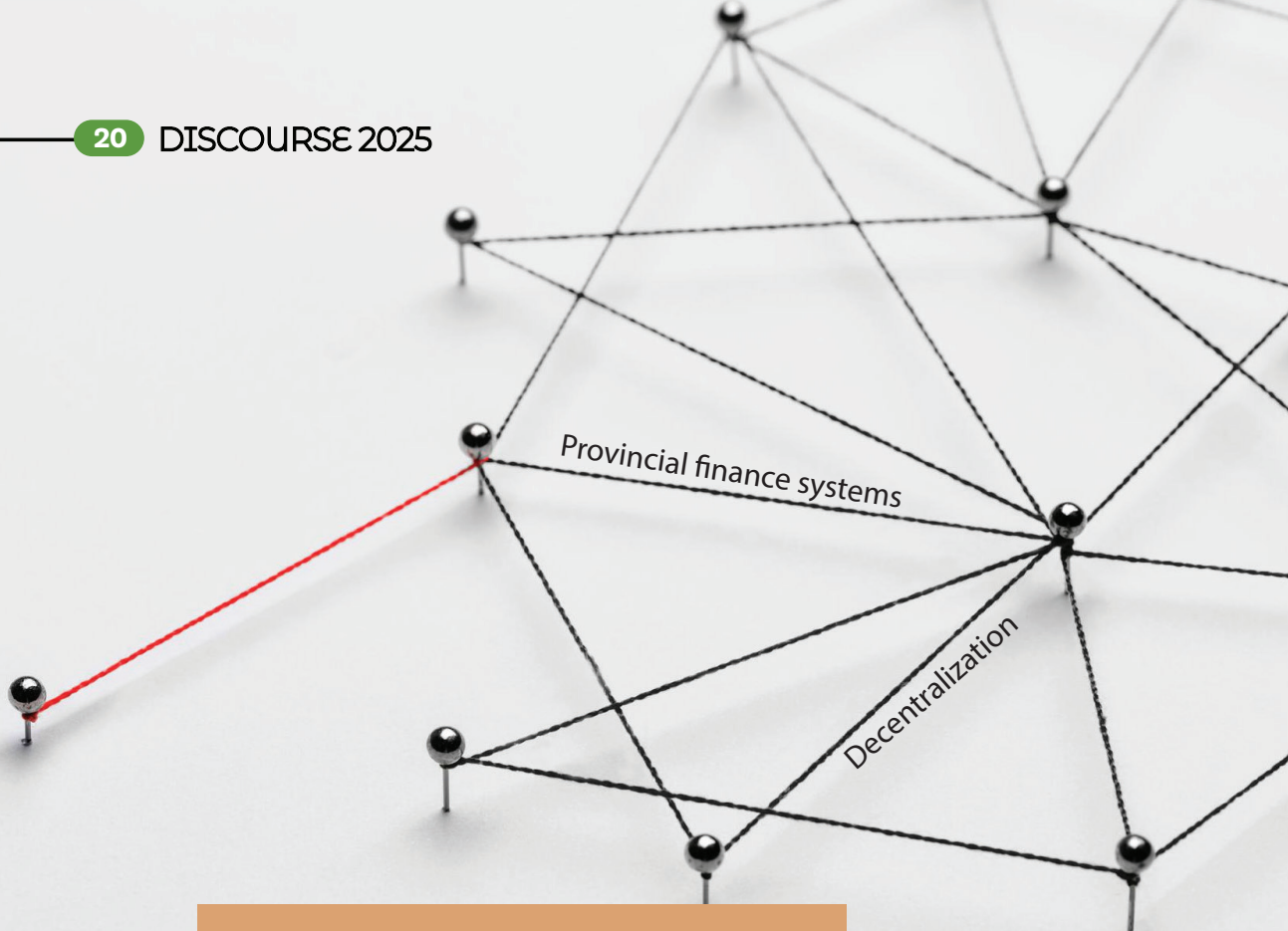
## CONCLUSION

The NFC Award represents one of the most significant instruments for promoting fiscal federalism in Pakistan. While the 7<sup>th</sup> NFC Award marked a positive shift toward decentralization, most of its projected targets and goals were missed because of deep-rooted structural challenges embedded in the country's public finances. For Pakistan to navigate its economic instability, increasing debt burden, and provincial disparities, a comprehensive and collaborative reform agenda of resource mobilization, expenditure rationalization and PFM for both the tiers of government is not just necessary—it is urgent.

Simultaneously, a transparent, inclusive, and outcome-oriented approach to the next NFC Award will be essential to promote fiscal responsibility, equity, sustainability, and national cohesion. Effectively instituted fiscal federalism can lead to a more developed and stable Pakistan.

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# ETHNIC CLEAVAGES AND THE IMPLEMENTATION OF 18<sup>TH</sup> AMENDMENT

Dr. Karim Khan

## INTRODUCTION

Pakistan, being an ethno-federation, is a classic example of multi-ethnic society where different ethnic groups are characterized by power asymmetries.

<sup>1</sup>In such ethnically-diverse societies, constitution is meant to ensure resource and power sharing mechanisms amongst different groups. In this regard, adherence to the commitments accentuated in the constitution is Pareto superior outcome that not only prevents exploitation by the powerful group but also mitigates the risk of rebellion by the minority groups. A break-down arises when, in the presence of power asymmetries, the dominant

coalition has an incentive to renege on commitments by appropriating more than the agreed-upon share of resources. In Pakistan, ethno-nationalism has always been a challenge to Pakistan's national, political, and even geographical integrity.

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<sup>1</sup> Ethno-federation is a form of federal system in which the federated regional or state units are defined by ethnicity. Usually, ethnic federations are instrumental in ensuring ethnic autonomy or managing inter-ethnic tensions within a state.

Alternatively, there has always been contention on the distribution of political power and economic resources between the federating units. This distribution has invariably been skewed in favor of Punjab throughout the country's history. It has propelled the country into several civil wars and periods of widespread ethnically motivated violence. It has led to a successful secession movement in East Pakistan and quite a few unsuccessful, albeit violent, ones in Balochistan and Khyber Pkhtunkhwa (KPK). The consensus on the 7<sup>th</sup> National Finance Commission (NFC) award and 18<sup>th</sup> Constitutional Amendment are deemed as steps towards provincial autonomy by bringing greater clarity to the roles and responsibilities of various orders of government and increasing shares of the provinces in the divisible pool of revenue. In this article, I am elaborating on whether the implementation of 18<sup>th</sup> Constitutional Amendment and the revised distribution criteria in the 7<sup>th</sup> NFC award can ameliorate ethnic cleavages amongst different ethnicities.

## MAIN POINTS OF 18<sup>TH</sup> CONSTITUTIONAL AMENDMENT AND 7<sup>TH</sup> NFC AWARD

The 18<sup>th</sup> Amendment has been an important constitutional change in the history of Pakistan, bringing several changes to the institutional framework of the country. First, it restored the parliamentary structure of the constitution by enhancing the roles and powers of prime minister and his cabinet, and abolishing Article 58-2(B).<sup>2</sup> Second, it strengthened the provinces in the federation by culminating the Concurrent Legislative List, and enlarging the Federal List part II.<sup>3</sup> Third, the Council of Common Interests (CCI), entrusted with discussions on the newly structured Federal List part II, was restructured to be chaired by the prime minister, with four provincial chief ministers and three federal government nominees as its members.<sup>4</sup> Fourth, the National Economic Council (NEC), a representative body of the country's economic policies, was reshaped in favor of the provinces by mandating two provincial members each, including the chief ministers of each province, and four federal members appointed by the prime minister.<sup>5</sup> Fourth, the power of provincial governors, representatives of the federal government in provinces, were reduced and the power of upper house (Senate) was enhanced, implying larger say of the provinces in the national matters. Fifth, 17 federal

ministries were abolished, including the ministries of food and agriculture, education, health etc. and their functions were devolved to the provinces. All these changes suggest that devolution of functions to provinces, on one hand, and giving them a greater role in running federal affairs, on the other, are greater steps towards provincial autonomy, social cohesiveness, and more inclusivity. An attached institutional change with the 18<sup>th</sup> Amendment was the consensus on the 7<sup>th</sup> National Finance Commission (NFC) award which increased the shares of the provinces in the federal divisible pool. Prior to the 7<sup>th</sup> NFC award, the share of all provinces comprised 45% of the divisible pool; while in the 7<sup>th</sup> NFC award, it rose to 57.5%. Moreover, as can be seen from Table I, inter-provincial distribution of revenues was also revised as criteria broader than population were devised, including contribution to national exchequer, levels of poverty (or backwardness) and inverse population density (especially important for Balochistan). This decreased Punjab's share by 6.14%, while simultaneously increasing the shares of KPK and Balochistan by 1.12% and 3.79%, respectively.



2 Article 58-2B gave the President the power to dissolve assemblies which was, in fact, established by military president Zia.

3 Concurrent List implied the list of functions on which both the federal government and provincial governments could do legislations which had created larger institutional ambiguities. The abolition of this list brought greater clarity to the roles of both orders of government.

4 The CCI, with a permanent secretariat, was mandated with at least one meeting every quarter to supervise and make decisions with regard to the Federal Legislative List Part II.

5 Previously, though chaired by the prime minister, the NEC membership had been left to the president's discretion, provided that at least one member from each province was represented.

**Table 1: Main Features of 7<sup>th</sup> National Finance Commission (NFC) Award. Shares of Provinces and Federal Government in the Federal Divisible Pool\***

Shares	Previous Award	7th NFC Award	Percentage Change
Federal Government	55%	42.50%	-12.50%
Provinces	45%	57.50%	12.50%
Total	100%	100%	

**Inter-Provincial Distribution Criteria**

Indicator	Previous Award	7th NFC Award
Population	100%	82%
Backwardness and Poverty	0%	10.30%
Revenue Generation	0%	5%
Inverse Population Density	0%	2.70%

**Shares of Provinces in NFC Awards**

Province	Previous Award	7th NFC Award	Percentage Change
Balochistan	5.30%	9.09%	3.79%
Khyber Pakhtunkhwa	13.50%	14.62%	1.12%
Punjab	57.88%	51.74%	-6.14%
Sindh	23.28%	24.55%	1.27%
Total	99.96%	100.00%	

Source: 7<sup>th</sup> National Finance Commission (NFC) Award 2010, Government of Pakistan.

Notes: \* All Duties and Taxes included in the Divisible Pool such as Income Tax, Wealth Tax, Capital Value Tax, Sales Tax, Export Duties, Custom Duties, any other Tax collected by Federal Government, Royalties on Crude Oil, Gas Surcharge etc.

## PAKISTAN'S PROVINCE-WISE ECONOMIC AND DEMOGRAPHIC INDICATORS

Pakistan has been characterized with larger economic and social disparities, especially, across the provinces. As is shown in Table 2, per capita income in Balochistan and Khyber-Pakhtunkhwa is only 71% and 79%, respectively, of the national per capita GDP<sup>6</sup>. Similar is the case in terms of the Human Development Index (HDI) of UNDP. In particular, Balochistan's HDI is only 64% of the national HDI, reflecting stark inequalities.<sup>7</sup> Moreover, according to middle income poverty line (US\$3.65/day 2017 PPP), poverty in Balochistan and Khyber-Pakhtunkhwa stands at 71.4% and 45.62%, respectively, compared to only 23.39% in Punjab. Similarly, literacy and labor force participation rates are low while the percentage of out of school children is high in Balochistan and Khyber-Pakhtunkhwa. Further, in terms of other characteristics such as use of electricity for lighting,

wood and gas for cooking, toilet facilities, immunization, availability of water and food security, Balochistan and Khyber-Pakhtunkhwa are worse off compared to the other two provinces (see Table 2 for details). Finally, societal and institutional frameworks are fragile in both Balochistan and Khyber-Pakhtunkhwa as is reflected in higher percentages of the incidents of political violence in the two provinces.<sup>8</sup> This, in other words, implies that persistent incidents of political violence is a clear reflection of a sense of marginalization across the two provinces.

<sup>6</sup> Pakistan's current per capita GDP is US\$1680.

<sup>7</sup> Pakistan ranks low on the Human Development Index (HDI), with ranking of 164th out of 193 countries and 2023-24 national HDI of 0.699.

<sup>8</sup> Data on political violence is taken from the BFRS Dataset which contains incident-level data on political violence in Pakistan from January 1988 to December 2010 based on press reporting.

