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NFC AWARDS
Commentary and Agenda

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Abstract. The paper reviews the evolution and working of NFC Awards since its emergence in 1951. Intergovernmental fiscal transfers are a cornerstone of the provincial governments financial system in Pakistan. The 1973 Constitution establishes the basis of transfers of revenues between the federal and provincial governments of Pakistan, whereas additional financial requirements of the provinces are met by grants in aid, subsidies, advances etc. Considering the importance of revenue sharing the Constitution under Article 160 establishes the periodically setting up a National Finance Commission (NFC) to operate the divisible pool. The purpose of NFC Awards is to support provincial governments financially to meet the expenditure liabilities. There have been seven NFC Awards since 1951 and the eighth is underway. The format of revenue sharing arrangement is required to revise every five years. With the exception of 1974 Award, the trend showed a continued increase in the revenue transfers to the provinces. NFC Award 1974 was achieved by sharing fewer taxes which later during 1991 Award were expanded with the inclusion of new taxes, especially excise duties on some commodities in the divisible pool. Later on in 1997 it was further expanded by including the royalty and development surcharges. NFC Award 1997 was adopted on population basis to the detriment of Sindh, NWFP and Balochistan. Now all the three provinces demand adoption of a balanced approach while dealing with the NFC Award 2004 in order to be fair with all the provinces. The 1991 NFC Award represents a big step forward in the process of the decentralization in the country. It rationalizes the intergovernmental fiscal relations and improves the financial position of the provinces and also gives them considerably more autonomy. However, full benefits could not be achieved as the provinces were not motivated to mobilize their own resources. It is recommended to the National Finance Commission for the upcoming NFC Award 2004 to find a formula which is acceptable to the central government as well as to four provinces to divide and allocate the country's earnings.

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I. INTRODUCTION

Intergovernmental transfers constitute a cornerstone in the Pakistan's provincial financing system. The NFC is formed to take care of the initial imbalance, that is, to support provincial government financially to meet their expenditure liabilities and secondly to alleviate horizontal imbalances, the depending in the revenue capacity of the constituent units of the federation. For this the constitution of Pakistan has formed a mechanism of revenue sharing between the federal and provincial governments. This format of revenue sharing arrangements is required to revise every five years. The allocation of means and responsibilities among different tiers of government is a critical issue as its misappropriation may lead to political, economical and social unrest. In this section, we will summarize the issues in intergovernmental fiscal transfer in developing countries. Pakistan is a federation comprising of federal government, four provinces and federally administered areas. Due to inter-provincial disparities in income distribution, capabilities in tax collection and expenditure disbursement there is a strong need for the fiscal arrangement between the federal and provincial governments.

The following reasons can be given for fiscal transfer in Pakistan:

The first reason in favour of allocation of means and responsibilities rest on the assumption that federal government is relatively efficient in collection of revenue or disbursement of expenditure. For example, federal government operates in a relatively open economic environment and may be efficient in undertaking major expenditure projects but may be inefficient in undertaking small projects. Federal government may also have reasonable infrastructure and efficient tax machinery to collect major taxes but may be economically inefficient to collect smaller taxes. Provincial level government, on the contrary, do not have necessary infrastructure and, therefore, unable to collect larger taxes and may be very efficient in collecting taxes of small and local base. Hence, the allocation of means and responsibilities must be based on the efficiency criterion.

The second reason is based on the fact that sub-national governments may lack the resources need to finance basic levels of local public service that may be regarded as the minimum requirement for civilized existence. The responsibilities of revenue generation and service provision are unequally distributed between the federal, provincial and municipal governments in Pakistan. On the average in last 10 years, out of the total revenue generated, 89 percent accrued to the federal government while the share of provincial and municipal governments was 5 and 6 percent respectively. Compared to the share of different tiers of government in resource mobilization, the allocation of functional responsibilities appears to be somewhat more balanced. The federal government incurs 74 percent of total recurring expenditure followed by provincial governments with 23 percent and local governments with 4 percent. The share of these governments in development expenditures, on the other hand, is 65, 29 and 6 percent respectively. This skewed distribution of allocation of functions with very limited own resource generation creates strong need to transfer resources from federal to provincial governments. On the other hand, taxes on mobile factors of production, residence-based taxes, such as excise, taxes on completely immobile factors and benefit taxes and user charges can be levied appropriately by all levels.

