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National Finance Commission Awards in Pakistan; It's Time for a Revisit

Functioning federal system needs a coherent, functioning and vibrant interaction between the centre and the federating units. Once the constitutional prerequisites are accomplished, the next most important condition to make a federation work is the functioning financial arrangements. Resource generation, its availability and timely utilization is what the representatives compete for in the federal and provincial governments to make their electorate satisfied and content with the representative's efforts. Thus, both the tiers are competing against each other while seeking resources, a setting that represents a trade-off. Resultantly, the efficient resource distribution mechanism calls for the ideal Pareto efficient point where no further improvement is possible without imposing a cost on the other party. This can only be achieved through a dynamic resource distribution formula.

Resource distribution in Pakistan has always remained a bone of contention. Historically, Pakistan has excessively remained a centralized federation, with the federal government having vast powers to collect revenues, leaving provinces with exhausted avenues for revenue raising. This implies two important policy lacunas. Firstly, the provinces always needed financial assistance, which federal government provided out of the excessive funds collected at the centre. Secondly, which is even more important, is that the said practice eroded provinces' capacity to raise revenues from potential indigenous resources. Till the 7th NFC award, the situation continued as the federal government distributed a manageable portion of additional resources among the federating units. However, the situation reversed in 2010, when it was decided that 57.5% of the total proceeds be horizontally distributed among the provinces while centre is left with 42.5% of the total divisible pool.

The given state of affairs though is applauded from the perspective of provincial autonomy, however, as obvious, this tilted arrangement has given birth to financial problems which is by no mean sustainable in the long run (NFC report, 2009). The NFC report by the government of Pakistan itself states that *"Under the options proposed, the overall fiscal deficit would neither be consistent with the one agreed with International Monetary Fund (IMF) nor desirable for a stable economy"*. The desired proposed options, as per NFC report, given to the stakeholders were: i) provincial share at 52.5%; and ii) provincial share at 55%. Here it is important to note that both these proposed shares are below the actual 57.5% that took effect in the NFC award.

The NFC report (2009) also elaborates that in addition to vertical distribution, the weights for

horizontal distribution were also decided arbitrarily without sufficient evidence and analysis on the implications. In addition, there are certain assumptions made while awarding the 7th NFC but these are still to be realized e.g. raising Tax to GDP ratio to 15% by 2014/15 (and onwards) and low inflation rate. Similarly, the historic lethargy in generating own revenues still continues and only the low hanging fruits like property taxes or taxes on services are pursued which resulted in double taxation. On the contrary, taxes on professions (like doctors, engineers, retail etc.) along with agricultural income tax are still to be initiated/raised to its full potential in the provinces. Similar is the case with incentivising the local taxes through PFC awards.

Moreover, the award turned a blind eye to the requirements of the centre especially related to debt servicing and defence. The current fiscal resource distribution mechanism has left the centre handicapped to take any policy initiative which is of immediate nature but have financial implications (like natural calamity in the form of Covid-19, merger of erstwhile FATA, floods, agricultural catastrophe like locust attack etc.). Moreover, the 18th constitutional amendment has also played an important role in further complicating the situation as the federal government is in a compromised situation to get into or fulfil international agreements as a number of ministries (including the environment) have been devolved to the provinces. This by no means imply that resources be centralized again but in fact a workable solution is necessary which can take care of the urgent national responsibilities as well as reward fiscal effort and discipline. Similarly, spending appropriations as per constitutional mandate and avoidance of duplication of effort needs to be checked through prudent fiscal discipline. These can only be achieved if we do away with discretionary spending and resort to evidence-based systematic transfers.

Certain provisions of the 18th amendment have also made the award inflexible in certain ways. The 18th constitutional amendment required that the provinces' share shall not be less than what is decided in 2009 NFC award. The non-flexibility clause added to the complexity and distorted the dynamism of the mechanism. This is reflected in the deadlocks experienced in the coming years, with no NFC awards because there is no incentive for the provinces to revisit as federal government has nothing more to offer. No revisiting means no reconsideration and no re-evaluation; an inbuilt inefficiency introduced through the 18th amendment which is against the spirit of the whole process.

Bottlenecks still exist and will persist until significant analysis is undertaken in this regard. With respect to resource distribution in Pakistan, three issues need attention. Firstly, what channel of vertical inter-governmental transfers does Pakistan follows? If we observe the global practices, the vertical transfers' approaches can be categorized in three: need based, equity based and efficiency based. Usually, the transition happens in the same order as mentioned and is tied with the stages of development. Where does Pakistan stand and should it continue with the existing stage or graduate from it; is an academic question. If Pakistan has to move to next level, then when and how, is what needs a thorough analysis. This analysis is highly likely to have political sensitivities attached to it and would not be based on sheer economic thinking. There is also need to shed some light on the political economy of NFC as well. The unanimity rule being adopted for approval of the NFC also has led to recurrent deadlocks so we need to find a way out. In short, we need to look for out of box solutions for future allocations by having deliberations to further the debate.

Policy Perspective

To conclude, the 7th NFC award was a bold step in Pakistan's resource distribution history, however, the situation demands further analysis to search for an optimal resource distribution mechanism where no one can externalize their inefficiencies upon the other member of the federation. The New formula is needed which can induce the centre and provinces to put in their maximum effort for optimal resource generation and to ensure spending efficiency in order to achieve the highest possible shared prosperity. The required mechanism would need best analysis to assess the needs of the population as well as the potential of the jurisdiction so that no one gets a free lunch. The new NFC formula is required not only to satisfy the expenditure needs (in wake of population needs or cost disabilities) but also to have sufficient incentives to reward efficiency and efforts.