Indicator	Pakistan	Balochistan	Punjab	Khyber-Pakhtunkhwa	Sindh
Per Capita Income as Percent of National Per Capita GDP	100.00	71.00	98.69	79.00	122.20
HDI as Percent of National HDI	100.00	64.00	109.00	93.00	92.00
Percent of Population Living below Middle Income Poverty Line	40.10	71.40	23.39	45.62	37.82
Out of School Children aged 6-16	24.41	47.20	19.60	34.60	25.30
Labour Force Participation Rate	32.26	27.23	34.86	27.63	30.86
Literacy Rate for Persons Ten Years Old and Above	58.91	43.58	64.01	54.02	54.57
Percent of Households using Electricity for Lighting	87.87	69.62	93.95	89.89	80.44
Use Wood for Cooking	58.44	75.07	57.85	72.70	49.50
Use Gas for Cooking	37.86	21.43	37.92	25.52	47.39
No Toilet	15.02	20.63	13.69	12.15	17.99
Toilet: Pit with Slab	21.47	31.88	22.59	29.76	13.80
Moderate or Severe Food Security	16.44	23.36	15.66	14.44	17.52
Tap as main Source of Drinking Water (2014-15)	27.00	18.00	33.00	35.00	41.00
Full Immunization (2014-15)	82.00	51.00	90.00	78.00	73.00
Incidents of Political Violence as percent of Total in Pakistan	100	30.92	19.40	35.60	14.08

Sources: Fair et al. (2024); Human Development Report 2023-24; Annual Status of Education Report (ASER) 2023; Pakistan Economic Survey 2023-24; Bueno de Mesquita et al. (2015).

## DISCUSSION AND THE WAY FORWARD

Fourteen years have been passed since the enactment of 18<sup>th</sup> Amendment and 7<sup>th</sup> NFC award but ethnic cleavages, triggered mostly by huge inter-provincial disparities, have not been ameliorated yet. Does it make 18<sup>th</sup> Amendment and changes in the inter-provincial distribution criteria of the 7<sup>th</sup> NFC award redundant? I would like to posit, no. A step in the right direction is, nevertheless, more desirable than apathy. In fact, it is the proficient utilization of the enlarged resources combined with effective implementation of the 18<sup>th</sup> Amendment that can rectify both the inter-provincial and intra-provincial inequities. Here, I highlight the steps that are needed as threshold conditions to reap the potential benefits of this huge institutional change. First, devolution of powers to local governments is an integral part of 18<sup>th</sup> Amendment as is envisaged in Article 140A of the constitution. Alternatively, devolving political, administrative and financial responsibility along with authority to the elected representatives of the local governments can make 18<sup>th</sup> Amendment a success in its true sense.<sup>9</sup>

Second, it is generally perceived that there are capacity issues in the fragile provinces but I would postulate that let the provinces resolve their capacity issues in their own way. In other words, why are there still governors, chief secretaries, and federal bureaucracy in the provinces, which all are representing federal government in the provinces? Complete autonomy with regard to the operating frameworks can lead to effective utilization of the increased resources. Third, controlling elite capture at intra-provincial levels is another necessary condition for achieving the true benefits of provincial autonomy. In this regard, effective Provincial Finance Commissions (PFCs) with functional inter-district decentralization within the provinces can trickle down the benefits to the common populace. Fourth, civil rights precede democratic institutions as democracy only works when there is social cohesion in the societal structure. Alternatively, we have to shape our behavioural structure such that it can eliminate biases against social identities like ethnicity, race, gender, religion, or caste, among others.

<sup>9</sup> Along with inter-provincial disparities, there are also intra-provincial disparities, especially in Balochistan.

Such a culture of empathy would be able to prevent people, who are discriminated against, from realizing their true potential and, in turn, would have mitigating effects on inequalities. Finally, we have to make our laws and policies such that they are in line with the principles of social justice. One such measure would be to make the Ehsaas Program, the largest and most systematic social protection initiative in the country, efficient by eliminating the inclusion and exclusion errors in identification. All these measures would go a long way in the success of 18<sup>th</sup> Amendment and 7<sup>th</sup> NFC award and would, thereby, mitigate inequities by ensuring distributive justice.

## CONCLUSION

Pakistan experienced a significant institutional change in the forms of 18<sup>th</sup> Constitutional Amendment and broadening the resources distribution criteria in the 7<sup>th</sup> NFC award. However, despite a significant time lapse of 14 years, it couldn't make provincial autonomy effectual. I postulate that, in order to reap the potential benefits of provincial autonomy, effective Provincial Finance Commissions (PFCs) with inter-district decentralization within the provinces; enacting civil rights laws within the provinces; establishing provincial capacities by eliminating federal intervention in the bureaucratic structure are of up most importance. This will ensure more equitable access to resources within the provinces and would pacify grievances and disparities that have divided this country since its inception.

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# PAKISTAN'S FISCAL TRAP: BREAKING FREE FROM ENDLESS CONSOLIDATION

Dr. Mohammad Ahmed Zubair

## INTRODUCTION: THE TWO PILLARS, ONE TRAP

Pakistan's macroeconomic policy rests on two pillars: an increasingly independent monetary framework and a persistently constrained fiscal framework. Over the past two decades, the SBP has steadily acquired legal and operational autonomy, enabling it to steer monetary policy with greater institutional discipline.

Fiscal policy, by contrast, remains shackled by entrenched political bargains, rigid structural arrangements, and an ever-expanding government footprint. The fiscal state is now approaching the upper limits of what can be extracted from the economy—both in terms of predatory taxation

and public debt—without inflicting further harm on businesses productive activity and households' disposable income.

At the heart of this fiscal bind lies a growing dependence on regressive taxation and heavy borrowing to finance the federal deficit. Successive governments, constrained by weak external credit ratings and recurring balance-of-payments crises, have had limited access to international capital markets. Domestic borrowing has thus become the primary fiscal lifeline. But with local banks already saturated with government securities, the room for additional borrowing has also narrowed sharply.

The outcome is a cycle of **perpetual fiscal consolidation**: year after year, budgets are tightened; profitability of businesses in the formal sector is squeezed; household disposable incomes decline;

and aggregate demand weakens, stifling both private investment and the prospect of growth recovery. The FY26 federal budget—crafted under the latest IMF-supported Extended Fund Facility (EFF)—is a textbook example of how deeply entrenched this pattern has become.

### Policy Insight

**Tightening into Stagnation:** Pakistan's current fiscal approach increasingly resembles a self-reinforcing austerity loop—reducing demand, slowing investment, and forcing further tightening to stabilize debt. Without bringing about structural changes in fiscal architecture, consolidation risks becoming an end in itself rather than a bridge to growth.

## HAS THE NATIONAL FISCAL PACT LOCKED THE FEDERAL BUDGET?

The IMF's 37-month, \$7 billion Extended Fund Facility (EFF), approved in September 2024, placed fiscal solvency at the heart of its program design. To navigate the politically sensitive terrain of the NFC Award—often portrayed as the fiscal glue binding the federation—the program relied on two instruments: sustained consolidated primary surpluses and a newly signed National Fiscal Pact (NFP) between the federal and provincial governments.

The FY26 federal budget data illustrate the pact's underlying dynamics. Debt servicing alone accounts for 50% of total expenditure, with domestic debt servicing consuming 44%. These ratios are virtually unchanged from the revised FY25 budget. Meanwhile, provinces are projected to generate a combined surplus of Rs. 1.5 trillion, yet this figure does not appear as a revenue item in the federal accounts. Instead, provincial surpluses are retained by provincial governments and invested in eligible securities.

As a result, the federal government still plans to borrow Rs. 6.4 trillion in FY26—an amount equal to half its total expenditure (or 5% of GDP)—despite the consolidated budget targeting a primary surplus of Rs. 3.2 trillion (2.4% of GDP). In other words, the NFP achieves its surplus target on paper, but the federal financing gap remains structurally large.

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This arrangement creates a policy treadmill. Under the 7<sup>th</sup> NFC Award, 57.5% of Federal Board of Revenue (FBR) collections are transferred to the provinces each year. The provinces are then tasked with running surpluses, while the federation shoulders rising debt-servicing costs and the fiscal imperative to raise yet more revenue—often through regressive taxation—to fund its own obligations. The result is a fiscal architecture that stabilizes little beyond the optics

### Policy Insight

**A Fiscal Surplus in Name Only:** The NFP allows the provinces to retain their surpluses while the federal government continues to borrow heavily. The arrangement meets consolidated IMF surplus targets but leaves the federal government in a persistent high-borrowing trap.

## CAN AN INTERIM NFC AWARD END ‘FOREVER’ FISCAL CONSOLIDATION?

The IMF’s first review of the EFF projects that real GDP growth will inch up from 3.6% in FY26 to 4.1% in FY27, stabilizing near 4.5% through FY30. That is, projected growth remains constrained by the persistent need to avert balance-of-payments crises.<sup>14</sup>

The fragility of the fiscal strategy is evident in the baseline projections. Tax revenues are expected to grow at around 11% per year in FY29 and FY30, equivalent to roughly 12% of GDP. Primary expenditure (excluding debt servicing) is projected to grow at the same pace, about 14% of GDP. Debt servicing obligations are forecast to decline from 8% of GDP in FY25 to 5% by FY30, allowing consolidated government and guaranteed debt to fall from 78% of GDP in FY25 to 64% by FY30—similar to the recent average for lower middle-income countries.

Yet the debt stock remains daunting. Between 2021 and 2024, public debt-to-budgetary revenue ratios in both Pakistan and Egypt (excluding Sri Lanka) exceeded 500%. In practice, this means that, hypothetically, it would take more than five years of allocating all annual tax revenue solely to debt repayment to clear the existing stock. For FY27–FY30, Pakistan’s public debt-to-federal-tax-revenue ratio is projected to fall only from 538% to 462%. That is, compared to peer countries, the “forever” fiscal consolidation still doesn’t resolve the institutionalized drivers of unsustainable debt accumulation—keeping the economy locked in what can only be described as “forever” fiscal consolidation.

This raises three unavoidable policy questions:

1. **Duration** – How long can fiscal consolidation continue without a defined endpoint?
2. **Political sustainability** – How long before the cumulative adjustment costs become politically untenable?
3. **Alternatives** – Could a restructured, interim and time-bound NFC arrangement deliver fiscal solvency without indefinite austerity?

Answering these questions requires testing counterfactuals against the IMF’s own baseline to see whether an interim redesign of the NFC could provide a credible exit from the perpetual consolidation loop.

### Policy Insight

**Five-Year Debt Shadow:** Even with optimistic IMF projections, Pakistan’s FY27 debt burden would require over five years of federal share of tax revenue to repay—leaving no room for development spending or growth-oriented investment.

## THE COUNTERFACTUAL: AN INTERIM NFC AWARD AND FISCAL SOLVENCY

Two counterfactual budget simulations were run to anchor debate around proposed interim arrangement:

- **Simulation 1:** Interim NFC Award recalibrating the divisible pool split from 42.5:57.5 to 60:40 in favour of the federation, while treating debt servicing and defence as first charges on consolidated revenue. Result: federal deficits fall sharply to below 1% of GDP by FY30—about four percentage points better than the IMF baseline.
- **Simulation 2:** Building on Simulation 1, domestic debt servicing is cut by 30% annually through restructuring. Result: the federal budget turns into surplus (1.5% of GDP by FY30), though this requires politically difficult and technically complex domestic debt restructuring.

<sup>14</sup> IMF – Pakistan: First Review under the EFF; Report No. 25/109; dated May 2025. It is important to note that the IMF’s baseline macroeconomic projections are not necessarily based on accurate realism of underlying assumptions. But, more importantly, baseline projections meet the requirements of macroeconomic consistency tests. That is, the baseline projections are internally balanced across all sectors of the economy, observe the various economic identities, and therefore are considered plausible and serve as a benchmark baseline projection.

The logic is straightforward. By increasing the federal share, Islamabad could reduce its dependence on new borrowing, lower debt-servicing pressures, and finance essential functions without pursuing “forever” fiscal consolidation. The IMF’s own framework allows for such adjustments, provided they are grounded in a credible political agreement and supported by measures to protect provincial fiscal space for delivering essential services.

However, political feasibility is far from guaranteed. The provinces, particularly those with smaller tax bases, are likely to resist any reduction in their share, citing constitutional guarantees under the NFC. Building consensus would require framing the interim award not as a permanent rollback, but as a **stability pact**—a shared sacrifice to restore macroeconomic health, after which the original distribution would be reinstated.

### Policy Insight

**Interim NFC Pact for Stability:** A temporary first charge of debt servicing and defence along with 60:40 split of the divisible pool could ease federal financing pressures, slow debt accumulation, and create non-debt fiscal space for growth initiatives—if backed by a credible, time-bound political pact.

## TESTING THE INTERIM AWARD: DEBT AND DEFICIT DYNAMICS

To gauge the fiscal impact of an interim NFC, we apply the IMF’s own baseline as the control and run the counterfactual for FY27–FY30. The results are striking.

With the interim award, the federal fiscal balance improves over the projection period. This improvement translates directly into reduced borrowing needs—shrinking the average annual fiscal deficit from 5% of GDP under the baseline to a surplus of 1.4% in the counterfactual scenario. In cumulative terms, it reduces the FY27–FY30 gross baseline federal deficit financing requirement from Rs 32.6 trillion to a surplus of Rs 9.3 trillion. Under this interim setup, the federal government’s

debt accumulation could rapidly slow enough to bring the public debt-to-tax revenue ratio closer to the upper middle-income country average—without the damaging side effects of deeper austerity.