The third reason for allocation of government function is for services whose externalities cannot be confined to the boundaries of an individual state or services whose costs and benefits cannot be aligned area-wise within a state should be allotted to the centre. On the other hand, services whose provision requires an accommodation of local peculiarities, needs and aspirations should be in the hands of the states.

The fourth reason that can also be advocated for the allocation among different governments is known as adequacy of revenues. By adequacy we mean not only a capacity of a level of government to produce a given initial amount of revenues but also its capacity to sustain it in such a manner as to permit the maintenance of a given volume and quality of governmental services. In Pakistan, the provincial governments have very limited capacity to finance projects and their capabilities are further limited to finance the maintenance of large projects.

The fifth reason is that there is a case for sharing of other taxes which are provincial in character but which have been pre-empted by higher levels of government. The examples are income tax and sales tax.

The sixth reason for intergovernmental transfers is that the taxes suitable for overall economic stabilization should be controlled by the federal government.

Rest of the paper is organized as follows. Section II explains the intergovernmental fiscal arrangements in Pakistan. Section III summarizes the evolution of NFC Award followed by section IV which discusses the major economic issues. Section V gives the conclusion and suggestions.

II. INTERGOVERNMENTAL FISCAL ARRANGEMENTS

The intergovernmental fiscal transfer is a prominent feature of the public finance structure of Pakistan. These transfers either take the form of revenue sharing, straight grants and loans. In Pakistan, financial resource transfers take place at four stages: first, from the federal government to the provincial government; second, from provincial government to the local governments; third, from federal to local; and fourth, from local to local governments.

These different types of flow of funds that take place are described below:

1. Revenue Sharing Transfers

Taxes collected by a federal government are shared with a lower level of government. The magnitude of flow of such funds depends upon the coverage (divisible pool) of the revenue sharing arrangement of taxes. In addition share of revenue from a specified source is to be given to the lower level of government according to prescribed arrangements. This latter includes royalty and surcharge on the exploration of national gas, oil and electricity.

2. Recurring Grants

The higher level of government may subsidize a particular activity (e.g. primary education) being undertaken at lower level through grants-in-aid so as to ensure an adequate level of provision. Alternatively, the latter may take on the responsibility of financing the overall recurring account deficit, especially if the lower level of government is constrained from bank or non-bank borrowing to cover this deficit.

3. Development Grants/Loans

The higher level of government may also make specific or block development grants to the lower level of government that either to raise the overall level of development expenditure or to increase coverage of a particular services. In addition, some of the development is also financed through loans. Usually this transfer of funds takes place out of the Annual Development Programme (ADP) of the higher level of government.

4. Loans

Transfers from federal to provincial government also take the form of soft loans. Debt servicing on these loans, however, represents a reverse flow of funds from the lower to the higher level of government. It consists of the interest and principal repayment component of past loans. Another reverse flow is revenues which accrue to the higher level of government from surcharges levied on taxes of the lower level government.

III. EVOLUTION OF NFC AWARD

Before independence, even on the eve of independence, the financial relations between the centre and provinces (government) were governed by the Government of India Act, 1935. The constitutional responsibilities of the federal government and the constituent units as well as on the distribution of revenues between various component units was specifically laid down in the Act.

Since independence (1947) seven revenue sharing awards have been announced in Pakistan. Raisman Award being the first in 1951, later followed by 1961-62, 1964, 1970, 1974, 1991 and 1997 Award. Two NFC were appointed in 1979 and 1985, but no award was announced due to lack of consensus among the members of the commission.

Under the 1973 Constitution of the Islamic Republic of Pakistan, the federation and the provinces had, in addition to their exclusive sources of revenues, a divisible pool comprising the net proceeds of specified taxes which is shared by all the provinces. The federal government meets the additional requirement of the provinces through various special transfers such as grant-in-aid, subsidies subvention, assistance, emergency relief and federalization of functions. Giving the importance and complexity of revenue sharing the Constitution provides (under Article 160) for setting up the NFC periodically to recommend on the operation of divisible pool, borrowing powers, grants-in-aid and other such matters.

Table 1 gives the composition of the share of the divisible pool, taxes shared between the federation and the provinces combined in various awards. There have been seven different awards in the country since 1951 and the eighth is underway. With the exception of 1974 Award, the trend is continued increase in the revenue transfers to the provinces as highlighted in the bottom line of the table. NFC Award 1974 was adopted on the population basis to the detriment of Sindh, NWFP and Balochistan. Uptill 1974 Award this was achieved by sharing fewer taxes which later in the 1991 Award were expanded with the inclusion of new taxes, specially excise duties on some commodities in the divisible pool. The 1997 Award that is now effective was further expanded by including the royalty and development surcharges. All taxes have been included in the divisible pool but the provincial share of the taxes has been reduced.

TABLE 1

Revenue Sharing Arrangements under Various NFC Award

(*Provincial share in percentage*)

Divisible Pool	Raisman 1951	NFC 1961-62	NFC 1964	NFC 1970	NFC 1974	NFC 1990	NFC 1997
Income Tax and Corporation Tax	50	50	65	80	80	80	37.5
Other Direct Taxes							37.5
Sales Tax	50	60	65	80	80	80	37.5
Excise Duty							37.5
• Tea	50	60	65	80	–	–	
• Tobacco	50	60	65	80	–	80	
• Sugar	–	–	–	–	–	80	
• Betelent	50	60	65	80	–	–	
Export Duties							37.5
• Cotton	–	100	65	80	80	80	
• Jute	62.5	100	65	80	–	–	
Import Duties							37.5
Estate/Succession Duties	–	100	–	100	–	–	37.5
Capital Value Tax on Immovable Properties	–	100	–	100	–	–	37.5
Petroleum Surcharge							100
Gas Development Surcharge							100
Divisible Pool Transfers as % of Federal Tax Revenue	12.8	23.1	2.7	53.4	29.8	35.3	37.3

Source: NFC Report.

Table 2 gives the summary of the share assigned under different awards indicating a close relationship between revenue share and population share. In the 1951 Raisman Award both Punjab and Balochistan got the share lower than they were entitled to on the basis of their population. While Sindh and NWFP got higher shares than their population shares. Later on again in 1970

NFC Award the pre-assigned share of Punjab was lower than its population share while that of the other provinces was higher. The shares almost exactly match the population share from the 1974 Award and onwards. In addition, the 1991 NFC extended the principle embodied in Article 161 of the Constitution which provides for transfer of royalty on natural resources to the province of origin by the inclusion of surcharge of natural gas and royalty on crude oil. As such, here has been an effort towards decentralization of the fiscal base and greater transfers to the provincial governments in Pakistan which have over the years played an increasingly important role in the provision of basic social and economic services like education, health, irrigation, road etc. in the country.

TABLE 2

Assigned Shares to Provinces under Various NFC Awards

Province	Raisman 1951	NFC 1961-62	NFC 1964	NFC 1970	NFC 1974	NFC 1990	NFC 1997
Punjab	59.39 (63.58)	–	–	56.50 (62.23)	60.25 (60.10)	57.87 (57.87)	57.88 (57.88)
Sindh	24.14 (18.71)	–	–	23.50 (20.45)	22.50 (22.62)	23.29 (23.29)	23.28 (23.28)
NWFP	15.32 (14.10)	–	–	15.50 (14.01)	13.39 (13.40)	13.54 (13.54)	13.54 (13.54)
Balochistan	1.15 (3.61)	–	–	4.50 (2.31)	3.86 (3.88)	5.30 (5.30)	5.3 (5.3)
Total	**100**	**–**	**–**	**100**	**100**	**100**	**100**

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

From the share of the former West Pakistan.

Including the State of Bahawalpur.

Including the State of Khairpur.

Not applicable because provinces were merged into one unit.

Table 3 presents the evolution of the revenue sharing formula under the initial award. The principle of allocating revenues on the basis of collection was formed. The sales tax was distributed fully on the basis of collection from the provinces (except Karachi Seaport). It was distributed among the federated units on the basis of pre-assigned shares. In the 1970 Award, distribution based solely on population shares of the provinces.