There are two next steps to extend the counterfactual: (i) trace the impact of interim NFC on provincial solvency and their ability to deliver social services, and (ii) examine the extent of second-order impact on private investments and growth recovery. Lower GoP borrowing needs will likely reduce crowding out of private sector borrowing and thereby assist in growth recovery.

### Policy Insight

**Breakout from existing NFC Straitjacket:** A radical and interim restructuring of existing NFC is essential to unshackle fiscal policy from “forever” consolidation. By improving savings-investment and external balances, a dramatic boost to sovereign credit ratings can be anticipated in the medium term.

## POLITICAL ECONOMY OF AN INTERIM NFC PACT

While the fiscal arithmetic is compelling, the political economy is more complex. NFC negotiations are not about macroeconomic efficiency alone—they are deeply entangled with questions of political power, inter-provincial trust, and the historical memory of perceived fiscal injustices.

The 7<sup>th</sup> NFC Award, agreed in 2010, was celebrated as a milestone in decentralization, granting provinces an unprecedented share of federal revenues. Any proposal to alter that balance, even temporarily, risks being framed as a rollback of constitutional gains. This framing can quickly harden political positions, particularly in smaller provinces that fear being overshadowed by Punjab’s economic dominance.

For an interim award to gain traction, the federal government must adopt a **consensus-building approach** that emphasizes shared risks and shared rewards. The pitch should be framed not as an erosion of provincial rights but as a **joint**

**stabilization pact**—a coordinated response to an extraordinary fiscal moment. Clear commitments would be essential:

- **Time-bound adjustment** with automatic reversion to the reformed 7th Award formula after FY30.
- **Transparency mechanisms** to ensure that additional federal revenues are directed toward debt reduction and building fiscal buffers, not recurrent patronage spending.
- **Safeguards for provincial development budgets** to prevent disproportionate cuts in local service delivery.

History offers a cautionary note: fiscal compacts in Pakistan have a mixed track record of durability, often unravelling when political coalitions shift. The credibility of any interim arrangement would hinge on institutionalizing it through a federal–provincial agreement ratified by the Council of Common Interests (CCI) and backed by constitutional guarantees.

### Policy Insight

Trust is the Currency: Without strong political buy-in and time-bound safeguards, even the most fiscally sound NFC reform risks collapsing under the weight of inter-provincial mistrust.

## BEYOND NFC: STRUCTURAL FIXES FOR FISCAL SUSTAINABILITY

An interim NFC adjustment can provide breathing room, but it is no substitute for tackling the deeper structural causes of Pakistan’s fiscal fragility. Without addressing these, any short-term relief will eventually dissolve into the same cycle of deficits, debt accumulation, and IMF dependence.

The counterfactuals point to the need for deeper restructuring beyond NFC tweaks. Sustainable fiscal reforms demand targeted reductions in politically sensitive but non-productive spending areas: non-operational defence outlays, overly ambitious PSDPs, unfunded pension obligations, and poorly

targeted subsidies. Without tackling these, fiscal space for countercyclical policy will remain illusory.

## FORWARD PATHWAYS

1. **Recalibrate the NFC Award**  
Negotiate an interim NFC for FY27–FY30 that increases the federal share of revenues, prioritizes debt servicing, and enables debt restructuring without further burdening taxpayers.
2. **Leverage Banks’ Strong Capital Adequacy to Restructure Domestic Debt**  
To ease debt servicing pressure, capitalizing on the strong capital adequacy of domestic banks. Use savings to retire high-cost debt and reallocate resources to building fiscal buffers.
3. **Protect Core Security Spending**  
Ring-fence operational defence and pension spendings while reducing non-operational allocations within a fixed timetable.
4. **Reduce Government’s Economic Footprint and Legislate Fiscal Discipline**  
Enforce hard borrowing limits tied to debt-to-revenue ratios, mandate broader tax compliance, and restrict borrowing to income-generating infrastructure. Codify “odious debt” provisions. Require parliamentary vetting of all borrowing agreements.
5. **Public Debt Management**  
Reliance on short-term domestic borrowing leaves the fiscal framework exposed to rollover risks and volatile interest costs. Moving toward longer-maturity instruments, broadening the investor base, and deepening domestic capital markets can reduce these vulnerabilities over time.
6. **Modernize Budget Governance**  
Adopt zero-based budgeting, rolling three-year fiscal frameworks, and accrual accounting. Integrate real-time audit systems to tighten control over execution and enhance transparency.

These reforms are politically difficult because they disrupt entrenched interests, but they are also the only pathway to genuine fiscal sovereignty. Without them, Pakistan will remain locked in a permanent adjustment mode, where every budget is less a vision for growth and more a compliance document for external lenders.

**Policy Insight**

Radical Fiscal Reset, Room to Breathe, Not to Rest: An interim NFC fix can stabilize the patient, but only if structural reforms aimed at curing the underlying fiscal disease are also vigorously embraced.

**CONCLUSION: A PACT FOR STABILITY AND GROWTH**

Pakistan's fiscal story is often framed as a tug-of-war between austerity and populism, but the deeper truth is that both extremes avoid confronting the structural imbalances at the heart of the problem. The IMF's baseline projections show that, even with gradual improvement, debt burden will remain heavy, deficits persistent, and fiscal space minimal by FY30.

Macroeconomic stability will remain elusive unless Pakistan breaks the structural trap of "forever" fiscal consolidation. Without debt restructuring, the fiscal burden will continue to crowd out investment, suppress growth, and erode living standards. The current consensus—accepting permanent consolidation as inevitable—imposes unsustainable costs on the economy.

A truly liberated fiscal policy, aligned with an independent monetary stance, is essential for countercyclical flexibility. By redesigning fiscal federalism, restructuring debt, and legislating discipline, Pakistan can replace austerity's slow suffocation with a credible path to growth and resilience.

An interim NFC adjustment should aim to rebalance the vertical fiscal equation to give the federation enough space to reduce borrowing, slow debt growth, and restore its countercyclical function. If framed as a time-bound national stability pact, and anchored in the Council of Common Interests, the interim NFC could become more than a stopgap—it could serve as a bridge from permanent adjustment to sustainable recovery and growth. The alternative is to drift along the baseline path: slow consolidation, heavy debt, and a budget process perpetually beholden to external lenders.

The choice is less about technical feasibility than about political will. Pakistan's fiscal future hinges on whether its federation can, for once, act as a united entity in pursuit of a shared goal: stability today, growth tomorrow.

**Policy Insight**

A Bridge, Not a Detour: A time-bound NFC adjustment, paired with genuine structural reforms, could shift Pakistan from perpetual crisis management toward a trajectory of fiscal sovereignty and sustainable growth.

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# 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 19<sup>th</sup>-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.

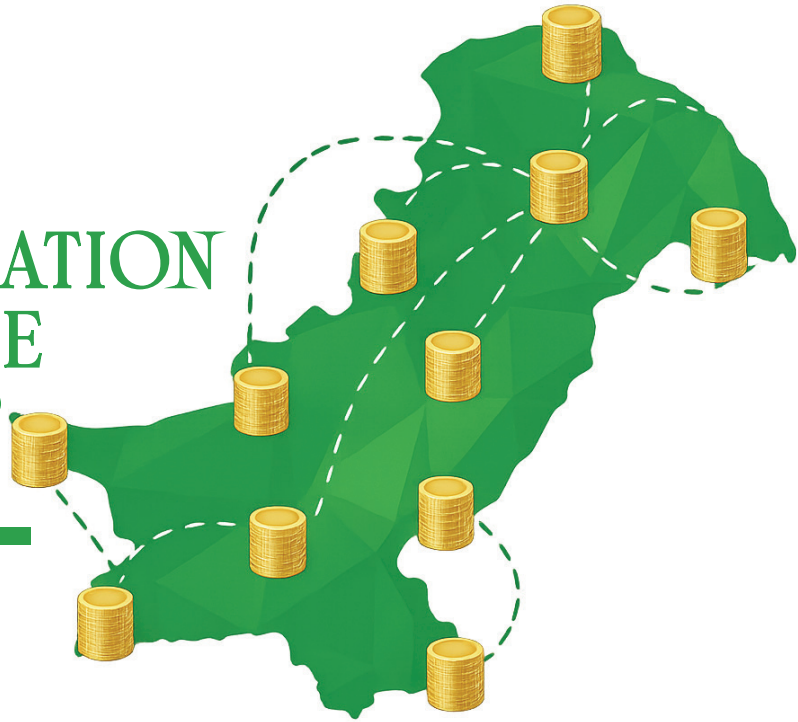
Lagged regions like the tribal areas lack economic opportunities and have been safe havens for terrorists; once the nation sees the correlation between the lack of opportunities in a region and the safe havens for terrorists, it will not be difficult to find the money to spend to be spent on creating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

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# WHY PROVINCIAL REVENUE MOBILISATION IS CENTRAL TO THE NFC FRAMEWORK?



**Hina Shaikh**

Pakistan's National Finance Commission (NFC) Award determines how federal tax revenues are shared between the federation and provinces. Under the 7<sup>th</sup> NFC Award (2010), the provincial share of divisible pool taxes rose sharply from 47.5% to 57.5% giving provinces greater fiscal space but also higher expenditure responsibilities, particularly in devolved subjects like health, education, and infrastructure.<sup>1</sup>

The limited growth in tax revenues has contributed to major gaps in public service delivery: over 20 million people lack access to clean water close to their homes<sup>2</sup>, nearly one in three lack adequate sanitation<sup>3</sup>, and around 40% of children<sup>4</sup> under five suffer from stunted growth compared to South Asian average of 31<sup>5</sup>.

While designed to promote equity, the NFC has created structural fiscal dependence and weakened incentives to develop provincial tax bases. In recent years, around 80% of provincial revenues in Punjab for example came from federal transfers, with own-source revenue (OSR) contributing just 15-20% on average<sup>6</sup>.

A new NFC framework is now under discussion. While still in negotiation, the new framework is expected to link transfers more clearly to provincial revenue efforts<sup>7</sup>, possibly through performance benchmarks or a smaller divisible pool share, to create both pressure and opportunity for provinces to strengthen OSR. This shift is driven by fiscal stress at the federal level, rising provincial expenditure commitments (including pensions), and the need for more accountable, responsive service delivery, best achieved when revenue is raised and spent locally.

## WHERE DOES PROVINCIAL REVENUE STAND TODAY

Despite slight improvement over the past decade, provincial OSR remains low. In fact, total provincial revenue collection remains less than one percent of GDP<sup>8</sup>. Provinces cover only about 16% of their expenditures with their own revenue collection<sup>9</sup> despite the potential for provincial taxation to reach 2-3% of GDP<sup>10</sup> (currently at less than 1%)<sup>11</sup>.

1 <https://finance.gos.pk/ResourceDistribution/NFC>

2 <https://www.wateraid.org/where-we-work/pakistan>

3 <https://www.wateraid.org/where-we-work/pakistan>

4 <https://www.nature.com/articles/s41598-022-24063-2>

5 <https://blogs.worldbank.org/en/endpovertyinsouthasia/addressing-pakistans-high-level-stunting-now>

6 <https://finance.punjab.gov.pk/system/files/WP24-25.pdf>

7 <https://www.dawn.com/news/1929983>

8 <https://thedocs.worldbank.org/en/doc/7b6-ba1ef456f3bc07c84f3af0aa8f4f3-0310062023/original/Pakistan-Reforms-For-A-Brighter-Future-Policy-Note-6-Strengthening-Government-Revenues.pdf>

9 [https://www.finance.gov.pk/survey/chapters\\_23/04\\_Fiscal%20Development.pdf](https://www.finance.gov.pk/survey/chapters_23/04_Fiscal%20Development.pdf)

10 <https://tribune.com.pk/story/2440273/agri-property-taxes-top-priority>

11 <https://stats.oecd.org/Index.aspx?DataSetCode=REVPAK>

This creates fiscal vulnerability for provinces which face immediate shortfalls whenever federal revenue declines. This also leads to restricted ability of provinces to respond to local needs and priorities.

Underperforming taxes include Sales Tax on Services (STS) at just 7% of total provincial revenues in 2023 and property tax, at less than 2%, despite being progressive, efficient, and suitable for local government. Despite having a population of over 100 million, entire Punjab collects less urban property tax than India's city of Chennai, which has a population of just around 10 million<sup>12</sup>.

Other OSR sources (stamp duties, motor vehicle tax, agricultural income tax) remain small and often under-collected. With services now contributing close to 60% of GDP, STS has high growth potential<sup>13</sup>. Urban property markets have also seen double-digit annual value increases in most major cities, yet valuation rolls are outdated and undervalued. In a fast-urbanising context with rising local demands, this underperformance represents a significant untapped opportunity.