TABLE 3

Revenue Sharing Formula under NFC Awards

Award	Tax	Sharing Criteria (Weight)
Raisman 1951	Sales Tax Income Tax and Excise Duties Export Duties	Collection (100%) Pre-assigned Shares (100%) Pre-assigned Shares (100%)
NFC 1961-62	Sales Tax	Collection (30%) Pre-assigned Shares (70%)
NFC 1964		
NFC 1970	Other Taxes	Pre-assigned Shares (100%)
NFC 1974	All Taxes	Population (100%)
NFC 1990		
NFC 1996		

The basis framework for the management of public finance, division of financial powers and distribution of revenues between the federation and the provinces is laid down in the Constitution. It appears that the divisible pool between the federation and the federating units has been evolved within the broad, highly progressive manner to promote fiscal decentralization. This was followed by strengthening the resource base of the provinces and making them more dynamic service delivery agencies in the country.

1991 NFC AWARD

Under this award 80 percent of the net proceeds of divisible pool taxes, *viz.* income tax, sales tax, export duties on cotton, excise duty on tobacco and tobacco manufactures and excise duty on sugar were transferred to the provinces on the basis of their population according to the 1981 Census.

In addition the 1991 NFC extended the principle embodied in Article 161 of the Constitution which provides for transfers of royalty on natural resources to the province of origin by the inclusion of surcharge on natural gas and royalty on crude oil. Under these awards there has also been a great effort to decentralize the fiscal base and increase transfers to the provincial governments in the country. Straight transfers assigned greater importance in the intergovernmental arrangement in Pakistan after 1991 NFC Award.

1997 NFC AWARD

The 1997 NFC Award formed the basis of more sophisticated intergovernmental fiscal transfers mechanism. It is different from the previous awards in many ways and introduced new ideas. It has redefined the federal divisible pool and the revenue sharing formula. The features of this Award are highlighted below:

1. Distribution of Revenues

The 1997 Award included all the taxes in the divisible pool and changed the federal and provincial shares to 62.5 percent and 37.5 percent respectively. Taxes included are: (*a*) taxes on income, (*b*) wealth tax, (*c*) capital value tax, (*d*) taxes on sales and purchases, (*e*) export duties on cotton, (*f*) customs duties, (*g*) federal excise duties excluding the excise duty on gas charged at wellhead, and (*h*) any other tax which may be levied by the Federal Government.

2. Allocation of Shares to the Provincial Governments

The sum assigned to the provincial governments under Article 3 shall be distributed amongst the provinces on the basis of their respective population in the percentage specified against each:

Punjab	57.88%
Sindh	23.28%
North-West Frontier Province	13.54%
Balochistan	5.30%
Total	100.00%

3. Payment of Net Proceeds of Royalty on Crude Oil

Each of the provinces shall be paid, in each financial year, a share in the net proceeds of the total royalties on crude oil, an amount which bears to the total net proceeds the same proportion as the production of crude oil in the province in that year bears to the total production of crude oil.

4. Payment of Net Proceeds of Development Surcharge on Natural Gas to the Provinces

Each of provinces shall be paid, in each financial year, a share in the net proceeds of surcharge on natural gas, an amount which bears to the total net proceeds the same proportion as the wellhead production of natural gas in the province in that year bears to the total wellhead production of natural gas.

5. Grants-in-Aid to the Provinces

These shall be charged upon the federal consolidated fund each year, as grants-in-aid of the revenues of the provinces (for the period) specified against each, an amount as specified under:

Province	Period	Amount
North-West Frontier Province	For 5 Years	Rs. 3310 million
Balochistan	For 5 Years	Rs. 4080 million

NOTE: The grants-in-aid will be increased annually by 11 percent subject to subsequent adjustment in line with the actual rate of inflation for each year.

6. Matching Grants to Provinces

Whereas the provincial governments achieve a minimum growth of 14.2 percent in provincial receipts with fiscal efforts which include increase in tax rates, withdrawal of exemptions, imposition of new taxes and revision in rates of user charges, as ascertained and certified by the Auditor General of Pakistan, the Federal Government will pay to each province in the subsequent year, the matching grant subject to the maximum limits specified below:

Punjab	500 million
Sindh	500 million
North-West Frontier Province	100 million
Balochistan	100 million

ANALYSIS OF 1997 NFC AWARD

In 1991 NFC the difference between the projected figures of transfer and the actual transfer was not big (Government of Pakistan, Report on 1991 NFC). However, very large variation has been observed in last four years between the projected and the actual figures given in the 1997 NFC. This ranges from –21 billion in the first year of the award to –53 billion in 1999. Table 4 presents the revised shares as a percentage of total projected transfers. NWFP is the worst, receiving limited funds of 50 to 60 percent lowest. Balochistan receives more than the expected amount as high as 125 to 119 percent, which has left a limited amount of funds to other provinces. It resulted in forcing other provinces to borrow in order to meet their expenditures.

TABLE 4

Revised as Percentage of Projected Total Transfers under NFC 1997

Year	Total	Punjab	Sindh	NWFP	Balochistan
1997-98	78.79	76.96	97.11	52.41	125.90
1998-99	73.71	66.99	81.66	62.73	117.23
1999-2000	74.75	66.04	89.77	59.42	119.78
2000-01	80.00	70.31	98.02	61.58	130.99

Transfers include federal tax assignment plus straight grants.

The following reasons may be presented for this variation:

1. Due to world recession the prices of imports declined drastically. As a result the import tax collection went down which reduced the overall size of divisible pool.
2. Due to domestic recession the output in the economy fell and due to this reduction the collection of income tax and sales tax was reduced which reduced the transfer from federal to provincial governments.
3. Due to supply side tax concessions introduced by Nawaz Sharif Government in 1997-98 the divisible pool was further shrunk.
4. The actual inflation rate was less than the rate projected by NFC to adjust various allocations.

As the funds from the divisible pool are distributed on the basis of population, therefore, reduction in the divisible pool size affects larger provinces the most. This was the case with the last NFC Award when due to the world and domestic recession the divisible pool shrunk; Punjab, the most heavily population province, was adversely affected. According to the 1997 NFC Award the provinces were getting only 36.5 percent while the centre was getting the rest of 63.5 percent. The NWFP and Balochistan were also demanding funds on the basis of poverty. Poverty ratio is 44 percent in NWFP and 37 percent in Balochistan. However, no new formula was formed. Though the 1997 NFC Award was not updated, the share of the provinces was raised by the military government from 37.5 percent to just over 40 percent to finance district governments. On the other hand, the provinces were given a mandate to share roughly 40 percent of tax receipts from the divisible pool with the district governments.

IV. ISSUES IN INTERGOVERNMENTAL FISCAL TRANSFERS

In this section we will discuss very briefly the consequences of using different methods of fiscal transfer on the fiscal efforts and regional imbalances of provincial governments. The two broad instruments are (*i*) divisible pool and straight transfer and (*ii*) grants which include matching or non-matching block grant, matching or non-matching specific or categorical grant and deficit grant.

DIVISIBLE POOL

The first and foremost instrument of fiscal transfer from national to sub-national government is the constitutional requirement of distribution of government's revenue pool. There are two important issues arising out of the discussion of divisible pool. First, what taxes and non-taxes should constitute the divisible pool and, second, how this pool should be distributed between different levels of government. The provincial share in the divisible pool is determined by the fiscal space that the federal government is able to create after meeting its own expenses particularly in two priority areas, defence and debt servicing. Regarding the first issue it can be argued that all taxes which fall within the fiscal power of two levels of government should be included in the divisible pool and an efficiency criteria should be used for collection purposes. However, if one level government collects the revenues and then transfers it to the other government it raises the problems of sincerity of effort and of accountability. For example, in Pakistan both excise duty and sales tax were imposed. Excise duty was not part of the divisible pool whereas sales tax was. Since the revenue collection, equity and efficiency of both taxes are same, the federal government preferred to impose the sales tax. This problem was however resolved in 1996 NFC when all taxes were made part of the divisible pool.