## EVIDENCE-BASED PATHWAYS FOR PROVINCIAL REVENUE MOBILISATION

Experience from Pakistan and other countries shows that a mix of behavioural insights, digitisation, and governance reforms can significantly increase provincial revenues at relatively low cost.

### A. BEHAVIOURAL INSIGHTS CAN IMPROVE TAX COMPLIANCE

Behavioural interventions, grounded in understanding tax payer and tax collector behaviour, have shown strong potential to boost provincial tax collections in Pakistan<sup>14</sup>.

## CREATING INCENTIVES

- Non-monetary incentives can work. In Punjab, introducing a performance-based posting system for property tax staff - linking future postings to past revenue performance - raised collections by 30-41% in just one year<sup>15</sup>.
- Public recognition of top taxpayers can be effective in improving compliance rates by creating social prestige and public accountability. A recent study found that both publishing taxpayers' income tax payments and publicly recognizing the top 100 taxpayers in Pakistan significantly increased tax compliance suggesting that social disclosure and recognition can shift norms and boost revenue mobilization<sup>16</sup>.
- Receipt lotteries for targeted enforcement: In Khyber Pakhtunkhwa's (KP's) hospitality sector, the tax authority piloted a scheme that offered monthly consumer lotteries for submitting receipts via WhatsApp, combined with targeted enforcement against non-compliant businesses<sup>17</sup>. While full results from the pilot are pending, similar receipt-lottery models in Brazil increased reported sales by 21% over four years and generated higher net tax revenue even after prize payouts<sup>18</sup>.

**Creating awareness via Informational nudges** can improve compliance by explaining how taxes are calculated, outlining penalties for non-payment, and showing how revenues are used. However, a 2022 survey of 604 property taxpayers in Lahore found that over 90% were unaware of the valuation basis for their tax, underscoring the need for public education<sup>19</sup>.

**Creating evidence to support policy uptake:** KP has institutionalised behavioural experimentation through MindLab, the first sub-national behavioural insights unit in a developing country<sup>20</sup>. Established in 2021, it has run trials to improve compliance, drawing on approaches from Bangladesh, India, and Sri Lanka, including SMS reminders (which had limited impact due to reliance on tax consultants) and is now testing reward and enforcement schemes, receipt submission systems, and consumer surveys. It runs randomised trials to improve tax compliance.

12 <https://www.theigc.org/publications/urban-property-taxes-pakistans-punjab>  
13 Economic survey 2024-25

14 <https://www.povertyactionlab.org/evaluation/incentivizing-property-tax-inspectors-through-performance-based-postings-pakistan>

15 <https://www.povertyactionlab.org/evaluation/incentivizing-property-tax-inspectors-through-performance-based-postings-pakistan>

16 [https://www.nber.org/system/files/working\\_papers/w25623/w25623.pdf](https://www.nber.org/system/files/working_papers/w25623/w25623.pdf)

17 <https://www.brecorder.com/news/40294117>

18 <https://www.aeaweb.org/content/file?id=9694>

19 <https://www.theigc.org/sites/default/files/2023-03/Abbas%20et%20al%20Policy%20brief%20December%202022.pdf>

20 <https://seed-pk.com/mindlab/>

## B. TECHNOLOGY AND DIGITISATION CAN DRIVE ACCURACY, ACCOUNTABILITY, AND TRANSPARENCY

Digitising tax information can significantly enhance accuracy and accountability in revenue administration while building datasets that can be used for research and policy design. Digital systems streamline tax processes, improve documentation, and make transactions traceable, thereby increasing transparency. Technologies such as electronic fiscal devices, digital payment systems, and e-filing platforms reduce direct interaction between taxpayers and tax collectors.

**Improving access to tax data:** Digitisation can also democratise access to tax data, enabling civil society and citizens to monitor performance. Evidence from an experiment in Ghana demonstrates that technology can expand the effective tax base and improve compliance<sup>21</sup>. However, the same study found that digitisation can have unintended effects: increasing the bargaining power of tax collectors in ways that allow them to extract more bribes from poorer households<sup>22</sup>.

**Expanding the tax net:** In Punjab, the electronic invoice monitoring system has improved documentation and increased reported liabilities. Expanding POS systems and electronic payments has brought more businesses into the tax net<sup>23</sup>. A notable reform was reducing the restaurant sales tax rate from 16% to 5% for card payments, which increased transparency, curbed under-reporting, and boosted documented sales<sup>23</sup>.

## ENHANCING ACCURACY OF TAX ASSESSMENTS:

- In property taxation, Punjab has used high-resolution satellite imagery and GIS mapping to uncover thousands of unrecorded properties<sup>24</sup>. In Sindh, the Board of Revenue completed a province-wide digital cadastre, geo-referencing all 5,979 Dehs<sup>25</sup> and integrating 2,933 at the survey-number level into the Land Records Management Information System (LARM-IS), improving valuation transparency and reducing discretion<sup>26</sup>.
- In Sindh, the Board of Revenue completed a province-wide digital cadastre about a decade ago, digitising and geo-referencing all 5,979 Dehs, and integrating 2,933 of them to the survey-number level into the Land Records Management Information System (LARM-IS). This integration has improved valuation transparency, reduced discretion in tax assessment, and strengthened oversight.

**Improving compliance:** For the sales tax on services, POS technology is improving compliance. Nationally, the Federal Board of Revenue (FBR) reported a 40% jump in POS-mediated sales tax collection in FY 2025 (PKR 414 billion versus PKR 295 billion the previous year)<sup>27</sup>. In KP, restaurants and salons have begun adopting POS systems integrated with KPRAs' platform, issuing QR/barcoded invoices that customers can verify through the KPRAs app<sup>28</sup>.

### C. Reforms in tax governance and administration essential

Provincial tax administration in Pakistan is as much about governance and institutional relationships as it is about technical capacity. For example, although property tax in Pakistan is legally a local government levy, its collection is managed by provincial governments, causing disputes over ownership, responsibility, and control. Lower-tier collectors often hold detailed local knowledge of the tax base and can use this discretion in ways that undermine compliance.

21 <https://www.theigc.org/blogs/promise-and-pitfall-technology-evidence-tax-collection-ghana>

22 <https://www.theigc.org/blogs/taxing-effectively/electronic-invoice-monitoring-systems-improve-tax-compliance-evidence>

23 <https://taxbeing.com/punjab-government-reduces-sales-tax-to-zero-percent/>

24 <https://tribune.com.pk/story/2276126/punjab-to-use-satellite-imagery-to-trace-tax-evaders>

25 "Deh" refers to a unit of land, essentially a village or a specific area, for which a separate record of rights or land revenue assessment exists

26 <https://www.dawn.com/news/1117976>

27 <https://profit.pakistantoday.com.pk/2025/07/02/fbr-reports-40-surge-in-sales-tax-collection-through-pos-system-in-fy25>

28 <https://kpra.gov.pk/officials-of-kpra-visited-restaurants-in-peshawar-to-integrate-to-their-pos-system-with-rims-of-kpra/>

- **Technology for oversight and standardisation:** Technology can help rebalance information flows by giving higher tiers real-time visibility into the tax base, enabling standardised assessments and better oversight. For instance, machine learning pilots in KP using third-party data have improved property valuations, but require accompanying reforms such as standardised valuation methods, transparent record-keeping, and clear accountability mechanisms.<sup>29</sup>
- **Aligning roles with capacity:** Governance reform also means aligning responsibilities with capacity. If local governments are to play a bigger role in tax administration, they need trained staff, stable funding, and reliable data access. Provincial governments should provide oversight and policy guidance without micro-managing operations.
- **Strengthening the fiscal contract:** A stronger fiscal contract, linking taxes paid to visible local services, can also raise voluntary compliance. Utilising tax funds in the localities in which those funds are earned is crucial for revenue mobilisation. However, currently, Pakistani local authorities lack capacity to manage large-scale development funding effectively and therefore citizens do not clearly see the link between tax allocation and spending. An IGC-funded experiment found that allocating 35% of tax revenues to locally chosen development projects increased compliance<sup>30</sup>. Ring-fencing revenues to the municipality where they are collected can reinforce this link, but requires empowering local governments to both collect and administer taxes.
- **Addressing fragmented revenue collection:** Currently, in KP, multiple authorities (e.g., KP Culture Tourism Authority, KP Revenue Authority, Galiyat Development Authority) collect taxes without direct municipal accountability limiting citizen trust<sup>31</sup>. Empowering elected local governments with both revenue authority and accountability mechanisms is key to building a sustainable tax base.
- **Institutional coherence:** Finally, governance reform requires institutional coherence. Unified revenue authorities, such as the Sindh Revenue Board and the Punjab and KP Revenue Authorities, have demonstrated that integrating tax functions under one institution can streamline operations and improve

oversight. Pairing such institutional reforms with digital tools and transparent processes creates a system where discretion is limited, responsibilities are clear, and compliance is both easier for taxpayers and harder to evade.

## TO CONCLUDE: COMBINE QUICK WINS WITH LONG-TERM REFORM

Pakistan's provinces do not need to choose between immediate results and long term structural/systemic change. Behavioural nudges can deliver quick gains, while digitisation and governance reforms create the structural capacity for sustained growth in mobilisation revenue. With the new NFC framework likely to tie transfers more closely to provincial revenue performance, scaling tested interventions is urgent. By combining behavioural insights, technological innovation, and governance reform, provinces could double or even triple their OSR within a decade, reducing dependence on federal transfers and strengthening fiscal autonomy. In the next NFC settlement, the provinces that move first will be best positioned to secure both resources and authority.



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<sup>29</sup> <https://www.theigc.org/collections/cross-verification-revenue-data-using-third-party-data>

<sup>30</sup> <https://www.theigc.org/collections/rebuilding-social-compact-urban-service-delivery-and-property-taxes-pakistan-0>

<sup>31</sup> <https://cdpr.org.pk/creating-fiscal-space-for-sustainable-tourism-in-kp/>



# BEYOND THE NFC AWARD: PAKISTAN'S UNFINISHED DEVOLUTION TO LOCAL GOVERNMENTS

Dr. Usama Ehsan Khan and Uzma Aftab

The passage of Pakistan's 18th Constitutional Amendment in 2010 was widely recognized as a landmark reform in the country's democratic trajectory and fiscal federalism. By devolving political, administrative, and fiscal powers from the federal government to the provinces and increasing share of provinces National Finance Commission (NFC) Awards was seen as a long-overdue correction to decades of over-centralization. For the first time in Pakistan's history, provinces were guaranteed 57.5% of the federal divisible pool, a change that many considered the strongest move of fiscal federalism since independence.

This fiscal realignment was aimed to bring governance closer to the people by strengthening not just the provincial tier but also the local tier including the municipalities, town councils, and district administrations responsible for delivering essential services such as water, sanitation, primary

education, and waste management. While provinces have flourished under NFC transfers, the local governments, arguably the most critical link in democratic service delivery, remain chronically underfunded and institutionally sidelined.

The Devolution Plan, 2001, envisaged the setting of a Provincial Finance Commission (PFC) in each province to decide on the nature of fiscal relations between provincial and local governments. PFCs implementation from 2001 to 2007 has been considered as a golden age (Pasha, 2018).<sup>1</sup>

■

<sup>1</sup> Pasha, H. A. (2018). Growth and inequality in Pakistan. Islamabad, ISB: Friedrich-Ebert-Stiftung (FES), Pakistan Office

However, none of the provinces announced PFC Awards on regular basis. Sindh has so far announced four PFC Awards, Baluchistan – five, whereas Punjab has only announced three PFC awards whereas KPK has announced ten PFC Awards as presented in the Table I. This great disequilibrium in distribution of resources resulted a hollow core in Pakistan’s federalism: a robust first and second tier, but a weak, fiscally starved third tier.

Table I: Timeline for Provincial Finance Commission (PFC) Awards

Fiscal Year	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Sindh	1 <sup>st</sup>		2 <sup>nd</sup>	3 <sup>rd</sup>	-	4 <sup>th</sup>	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Punjab		1 <sup>st</sup>		2 <sup>nd</sup>	-	-	-	-	-	-	-	-	-	3 <sup>rd</sup>	-	-	-	-	-	-	-
Balochistan	1 <sup>st</sup>	2 <sup>nd</sup>	3 <sup>rd</sup>	4 <sup>th</sup>	5 <sup>th</sup>	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
KPK	1 <sup>st</sup>	2 <sup>nd</sup>	3 <sup>rd</sup>	4 <sup>th</sup>	-	-	-	5 <sup>th</sup>	-	-	-	-	-	6 <sup>th</sup>	7 <sup>th</sup>	8 <sup>th</sup>	9 <sup>th</sup>	10 <sup>th</sup>	-	-	-

Sources: Provincial Finance Ministries, Provincial Assemblies

## CONSTITUTIONAL AMBIGUITY AND PROVINCIAL CONTROL

The imbalance between provincial and local fiscal powers stems, in large part, from a structural flaw in the constitutional framework. The NFC enjoys explicit and detailed constitutional coverage under Article 160, with mandatory award cycles. The PFC, however, is only indirectly referred to under Article 140A, which obligates provinces to establish a local government system but leaves the scope, composition, and frequency of PFC awards entirely at the discretion of provincial legislatures. It recognized the local government as a legitimate tier by inserting Article 140A which states:

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.