However, in designing 1997 Award a tendency appeared to increase the share of revenue sharing transfer at the expense of grant. The share of such transfer was increased from 45 percent in 1988-89 to more than 75 percent in 1998-99, after all taxes were included in the divisible pool. This switching from grants to revenue sharing is a positive step which increased transparency, simplicity and predictability of intergovernmental fiscal arrangements in Pakistan.

TABLE 5

Revised Projected Percentage of Tax Transfers to the Provincial Government

Year	Total	Punjab	Sindh	NWFP	Balochistan
1997-98	84.77	76.64	96.75	74.51	147.06
1998-99	73.64	66.86	82.19	65.26	132.24
1999-2000	72.84	64.97	85.23	62.85	130.63
2000-01	79.76	NA	NA	NA	NA

Sources: 1. Explanatory Memorandum on Federal Receipts.
2. Federal Budget in Brief.
3. Report of National Finance Commission 1996.
NA Data are not published.

If the federal government transfers revenues from divisible pool, it will increase the permanent income of the provincial and that in turn will affect both the revenues and expenditures pattern of these governments. Several possible scenarios may arise. First, increase in transfer through divisible pool might slacken the fiscal efforts of provincial governments. Second, increase in transfer may also change the expenditure patterns which may increase non-development expenditures. In both cases the fiscal deficit of provincial government will persist and will have a tendency to increase further. Alternatively if the increased transfer is being used for development purposes then it is likely to increase the tax potential of provincial governments in future which will and subsequently requires less grants. In Pakistan, it has been observed in past that the increase in federal transfers increases the non-development expenditures of the provincial governments. This tendency has been more obvious in the most underdeveloped province of Balochistan. The second issue regarding fiscal transfer is how the tax pool should be distributed between the national and sub-national governments. Generally, for the revenue sharing, a population formula, derivation formula, inverse income formula, distance formula, index of backwardness formula and minimum responsibilities formula are used. However, in Pakistan, the transfer is very simple in which the whole divisible pool is distributed among the provinces on the basis of population and all straight transfers are distributed on the basis of collection. In Pakistan, population is concentrated in two provinces, Punjab and Sindh. The endowment of natural resources is also skewedly deposited with gas in Sindh and Balochistan, electricity is concentrated in NWFP and oil mostly in Sindh and Balochistan. If only population criterion is used for the allocation of divisible pool it might widen the disparities already prevailing in the country. Similarly if only collection formula is used it will leave very little for the backward provinces. Therefore, in order to have equitable distribution of resources it is necessary that backwardness must be given high weight by national government in the allocation from the divisible pool. For example, in Pakistan, divisible pool is distributed on the basis of population, therefore, only Punjab (58%) and Sindh (28%) are the main beneficiaries, whereas the Balochistan Province which covers more than 40 percent of the area gets only 6 percent of resources. Due to very large areas the unit cost of provision of services is very high and the share of divisible pool is insufficient to cover it.

Since the divisible pool is distributed on the basis of population, therefore, any shrinking in the divisible pool affects larger provinces more severely. This happened with the 1997 Award when due to world and domestic recession the divisible pool shrunk. The more densely populated province, Punjab, was most adversely affected followed by Sindh. Balochistan was least affected.

STRAIGHT TRANSFERS

The second instrument of federal transfers to the provinces is straight transfer. These show better picture of the divisible pool. In this head the figures for last four years show that the actual transfers are closer to the projected transfers. For first four years the projected transfer was 115 billion. Against this projected figure 106 has been transferred according to revised figures. Straight transfers assumed greater importance in the intergovernmental arrangements in Pakistan after the 1991 NFC Award. The straight transfer is based upon the exploration of new natural resources share that is the most beneficiary of 1997 NFC. Table 6 presents the picture of straight transfers.

GRANTS

The second instrument of revenue transfer from national to sub-national governments comprises of grants. There are several types of grants through which resources shift from federal to provincial and local governments. Among them are block grant, matching grant, specific or categorical grant and deficit grant. A non-matching block grant can be used for any purpose. But usually in most of the developing countries, it is being used to pay the salaries of the employees of the councils. Matching or non-matching specific grants are those which are provided by the federal government for specific purpose with or without raising the matching fund by the local government.