This legal ambiguity has produced a chronic pattern of delay and selective compliance. Provinces can simply postpone the formation of Provincial Finance Commissions (PFCs) without breaching any explicit constitutional timelines. Even when they do establish such commissions, mandates can be weakened by excluding key revenue sources or limiting the scope of transfers. In some cases, the

law may formally require regular PFC cycles but in practice, compliance remains optional and unenforced.

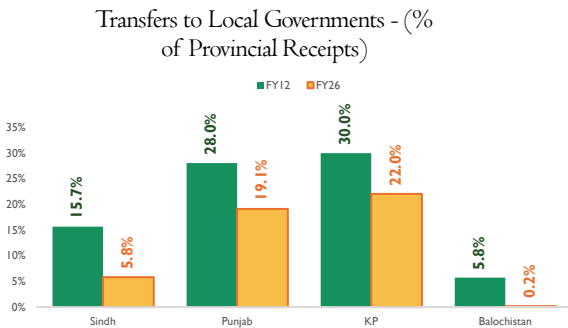
In the absence of predictable, formula-based transfers, provincial finance ministries have discretionary powers of local funding, disbursing resources through ad hoc grants and sub-optimal development schemes, mechanisms that consolidate political control while undermining local fiscal autonomy.

## THE SCALE OF LOCAL EXCLUSION – PROVINCIAL TRENDS

Despite the 18th Amendment’s commitment to empower local governments through fiscal devolution, the actual transfer of resources has moved in the opposite direction over the past decade. The data show that in FY12, Sindh transferred 15.7% of its provincial receipts to local governments, but by FY26 this had dropped to just 5.8%. Punjab’s share fell from 28.0% to 19.1% over the same period, while Khyber Pakhtunkhwa saw a reduction from 30.0% to 22.0%. The most severe decline occurred in Balochistan, where transfers plummeted from 5.8% to an almost negligible 0.2%.

This consistent downward trend points to a steady centralization of fiscal authority at the provincial level, undermining the capacity of local governments to function as autonomous units.

Reduced fiscal transfers leave local administrations dependent on provincial grants, constraining their ability to maintain infrastructure, deliver public services, and respond to local development priorities. Over time, such fiscal dependency not only weakens service delivery but also deepens regional disparities. The widening gap between constitutional intent and fiscal reality has effectively marginalized local governments, limiting their contribution to socio-economic growth and governance at the grassroots level.



Sources: Provincial Finance Ministries, Planning and Development Departments, and Financial Statements from Accountant General - KP  
 Note: Share has been computed as share of Local Government Transfers to Provincial General Revenue Receipts  
 Balochistan is not represented in any of the graphs due to unavailability of its Budget Documents

KPK allocating the highest share (60%) to local governments, whereas Punjab retains more funds at the provincial level (56%) with additional special grants (6.5%). Horizontal distribution criteria also differ significantly, Punjab and Baluchistan heavily prioritize population (75%) whereas Sindh incorporates infrastructure (35%), development needs (10%), and performance-based incentives (10%), and KPK includes backwardness (20%) and infrastructure lag (20%). These differences reflect distinct fiscal priorities with Sindh and KPK emphasizing equity and service delivery, while Punjab and Baluchistan favor simpler, population-driven models, potentially neglecting underdeveloped regions.

## PROVINCIAL PRIORITIES AND PFC AWARDS FORMULA

Pakistan's Provincial Finance Commission (PFC) awards, intended to guide the equitable distribution of fiscal resources between provincial and local governments, show considerable variation in both structure and intent across provinces. The table reveals significant disparities in PFC Awards across provinces, with varying criteria for resource distribution. While all provinces broadly define their divisible pool as "all revenues excluding obligatory expenditures," their approaches differ in restrictiveness. Punjab and KP apply the simplest rule, excluding only obligatory spending, while Sindh uniquely excludes non-tax revenues (e.g., user fees, asset sales), retaining more central revenue control. Balochistan is the most restrictive, excluding major sources like GST shares, property tax, and net capital receipts, significantly shrinking the funds available to local governments and constraining grassroots fiscal space. Vertical distribution shows



Table 02: PFC Awards Criteria across Provinces (for latest PFCs only)

	Sindh	Punjab	KPK	Baluchistan
<b>Last PFC</b>	<b>2007-09</b> (4 <sup>th</sup> PFC)	<b>2016</b> (3 <sup>rd</sup> PFC)	<b>2020-21</b> (10 <sup>th</sup> PFC)	<b>2006-09</b> (5 <sup>th</sup> PFC)
<b>Divisible Pool</b>	All revenues excluding non-tax revenues and obligatory expenditures	All revenues excluding obligatory expenditures	All revenues excluding obligatory expenditures	All revenues excluding: - GST (2.5% Federal+ district share) - Property tax payable - Net Capital Receipts

Vertical Distribution				
<b>Provincial Government</b>	45.0%	56.0%	40.0%	56.0%
<b>Local Government</b>	55.0%	37.5%	60.0%	44.0%
<b>Grants for Special Purposes</b>	-	6.5%	-	-
Horizontal Distribution				
<b>Population</b>	40.0%	75.0%	60.0%	75.0%
<b>Backwardness</b>	-	25.0%	20.0%	-
<b>Expenditure Need</b>	-	-	-	-
<b>Cost of Service Delivery</b>	-	-	-	-
<b>Service Infrastructure*</b>	35.0%	-	-	-
<b>Lag in Infrastructure**</b>	-	-	-	20.0%
<b>Development Needs</b>	-	10.0%	-	-
<b>Area</b>	-	5.0%	-	25.0%
<b>Performance:</b>	-	10.0%	-	-
<i>i. Revenue Collection (RC)</i>	-	05.0%	-	-
<i>ii. Primary School Enrollment</i>	-	05.0%	-	-
<b>Total</b>		<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

Source: Provincial finance departments

\*Service Infrastructure includes inverse per capita hospital beds, inverse length of roads per km area, and inverse per capita distance from primary school \*\*Lag in Infrastructure index derives from urban development, rural sanitation, and transport and communication.

## CONCLUSION

Pakistan's fiscal federalism remains structurally imbalanced, while the NFC has strengthened provincial autonomy, absence of PFC Awards has left local governments underfunded and subordinate to provincial bureaucracies. A meaningful path forward requires reforms on multiple fronts. Constitutional amendments to Article 140A should make PFCs mandatory, enforce a fixed three-year award cycle, and embed legally binding allocation formulas. Provincial budgets must guarantee a minimum of 25% for local governments, while granting them tax autonomy over property taxes, user fees, and other local revenue instruments.

Only when fiscal democracy flows beyond the provincial tier to the street corner, the school, and the neighborhood tap will it acquire the depth and resilience necessary to meet Pakistan's governance challenges.

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# FISCAL RESOURCE DISTRIBUTION: Criteria, Incentives and Institutional Mechanism A Comparison between Neighbors

Dr. Iftikhar Ahmad and Zahanat Hussain

## FISCAL RESOURCE DISTRIBUTION MECHANISM IN INDIA

The Indian federation faces the classic vertical fiscal gap problem, where the center assumes the revenue collection responsibility while the states are entrusted with expenditure responsibilities.

Table I indicates the total vertical fiscal gap for FY 2018-19. With the system built fiscal gap, it necessitates systematic funds transfer from the center to the states to ensure sustainability and predictability in states' finances. For this purpose, Indian Finance Commission (FC) is assigned the responsibility to propose feasible resource transfer mechanism between the center and the states.

Level of Government	Total Resources Generated	Total Government Expenditures
Indian Central Government	62.7	37.6
Indian State Governments	37.3	62.4

Source: 15<sup>th</sup> FC Report (2020)

## INSTITUTIONAL MECHANISM OF INDIAN FINANCE COMMISSION: THE STRUCTURE

The President constitutes and announces the Finance Commission (FC) after every five years. The commission comprises of Chairman<sup>1</sup> and four members who are experts in the field of public policy and economics. The FC is provided with a secretariat along with special powers to engage with relevant stakeholders (central and states' government officials, academia, researchers, public policy experts etc.), prepare reports and can even commission studies; indicating government's seriousness to the cause.

The FC also undertakes extensive visits throughout the country to grasp ground realities and invites proposals on desired FC formula from the state governments. The head of the commission is empowered to engage professionals and support staff (from the market as well as on deputation). Intensive field visits to states, research institutions and other relevant stakeholders takes place and the commission also arranges and facilitate conferences on relevant issues as per assigned ToRs. The recent appointments of the Chairman FC (who are experienced professionals and belongs to academia) suggests that Indian government wants to approach the resource distribution issues professionally and efficiently.

The commission is required to make recommendations to the President on the vertical and horizontal resource distribution<sup>2</sup>. In addition to the formula transfers, the FC also make recommendations on the Grants-in-Aid to the states. The commission also deals with supplementary fund allocation to the local governments (including municipalities and Panchayats), which obviously is meant to shield the LGs from full financial dependence on states.

## 15<sup>TH</sup> FC AWARD DIVISIBLE POOL:

The FC deal with the defined divisible pool, which currently consists of the net proceeds of all taxes<sup>3</sup> collected by Union. This also includes GST on Good and Services; the matter amicably settled in 14<sup>th</sup> FC ward.

Criteria	Weight (%)
Population	15.0
Area	15.0
Forest and ecology	10.0
Income distance	45.0
Tax and fiscal efforts	2.5
Demographic Performance	12.5
<b>Total</b>	<b>100</b>

Source: 15<sup>th</sup> FC report (2020)

Finance Commission Award	11 <sup>th</sup>	12 <sup>th</sup>	13 <sup>th</sup>	14 <sup>th</sup>	15 <sup>th</sup>
States share in DP	29.5	30.5	32.0	42.0	41.0

The FC formula in India is based on three main pillars i.e. the need based principal, the equity based principal and the performance based principal. The criteria including population, area and forest cover<sup>4</sup> constitute the 'basic need' principle for the states and each aspect is covered in the resource distribution formula by assigning different weights to each criteria.

1 Dr. Arvind Panagariya, is appointed as Chairman for the current 16th FC. Prior to this responsibility he was serving as Professor at Columbia University and is the former Vice-Chairman of the 'National Institution for Transforming India (NITI)'; A public sector public policy think tank established as replacement of 'Indian Planning Commission'

2 The commission is allowed a maximum period of 22 months (the 15th FC: January 1st, 2024 till October 31st, 2025) to make recommendations for the next five years starting on April 1st, 2026. This allow six months for the government to debate and deliberate on the FC's recommendations.

3 Other sources like duties, cess and surcharges are not included

4 Meant to measure the opportunities foregone for country's common prosperity

Similarly, the criteria of income distance, infrastructure and fiscal capacity have been historically used to fulfil the ‘equity’ principle and has historically enjoyed the highest weightage throughout.

Lastly, the ‘performance’ principal is used to reward the demographic performance, the tax effort and the fiscal efforts by the states. The demographic performance is measured as inverse of age-specific fertility rate.

Thus, despite being criticized in the literature for adopting multi criteria formula, the Indian FC award covered the need and equity criteria as well as has accommodated incentive for the states that perform better on agreed national goals. This aspect is missing in Pakistan’s NFC award, which predominantly takes into account the needs and cost disabilities mainly. Another important lesson to learn from the Indian FC awards, as presented in Table 5, is the continuous experimentation in search of optimal balance of ‘needs’ versus ‘effort’. Historically, all finance commission yielded awards and each commission has experimented by assigning different weights to different criteria in search of the optimal, which deserves appreciation.

**Table 5: Criteria and Weightage in Previous Finance Commission awards**

Columnl	Criteria	FC-XI (2000-05)	FC-XII (2005-10)	FC-XIII (2010-15)	FC-XIV (2015-20)
Need and cost disability	Population (1971)	10	25	25	17.5
	Population (2011)				10
	Area adjusted	7.5	10	10	15
	Forest cover				7.5
Equity	Index of infrastructure	7.5			
	Income distance	62.5	50		50
	Fiscal capacity distance			47.5	
Performance	Tax efforts	5	7.5		
	Fiscal discipline	7.5	7.5	17.5	
		<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

## EQUALIZATION TRANSFERS:

In addition to criteria based transfers, the FC award allocates equalization funds to different states. This is in line with international practice such as Canada and Australia, where the central government makes equalization transfers to states to enable the states to provide reasonably comparable level of public services. This happens while ensuring that states have made adequate tax effort and worked with acceptable efficiency. Thus, equalization transfers need to be designed in a way where states are enabled to provide comparable services, barring their capacity to externalize their costs to others without making comparable effort. Thus, needs and cost disabilities are to be covered only after the states have exhausted their true potential to raise revenues and have achieved fiscal efficiency.

## EMPOWERING LOCAL GOVERNMENT

Another unique feature of the Indian FC award is that it engages with the local governments and provides performance incentives. Following the need-based principal, the FC directly transfer<sup>5</sup> funds to the local governments by allocating 90 percent weightage to ‘population’ while 10 percent weight is assigned to ‘area’. The FC awards apportion these funds with a ratio of 67.5:32.5 between rural and urban local bodies. During 2021-26, the FC has recommended total grants of Indian Rs. 436,361 crore for local governments to cater with their emerging needs and act as the engines of growth. This again is futuristic in nature and is bound to bring long run benefits to the economy. This arrangement ensures avoiding the concentration of fiscal power at the second tier, allowing LGs to take local policy decisions. However, 60 percent of the total grants is tied to national priorities while 40 percent is left at the discretion of the LGs. However, in order to qualify for the federal grants, LGs are required to meet some basic prerequisites. These include digitalization of annual audited accounts at LG level. Additionally, the urban local bodies are required to have state’s notified minimum floor rates for property taxes and a decent collection effort. Thus, LGs transfers are not guaranteed rather these are treated as reward performances.

**Table 6: Criteria for Grants to LGs by FC awards**

	FC-X	FC-XI	FC-XII	RLB*	FC-XIII	ULB**	FC-XIV	FC-XV
								(in per cent)
Population	100	40	40		50		90	90
(Census)	1971	1971	2001		2001		2011	2011
Geographical area	-	10	10		10		10	10
Distance from highest per capita income	-	20	20	10		20	-	-
Index of decentralization	-	20	-		15		-	-
Index of deprivation	-		10				-	-
Revenue effort	-	10	20				-	-
Proportion of scheduled castes/scheduled tribes in population	-	-	-	10		0	-	-
FC local body grants utilization index	-	-	-		5		-	-

Source: 15<sup>th</sup> FC award report  
\*RLBs – rural local bodies; \*\* ULBs – urban local bodies

## FISCAL RESOURCE DISTRIBUTION MECHANISM IN PAKISTAN

Given the fiscal imbalances between federal and provincial tiers, Pakistan need to adopt an efficient resource distribution mechanism. For this purpose,

<sup>5</sup> Pakistan used to do the same under ‘Local Government System, 2002’

the National Finance Commission (NFC) Award mechanism is in place to resolve the financial discrepancies among the government tiers and to manage the financial resources in Pakistan. This mechanism is aimed to arrive at an amicable resource distribution criteria where the center and provinces are able to meet their expenditure obligation for efficient public service delivery (Ahmad, 2021). Fiscal resources and responsibilities need to be distributed in a way so that sub-governments have a clear mandate, adequate resources, and the flexibility to make decisions (Bird & Smart, 2002). Furthermore, any efficient resource distribution mechanism is ideally a source of competition among the provincial governments, where each have the incentive to provide public services efficiently, make coordinated efforts for macroeconomic management and encourage savings in operational cost (Iqbal, Din, & Ghani, 2013). Around the world, countries have employed fiscal allocation as a reform to make an effort to improve the efficiency of public services while reducing poverty and corruption (Fisman & Gatti, 2002).

According to the Article-61 of the constitution of Pakistan, the NFC is constituted to propose a resource distribution mechanism between the federal and provinces and subsequently among the provinces. The history of resource distribution in Pakistan goes back to 1951, however, following the currently enforced 1973 Constitution of Pakistan, seven<sup>6</sup> awards have so far been announced. The NFC comprises of the federal finance minister (chairperson) and the provincial finance ministers along with their nominated member from each province. The NFC is meant to distribute the given divisible pool as defined in the presidential order at the time of announcement of the commission. Currently the divisible pool consists of all major taxes (i.e. Income Tax, General Sales Tax on goods, Wealth Tax, Capital Gains Tax, and Custom Duty Tax) collected at federal level. The pool, however, does not include any levy or duty imposed by the federal government.

Despite having an elaborated forum, few inbuilt problems have resulted in inconclusive NFC awards, violating the constitutional mandated. If we analyze the design, it is clear that NFC in Pakistan is a political forum, which is mandated to take economic decisions. Secondly, in order to announce an award, members are required to have achieved a complete consensus, which is not easy at times due to diverging interests and dissimilar strengths of the federating units, thus leads to compromises or failure. Any change in the share of

one federating unit affects the rest of the members accordingly, thus it is not easy to develop consensus among the members unless based on clear economic rationale, which the given NFC forum seems to have failed to ensure. History of NFC awards in Pakistan reflects the repeated failure of the forum (Table 7), the necessitating reconsideration.

S.No	NFC Award	Prime Minister/ President	Period	Distribution
1	NFC Award 1974	Zulfiqar Ali Bhutto	1974-79	Fed: 20 Prov:80
2	NFC Award 1979	Zia-ul-Haq	1979-84	Inconclusive
3	NFC Award 1985	Zia-ul-Haq	1985-90	Inconclusive
4	NFC Award 1991	Nawaz Sharif	1990-95	Fed: 20 Prov:80
5	NFC Award 1996	Malik Meraj Khalid	1996-2000	Fed: 62.5 Prov:37.5
6	NFC Award 2002	Pervez Musharraf	2001-06	Inconclusive
7	NFC Award 2006	Pervez Musharraf	2006-10	Fed: 50 Prov:50*
8	NFC Award 2010	Yousaf Raza Gillani	2010-15	Fed: 42.5 Prov:57.5
9	NFC Award 2015	Mian Muhammad Nawaz Sharif	2015-20	Inconclusive
10	NFC Award 2020	Imran Khan	2020-25	Inconclusive

\*The share was 55:45, where the provincial share was gradually increased till the ratio reached 50:50

Source: Ahmad, Iqbal, & Khalid (2021); (dawn.com, 2002)

## 18<sup>TH</sup> AMENDMENTS AND 7<sup>TH</sup> NFC AWARD:

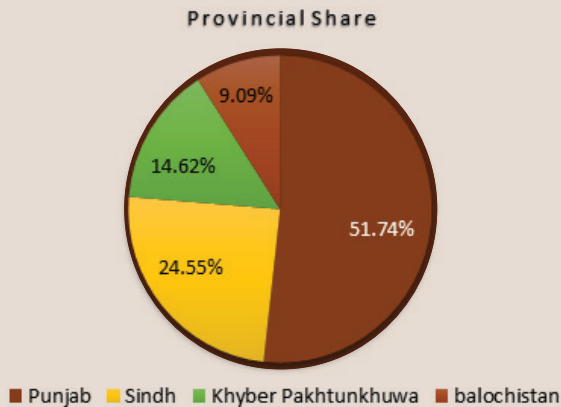
Prior to the 7<sup>th</sup> NFC award, shares were distributed based on population only, which was contested by the less populated provinces (Pasha, Imran, & Pasha, 2010). Discourse on the topic highlighted demands from the provinces that additional factors including revenue generation, population density, and backwardness, are essential while apportioning shares. Consequently, the 18<sup>th</sup> constitutional amendment embedded a revised resource distribution formula, promising more financial resources and autonomy to the provinces. Resultantly, a larger share of the divisible pool was assigned to the provinces. Thus, the new NFC award was more inclusive and the new distribution mechanism brought transparency to the resource distribution.

Under the 7<sup>th</sup> NFC award, vertical resource distribution between the center and provinces was decided as 42.7% and 57.5 % of the total divisible pool, respectively. Most importantly, the new NFC award successfully transitioned from using single criteria of 'population shares'.

Honoring provincial demands, the new distribution formula was diversified, which now includes population share, revenue generation, poverty levels, and inverse population density. However, the share of population still carries 82% weight leaving only 18 percent to the rest of the three criteria in the total distribution formula. Box-I summarizes the current NFC formula. It is important to note that within the horizontal share (57.5%), the shares of Punjab, Sindh, Khyber Pakhtunkhwa and Balochistan are 51.74%, 24.55%, 14.62% and 9.01%, respectively, as shown in the following Graph I.

**BOX-1: 7TH NFC AWARD (2010)**

Vertical Distribution:	
Federal Share	42.5%
Provincial Share	57.5%
Horizontal Distribution:	
Population	82 %
Poverty or Backwardness	10.3%
Revenue Collection or Generation	5 %
Inverse Population Density (Area)	2.7 %



Source: (Finance Department Sindh, 2021)

## SUMMARY AND CONCLUSION:

The fiscal relations between different levels of government in Pakistan are characterized by imbalance. According to the Annual Budget Statement (2024), provinces are consuming around 30% of total government expenditures while generate only 8% of the consolidated national total tax revenue, or less than one percent of GDP. The provinces receive 57.5% of the federal tax revenues, which

constitute predominant portion of the provincial budgets (e.g. 90% in case of Khyber Pakhtunkhwa), hence are heavily dependent on the federal government.

This article has explored the structure of resource distribution mechanism in Pakistan and has compared it with the neighboring country, India. Despite the fact, that literature has criticized the Indian finance commission awards due to its multi-criteria and complex nature, there are several institutional aspects from which Pakistan can draw lessons. The economic viability of fiscal federalism depends on a system in which federation and the federating partners agree on major socio-economic targets for nation's development. Furthermore, a mutually agreed system of resource distribution needs to be defined in a way that contains decent incentives for making best efforts for achieving optimal resource mobilization and ensuring expenditure efficiency at each level. The resource distribution mechanism should be designed in a way where each partner puts in their maximum effort followed by a mechanism to allocate equalization funds so that citizen has relatively comparable access to basic public services across the country.

In this context, the resource distribution mechanism of Pakistan and India can be summarized as below:

Both in Pakistan and in India, the respective Finance Commissions are responsible for the fiscal resource distribution between the federal government and provinces/states. The functions and mandate are similar, however, their structures, procedures and efforts to reach to an amicable formula are significantly different.

The National Finance Commission of Pakistan is established under Article 160 of the constitution of Pakistan and it consists of the federal finance minister (Chairperson), and the four provincial finance minister (along with experts from each province) as the NFC members, appointed by the President of Pakistan. Hence, apparently the NFC is a political forum where respective finance ministers are making decisions, which inherently is inconsistent with their assigned jobs (i.e. to guard the interest of their respective jurisdiction). The reason is that any change in the formula allocations has a direct bearing on their fiscal space hence inherently carries incentive to work for individual interests instead of striving for an efficient formula which is nationally beneficial. Conversely, the Indian Finance Commission is constituted under

Article 280 of the constitution and consists of a Technocrat as Chairman and three other members. Hence, the Indian FC can be characterized as an academic forum where findings and recommendations has no direct bearing on the member's term in offices. This institutional arrangement carries the incentive to strive for a formula that is grounded in evidence and consultations based on academic exercise, which essentially makes them accountable and prone to scrutiny by the academic and policy circles.

In both countries, the Finance Commission awards are for five years. In Pakistan, the NFC award should necessarily be a consensus award, which historically has resulted in failure to announce awards. Whereas in India, the commission is allowed a maximum of 22 months to consult relevant stakeholders, engage with experts and commission studies to make recommendations for the next five-year formula in the form of proposals and conferences. Unlike the well-organized and focused efforts of the Finance Commission of India, Pakistan's system is characterized by its static nature and absence of a policy framework focused on informed economic-rational-based decision-making.

Pakistan lacks a dedicated functioning secretariat for the Finance Commission, while India operates under a permanent secretariat system. In India, the Finance Commission conducts extensive field visits across the country to understanding ground realities. Additionally, it actively solicits inputs and suggestions from various state governments on desired Finance Commission's formulas. The head of the commission is empowered to engage professionals and support staff (from the market as well as on deputation). Intensive field visits to states, research institutions and other relevant stakeholders takes place and the commission also arranges and facilitate conferences on relevant issues as per assigned ToRs.

Due to the given factors, Indian FC does not have inconclusive awards while Pakistan is still following the 7th NFC award of 2010, after which the two commissions have failed to announce new formula. The given forum lacks any accountability mechanism for inconclusive awards.

Finally, the National Finance Commission in Pakistan considers various factors such as population, revenue generation, backwardness, and resource mobilization capacity of provinces while recommending the allocation of resources. On the

contrary, the Finance Commission in India considers additional factors including population, area, forest cover, income distance, tax & fiscal efforts and demographic performance of states while making recommendations for resource allocation. Additionally, the LGs' needs are also considered while making resource distribution. Considering the given facts, the Indian formula looks more dynamic and ever changing so they are constantly experimenting. However, in case of Pakistan, despite diversifying in 2010, the current NFC award formula is still stagnant because 82% of the divisible pool is still allocated on the basis of population, leaving only 18% for the rest of the three criteria. Conversely, India has allowed only 15% weight to the population criterion.

Overall, while both the Finance Commissions in Pakistan and India serve similar functions of distributing financial resources, there are fundamental differences in their composition, institutional arrangements and incentive mechanisms, reflecting the need for Pakistan to reconsider.

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# A CASE FOR CLIMATE-CENTRIC NFC

**Moazz Manzoor**

For Pakistan's citizens, climate change has become a lived reality rather than a distant threat, and with each passing day, the dangers of climate-induced disasters are becoming more deadly than ever before. The country is witnessing erratic weather patterns, monsoon cycles, glacial lake outbursts and scorching heatwaves, making the country extremely vulnerable to climate threats.<sup>1</sup> Pakistan stands at a crossroads where the cost of inaction will be insurmountable, necessitating that Islamabad implement a meticulous, proactive adaptation and mitigation strategy to avert losses. Though Pakistan's contribution to climate change is meagre but that's not a defence for inaction. With climate change posing an imminent existential threat, it is high time for national introspection to revisit our national priorities, goals and interests. The current system of fiscal distribution under the National Finance Commission (NFC) award between the centre and provinces, as envisioned in the historic 18th Amendment, is falling short of meeting the new realities of climate change, debt and development. The 7 NFC framework, which expired in 2015, has been in

effect for nearly 15 years due to disagreement over the new formula between the provinces and the Centre.<sup>2</sup>

Though the award was unprecedented, the framework is riddled with persistent horizontal and vertical imbalance. The formula's 82% weight on population now feels outdated if not counterproductive. By tying such a large share of resources to population, the system has inadvertently incentivised provinces to prioritise numbers over sustainability, affecting everything from the allocation of National Assembly seats and government job quotas to university admissions and funding for social programmes. This population-focused approach has been one of the factors fuelling high demographic growth.

1 Lina Adil, David Eckstein, Vera Künzel, and Laura Schäfer, *Climate Risk Index 2025 - Who Suffered Most from Extreme Weather Events?*, *Climate Risk Index 2025* (Bonn: Germanwatch, 12 February 2025), accessed 13 August 2025, <https://www.germanwatch.org/en/cr/>.

2 Jawaid Bokhari, "Updating NFC Award," *Dawn, The Business and Finance Weekly*, August 11, 2025, updated August 11, 2025, accessed August 13, 2025, <https://www.dawn.com/news/1929983/updated-nfc-award>.

It also fails to address the pressing realities Pakistan faces today, in an era where rising temperatures, erratic monsoons, and depleting water tables are no longer rare warnings but part of a troubling new normal.

The 2022 floods are a stark reminder that a third of the country was underwater. Crops were wiped out, entire districts were displaced, and the economic loss soared to \$ 30 billion. The tragedy was not just climatic; it exposed deep institutional, fiscal fault lines that climate change is not something we can respond to with ad hoc relief; it requires systemic reform. Similarly, provinces that bore the brunt of the devastation lacked the administrative and fiscal muscle to respond swiftly and recover sustainably. The federal government, already strapped for resources, struggled to fill the gap. This alone should have been the wake-up call to rethink how we distribute our national resources and on what basis.

Needless to say, demographics do matter, but the adoption of this one-size-fits-all model has created unintended consequences. It discourages population control, sidelines development performance, and ignores climate vulnerability. Provinces that have stabilised their population or made progress in human development often get penalised, while others benefit simply for being large. It's a model that might have worked decades ago, but in today's Pakistan, where climate change, water stress, burgeoning debt, and fiscal constraints dominate the agenda, it no longer makes sense. The world has moved on, and so should we. Brazil, for instance, introduced an ecological component in its fiscal transfers. Its "ICMS-E" model allows a portion of tax revenues to be distributed based on environmental indicators like conservation areas and biodiversity.<sup>3</sup> The results have been transformative, and local governments now actively invest in sustainability because it brings financial rewards. India's 14th Finance Commission also set a precedent by assigning weight to forest cover in its resource distribution formula, acknowledging the importance of environmental services provided by states like Arunachal Pradesh and Chhattisgarh.<sup>4</sup>

3 Alexandre Sauquet, Sébastien Marchand, and José Gustavo Feres, Ecological Fiscal Incentives and Spatial Strategic Interactions: the Case of the ICMS-E in the Brazilian State of Paraná, CERDI, *Études et Documents*, E 2012.19 (Clermont-Ferrand: CERDI), preprint submitted 23 May 2012, accessed 13 August 2025, <https://shs.hal.science/halshs-00700474v1/document>.

4 Vishal Aryan, Analysis of Relationship Between Devolution Based on Forest Cover by the Finance Commission and States' Forest Cover, under the supervision of Professor Saudamini Das, March 10, 2025, accessed August 13, 2025, <https://www.ies.gov.in/pdfs/Vishal-Aryan-march25.pdf>.

Pakistan doesn't need to copy-paste these models, but it can certainly draw inspiration. A new, climate-aware NFC formula should be built on multiple criteria that reflect the country's ground realities and development goals. Population can still be part of the equation, but its weightage must be reduced significantly to avoid distorting incentives. A frozen population baseline, such as the proposed 241.5 million, could help in phasing the shift more smoothly. What should come in, instead, are criteria that promote sustainability, equity, and performance. Likewise, indices of Climate vulnerability must be recognised explicitly; provinces and regions prone to floods, droughts, extreme heat or glacial melt should receive a larger share to invest in adaptive infrastructure. Moreover, forest cover, water resource management, and investment in renewable energy should be included as indicators that attract higher fiscal support. Lastly, provinces taking measurable steps in reforestation, building early warning systems, or climate-proofing their infrastructure must be rewarded.

However, the implementation of these reforms is a challenge. First, political resistance from larger provinces, particularly Punjab, which benefits from the current population-driven formula, may perceive vulnerability indices as reducing their shares. PIDE in its study notes that NFC negotiations are often dominated by provincial interests, complicating consensus on vulnerability-based allocations.<sup>5</sup> Second, data limitations for constructing climate vulnerability indices, such as inconsistent disaster impact records, pose a technical challenge. Third, provincial administrative capacity, particularly in Balochistan, remains weak, limiting effective use of conditional grants.

To counter these threats, a federal-provincial task force could be established to negotiate reforms, ensuring stakeholder buy-in. Meanwhile, a pilot 5% weight for vulnerability indices can be adopted in the NFC Award to build trust and demonstrate efficacy. Additionally, with regard to data limitations, the Ministry of Climate Change and Planning could partner with international organisations like the World Bank to develop robust metrics. Meanwhile, reactivating PFCs would strengthen local-level coordination, ensuring grants reach vulnerable districts.


5 Rashid Amjad, Musleh Ud Din, Idrees Khawaja, Nasir Iqbal, and Ahmad Waqar Qasim, The 7th NFC Award: An Evaluation, PIDE Monograph Series (Islamabad: Pakistan Institute of Development Economics, 2012), accessed August 13, 2025, <https://file.pide.org.pk/pdf/pidere-search/ms-08-the-7th-nfc-award-an-evaluation.pdf>

Moreover, capacity-building programs, funded through federal allocations, could mitigate this, ensuring provinces can implement resilience projects. Similarly, a concerted effort must be made to increase provincial taxes. Provinces that expand their tax base, digitise revenue systems, and increase their tax-to-GDP ratio deserve greater transfers. This will encourage autonomy and reduce the culture of dependency on the federal divisible pool. Human development should also be a pillar of progress in literacy, gender equity, health outcomes, and stunting reduction, influencing allocations.

In today's climate reality, fiscal federalism must do more than divide the pie. It must help us grow sustainably, equitably, and strategically. The case for a climate-centric NFC is no longer theoretical. It is a national imperative. It's high time we start aligning our financial systems with our environmental vulnerabilities, as without incorporating this critical aspect, the promise of fiscal decentralisation under the 18th Amendment will remain half-baked. While provinces have gained more funds, many have failed to devolve these resources to provincial finance commissions, which are either inactive or non-transparent. A reformed NFC must not just recommend, but mandate the activation and regular functioning of PFCs as part of the broader devolution framework. Only then will equity flow within provinces, not just between them. Pakistan is not short of plans. What we lack is coherence between them. These reforms are a good start, but they cannot happen in a vacuum. Unless the NFC, which shapes the fiscal spine of the federation, reflects these priorities, we will always be running behind disasters.

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# PAKISTAN'S FISCAL FEDERALISM: FROM STALEMATE TO SOLUTION – CHARTING A COOPERATIVE FISCAL FUTURE

Saba Asghar Bhutta

## UNDERSTANDING FISCAL FEDERALISM IN PAKISTAN

Article 160 of the 1973 Constitution mandates a National Finance Commission (NFC) every five years to recommend how the “divisible pool” of federal taxes is distributed—vertically between the federation and the provinces, and horizontally among provinces on agreed criteria.

The landmark 7th NFC Award of 2009 (implemented in 2010), together with the 18th Constitutional Amendment (2010), dramatically reshaped

this arrangement. It significantly increased the provincial share of federal tax revenues, raising it from roughly 47.5% to 56% in FY2010–II and to 57.5% from FY2011 onward.

## THE NFC AWARD STALEMATE: A 15-YEAR HIATUS

While the 7<sup>th</sup> NFC Award and the 18<sup>th</sup> Amendment were hailed as historic steps, they also exposed deep structural challenges. Pakistan has not seen a new NFC Award since 2009/2010, despite the Constitution's clear five-year renewal requirement.

Multiple attempts since 2015 have failed to reach consensus, producing an impasse. Several key issues lie at the heart of this deadlock:

## 1. Vertical Fiscal Imbalance

The federal government's fiscal position has grown increasingly strained after ceding 57.5% of tax revenues to provinces. The centre still bears responsibility for debt servicing, defence, federal administration, and nationwide infrastructure, but must finance these largely from its 42.5% share. Federal spending has surged while revenues have remained capped, leading to persistent budget deficits financed by borrowing. This vertical imbalance between revenue and expenditure responsibilities is unsustainable in the long run.

## 2. Provincial Dependencies and Weak Revenue Effort

Provinces, cushioned by guaranteed federal transfers, have displayed little urgency in expanding their own-source revenues. Despite authority over agriculture income tax, property tax, and services sales tax, provincial collections remain stagnant at 0.7–0.8% of GDP. Politically powerful lobbies and limited administrative capacity have kept tax bases narrow. The incentive structure is weak: provinces receive large, unconditional funds regardless of tax effort. This dependency mind-set hinders the development of robust provincial revenue systems and leaves subnational governments reliant on federal transfers for most of their spending.

## 3. Constitutional and Political Rigidity

The unanimity rule and the constitutional bar on reducing provincial shares have paradoxically locked the system in place. Provinces, content with existing allocations, see little reason to renegotiate. The federal government, burdened with growing expenses and shrinking fiscal space, hesitates to give more. This tug-of-war has created a deadlock. What was once a well-intentioned safeguard to protect devolution has now turned into a rigid structure, making compromise near impossible.

## 4. Horizontal Inequities and Emerging Needs

The frozen award ignores shifting realities. The merger of FATA into Khyber Pakhtunkhwa (K-P) in 2018 added over 5 million new citizens, yet K-P's share remains the same as in 2010. This is arguably unconstitutional, since population is the main criterion for horizontal distribution. Similarly, Balochistan—with its vast territory and sparse population—continues to receive an allocation many argue does not cover its higher per-capita costs of service delivery. These inequities fuel provincial grievances, but other provinces remain unwilling to surrender part of their share.

## 5. Political Economy of Deadlock

Politics has further complicated matters. Since 2010, different parties have ruled at the federal and provincial levels, making consensus harder. No party wants to be seen compromising on fiscal rights, particularly in a polarized climate. Frequent government changes and short tenures in Islamabad have also pushed the NFC down the priority list. Successive governments have chosen to carry on with the old formula, sidestepping the Constitution's renewal clause, leaving Pakistan with an arrangement that no longer reflects today's fiscal or political realities.

In summary, the failure to convene a new NFC Award for well over a decade stems from a combination of constitutional rigidity, misaligned incentives, and political deadlock. The outcome has been a stagnant fiscal federal architecture: one that initially empowered provinces but now struggles to adapt to changing conditions or to ensure a sustainable national fiscal balance. The costs of this stalemate are increasingly evident in Pakistan's macroeconomic stress and inter-provincial frictions.

## The National Fiscal Pact (NFP) – An Interim Solution under IMF Auspices

With no new NFC Award in sight and fiscal pressures mounting, federal and provincial governments turned to a temporary arrangement. In late 2024, they signed the National Fiscal Pact (NFP) as part of an IMF-backed reform effort. The NFP is a political understanding, not a constitutional replacement, but it provides a short-term framework for stability and burden-sharing. Key Elements of the NFP are:

- **Devolution of Expenditure Responsibilities:** Provinces agreed to take on certain spending functions that were still being funded by the federal government, in line with the 18th Amendment's division of subjects. For instance, development schemes that benefit only a single province will, from FY2025-26 onward, be funded by that provincial government rather than by the federal PSDP. This prevents the center from incurring expenditure on essentially provincial domain projects, thereby reducing federal outlays. An exception mechanism via the Council of Common Interests (CCI) or National Economic Council (NEC) is included for any special cases, ensuring consensus on any federal involvement in local projects. Additionally, the federal government is undertaking a "right-sizing" initiative – cutting or restructuring federal ministries and departments that overlap with provincial functions – to shrink its footprint and expenditure accordingly.
- **Provincial Revenue Mobilization Commitments:** A key feature of the NFP is the provinces' commitment to step up their own revenue collection. For years, taxes under provincial control like those on agriculture, services, and property have remained largely underused. Now, all four provinces committed to reforming Agricultural Income Tax laws by October 2024, aligning them with federal income tax rates. From January 2025, farmers will be taxed like other citizens, a major shift for a sector long shielded from taxation. Provinces also adopted a "negative list" approach for Sales Tax on Services and moved toward harmonized property tax frameworks. Together, these reforms aim to tap under-taxed sectors such as agriculture, services, and real estate.
- **Tax Policy Harmonization:** Through the National Tax Council, federal and provincial governments will coordinate on property taxation, share data, and align agricultural pricing policies. Provinces also agreed to end market interventions such as separate support prices or large procurement drives, which often distort trade and strain budgets.
- **Shared Funding of National Programs (Adjusted in Final Pact):** An initial proposal for provinces share the cost of certain federal programs like the Benazir Income Support Programme (BISP) was softened after

resistance, particularly from Sindh. Instead of mandatory cost-sharing, both sides agreed to coordinate better on social protection to avoid duplication and use resources more efficiently. Still, provinces committed to gradually increase, provinces pledged to scale up their own spending on health and higher education, recognizing these as core responsibilities. The broader idea is that with greater fiscal space post-7th NFC, provinces should take more ownership of key social services, while the federal government limits its role to national-level support where needed. **Fiscal Coordination and Surpluses:** Provinces are encouraged to run surpluses that support federal fiscal targets, investing idle balances in federal securities to provide both returns for provinces and non-inflationary financing for the centre.

## A PRACTICAL BUT IMPERFECT STEP

The NFP reflects pragmatic compromise in tough times. It reduces duplication, nudges provinces to take ownership in health, education, and agriculture, and trims federal overreach. Perhaps most importantly, it demonstrates that cooperation across provinces and parties is possible.

Yet concerns remain. Some view the NFP as shaped more by IMF pressure than by genuine domestic consensus. Others worry that it could become a substitute for constitutional reform if allowed to drift beyond its intended role. For this reason, the NFP must be seen not as a destination, but as a stepping stone towards a stronger and fairer NFC Award.

## BRIDGING THE GAP

Pakistan's prolonged failure to finalize a new NFC Award is more than a procedural lapse. It reflects deeper structural issues within its fiscal federalism framework. The emergence of the National Fiscal Pact (NFP), though shaped by the urgency of IMF-led reforms, shows that intergovernmental cooperation is possible when the stakes are high. The NFP is not a perfect solution, but it is a timely reminder that Pakistan's existing fiscal arrangement is no longer fit for purpose. It has opened the door for rethinking outdated structures and provided a rare moment of consensus across party lines.

However, this temporary arrangement must not become a substitute for genuine, constitutional reform. Pakistan needs to seize this moment to rebuild the fiscal compact between the center and the provinces, one that upholds the spirit of the 18th Amendment while addressing today's economic realities.

The next NFC Award should be designed not just as a mechanism for dividing resources, but as a renewed social contract anchored in fairness, flexibility, and shared responsibility. To that end, it must resolve vertical imbalances by either assigning additional revenue streams to the federal government or having provinces absorb specific federal expenditures. It should also correct horizontal inequities using updated population data and additional criteria, including climate vulnerability and service delivery costs. Most importantly, the new formula must reward performance by embedding incentive-based transfers, rewarding provinces for revenue effort, governance, and better social outcomes for citizens. To support this shift, Pakistan should establish a permanent, technocratic NFC Secretariat under the Council of Common Interests (CCI), tasked with continuously analyzing fiscal data, preparing policy options, and fostering informed dialogue among stakeholders. Such an institutional body would depoliticize the NFC process, ground it in evidence, and make it a dynamic tool for cooperative fiscal federalism ensuring that both national unity and provincial autonomy are strengthened for generations to come.

On a hopeful note, the challenges of the past 15 years can be overcome by a New Fiscal Pact evolving into a New Fiscal Consensus. A data-driven, incentive-compatible sharing formula one that rewards revenue effort, addresses genuine needs, and promotes solidarity, could transform Pakistan's fiscal federalism from a source of friction into a pillar of national strength.

The time to act is now. With constructive engagement, Pakistan's federal and provincial leaders can ensure that the fiscal framework supports sustainable development, equity, and national cohesion for decades to come.



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# SPEECH OF PRESIDENT OF REFORMISTAN ON THE 11<sup>TH</sup> NFC AWARD

Dr. Nasir Iqbal

My fellow citizens

Today is a historic day in the journey of our beloved Reformistan. Standing here in the capital city of Reformistan, alongside Prime Minister, our Governors, our Chief Ministers, and the representatives of every province, I am proud to announce the 11th National Finance Commission Award — a new social contract between our federation and its provinces.

This award is not just about the division of resources; it is about the division of responsibility. It is about ensuring that every rupee collected from the people of Reformistan goes back to serve the people of Reformistan — fairly, transparently, and productively.

For too long, fiscal federalism in our country has been a matter of political bargaining rather than constitutional principle. Awards were delayed, formulas were outdated, and transfers became tools of patronage rather than engines of equity. That era ends today.

The 18<sup>th</sup> Amendment promised transformative change, but its vision was only partially realized, ministries remained largely under federal control, leading to increased national spending, and local governments were not fully revived, leaving grassroots governance disconnected. Now, we have ensured its complete fulfillment: transferring ministries to provinces to reduce federal costs, empowering provinces with true autonomy, and revitalizing local governments to bring decisions closer to the people.

Earlier this year, with the support of Parliament, we passed a landmark constitutional amendment that has changed the very foundation of fiscal devolution. This amendment introduced three fundamental reforms.

First, every province is now legally bound to announce its Provincial Finance Commission (PFC) Award annually. This ensures that money does not stop at provincial capitals but flows down to districts, municipalities, and even villages. If a province fails to announce its PFC, it will face

automatic suspension of federal transfers in the following year. This makes devolution a compulsion, not a choice.

Second, every government — federal or provincial — must publish an Annual Fiscal Report that will be reviewed by an Independent Fiscal Commission. This report will evaluate how funds were used, whether targets in education, health, and poverty reduction were met, and whether transfers were aligned with equity. Poor performance will have consequences, including reduced allocations the next year.

Third, the NFC Award will now carry a sunset clause. No more open-ended formulas lasting decades. By law, every five years a new award must be negotiated and announced, and it must be done in the fourth year of the cycle — even if an interim government is in place. Failure to announce a new formula within the stipulated time will automatically trigger the suspension of federal transfers to provinces until the new award is finalized. The discretionary power of governments to extend or carry forward an existing formula has been permanently abolished. This ensures that fiscal federalism remains dynamic, accountable, and in tune with the changing demographic, economic, and social realities of Reformistan.

These are not just procedural reforms; they are structural safeguards. They ensure that never again will our fiscal future depend on ad hoc arrangements or elite consensus alone.

Now let me turn to the formula itself. For the first time, the vertical distribution has been revised:

- The federal government will retain 45% of the divisible pool, dedicated mainly to defense, debt servicing, and federal-level projects.
- The provinces will receive 55%, constitutionally guaranteed for service delivery and local development.

The horizontal distribution among provinces has also been transformed. No longer will population alone determine the destiny of fiscal resources. Instead, we have introduced a multi-dimensional formula that reflects the realities of modern governance:

- Population (2025 Census): 50%
- Poverty and Human Development Index: 20%
- Revenue Effort: 15%

- Climate Vulnerability (Such as forest cover etc.): 10%
- Infrastructure Gaps: 5%

These weights reflect a careful balance of fairness and progress, designed to strengthen our federation. Population carries 50% because it ensures resources reach where people live, anchoring equity in the reality of our growing nation. Poverty and human development, at 20%, prioritize support for underserved regions like Balochistan and Khyber Pakhtunkhwa, breaking cycles of inequality with investments in people. Revenue effort, set at 15%, rewards provinces for their progress in tax collection relative to their own potential, ensuring smaller economies like Khyber Pakhtunkhwa and Balochistan aren't overshadowed by Punjab and Sindh's larger industrial and agricultural bases. Climate vulnerability, at 10%, directs funds to build resilience in areas hit hardest by floods and droughts. Infrastructure gaps, at 5%, address historical neglect, ensuring every region has the roads, power, and connections needed to thrive. These choices are deliberate, aligning Reformistan with a future where fairness drives prosperity.

This is a transformative step toward a stronger, self-reliant Reformistan. Provinces that have worked diligently to increase their own tax revenues are already seeing the rewards, moving away from over-dependence on federal transfers, where provincial collections once lagged. Through innovative and citizen-friendly approaches, provinces are building their own resources, fostering true fiscal independence and a more robust federation. We have already introduced reforms that prioritize simplicity, transparency, and growth. These include a uniform tax regime across all personal and non-corporate incomes, a reduced corporate tax rate of 25% to spur investment, and a harmonized value-added tax (VAT) set to gradually reach 10% to simplify compliance and build trust. We have also begun phasing out complex withholding taxes, while advancing digital tax administration to minimize direct interaction and boost efficiency.

Agricultural income remains under provincial authority, with exemptions eliminated and progressive tax rates introduced, already unlocking over Rs. 100 billion annually, complemented by a 1% rebate for corporate farming to promote efficiency and modernization. Property taxes have been reformed with inflation-adjusted capital gains, applying a 5% rate on short-term sales of open plots to encourage long-term investment and expand the tax base without hindering growth. These reforms, rooted

in fairness and predictability, are empowering provinces to drive sustainable prosperity.

This aligns Reformistan with global best practices. Countries like Canada, India, and Germany routinely revise their fiscal transfer models to account for inequality, performance, and vulnerability. Reformistan now joins their ranks with a formula rooted in fairness and foresight.

But beyond numbers, let me stress what this award symbolizes. It is the first NFC Award in Reformistan's history that directly integrates productivity and enterprise into fiscal devolution. Poverty cannot be fought with handouts alone. That is why this award mandates that provinces channel part of their transfers into Village Economic Zones (VEZs).

VEZs will be developed using existing assets — abandoned schools, basic health units, unused council offices — and converted into local economic hubs. They will integrate farmers, artisans, street vendors, and women entrepreneurs into value chains, supported by financing, training, and digital platforms. These are not charity projects. They are blueprints for sustainable livelihoods and local markets.

Furthermore, we are institutionalizing Joint Border Markets (JBMs) across districts bordering Balochistan, Khyber Pakhtunkhwa, and South Reformistan. These markets will formalize cross-border trade with Iran, Afghanistan, and other neighbors, reduce smuggling, and generate jobs in some of our poorest regions. With proper regulation, JBMs will become decentralized engines of export-led growth, creating prosperity where there was once poverty.

These innovations represent a shift from subsidies to sustainability, from transfers to transformation. My fellow citizens, fiscal reform cannot work without accountability. Under the new system, every government must publish results. Did health indicators improve? Did schools see higher enrollment? Did poverty fall? Did new enterprises emerge? For the first time, transfers will be tied to performance, not politics.

This accountability framework is historic. The Independent Fiscal Commission will publish an Annual Fiscal Report Card for each province, comparing outcomes across poverty reduction, education, health, and local empowerment. Provinces that underperform will see cuts in the

following year. This will incentivize delivery, not rhetoric.

Let me also emphasize the role of social protection. Our past reliance on large cash transfer schemes like the Benazir Income Support Program consumed hundreds of billions without creating sustainable poverty exits. Under this new framework, cash transfers will continue where necessary, but the emphasis will shift toward enterprise, assets, and local markets. Poverty will be reduced not by endless handouts, but by creating income-generating opportunities at the grassroots.

This is the Reformistan model — a model of fiscal federalism that combines equity with efficiency, compassion with productivity. In closing, I must remind us all: fiscal federalism is the lifeblood of our federation. If it is unfair, the federation weakens. If it is politicized, the federation fractures. If it is transparent, performance-driven, and inclusive, the federation thrives.

This 11<sup>th</sup> NFC Award of Reformistan is more than a fiscal document. It is a covenant between the center and the provinces, between government and citizens. It is a pledge that every rupee of the people will be spent on the people — not as largesse, but as investment in their future.

As your President, I assure you: this is the beginning of a new chapter. No more ad hocism. No more dropped catches. No more excuses. Reformistan has chosen accountability, productivity, and dignity. And together, we will build a federation that delivers. May Reformistan prosper.

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