TABLE 6

Revised as Percentage of Projected Province Wise Straight Transfer

Year	Total	Punjab	Sindh	NWFP	Balochistan
1997-98	86.07	88.76	98.66	63.67	97.48
1998-99	73.80	72.63	79.19	57.33	95.95
1999-2000	86.37	98.98	112.60	51.62	103.24
2000-01	113.37*	NA	NA	NA	NA

*2000-01 Budget Estimates available (2000-01).

Straight Transfers

1. Punjab
   (*a*) Excise duty on Natural Gas
   (*b*) Royalty on Natural Gas and Crude Oil
   (*c*) Surcharge on Natural Gas (share of net proceeds assigned to provinces)
   (*d*) Profit and Plus Electricity
2. Sindh
   (*a*) Royalty on Crude Oil
   (*b*) Excise duty on Natural Gas
   (*c*) Royalty on Natural Gas
   (*d*) Surcharges on Natural Gas
3. NWFP
   (*a*) Profit and Electricity Estimates
4. Balochistan
   (*a*) Federal Excise Duty and Royalty on Natural Gas Transfers
   (*b*) Surcharges on Natural Gas

Sources: 1. Annual Budget Statement, All provinces.
2. Report of National Finance Commission 1996.
NA Data are not published.

Generally the purpose of the specific grant is productive and known as development grant and given for education and health purposes. As can be seen in Table 7 no specific grant is given to the provinces of Sindh and Punjab as these are in better share than NWFP and Balochistan.

Matching specific grants may give an incentive to the local government to generate own resources to attract matching grant. However, the benefits of the matching grant are regressive in nature as the richer local councils have more access to matching grants. This grant, especially the open-ended matching grants, can increase the supply of public goods by the lower level government. It also tackles the problem of benefits externalities. This situation arises when one local government finances and provides a service but it also benefits the residents of the other local council which does not contribute in financing of the service. Matching grants are more effective than the block grant. This happens because the block grant has only income effects but the matching grants have both income and substitution effects. For example, if the higher government is providing matching grants for education, then the local government will provide more education because, first, due to income effects of grant this local council is richer now and, second, due to the substitution effects the education is cheaper commodity than other services.

TABLE 7

Revised Percentages of Projected Province Wise Special Grants

Year	Total	Punjab	Sindh	NWFP	Balochistan
1997-98	117.57	–	–	100.54	100.12
1998-99	112.20	–	–	100.02	100.18
1999-2000	205.50	–	–	123.25	104.28
2000-01	158.42*	–	–	–	–

* Budget Estimates (2000-01).

– Grants projection estimates are not available.

Sources: 1. Annual Budget Statement of all provinces.

2. Report of National Finance Commission 1996.

a This includes the octroi and Zila grant.

It is believed that due to the matching requirements of conditional grants the sub-national governments often induce to neglect activities that do not receive federal funds in favour of those that are federally supported. In such a way it ‘distorts’ the budgets of state and local governments by inducing changes in the expenditure patterns. However, the matching grant may be framed in such a way that lower level governments should respond to federal grants, not by ‘distorting’ at least their development expenditures. The third type of grant is known as the deficit grant. This grant is provided by the national government to the sub-national government, if their budgets are in deficit. The purpose of this grant is to fill the deficit of the lower government, therefore, naturally it has the tendency to have adverse impact on the fiscal efforts of the sub-national government. For the sake of discussion and with the courtesy of Shah (1993) we summarize below the main principles to deal with the fiscal gaps of sub-national governments through different types of fiscal arrangement.

Shah (1993) has identified criteria for the design of intergovernmental fiscal arrangements. The first criterion is ***autonomy***. Ideally transfers should honour the independence of sub-national governments in setting their own expenditure priorities. General transfers score the highest on this criterion. The second criterion is ***revenue adequacy***. Transfers should be adequate to cover both vertical and horizontal imbalances of sub-national governments to the extent possible. The third requirement is of ***equity***. Allocated funds should vary directly with fiscal need and inversely with the taxable capacity of each province. The fourth criterion is ***predictability***. The quantum of flow of funds should be known in advance so that recipient governments can plan with a degree of certainty. A related criterion is that of ***simplicity***. A sub-national government's allocation should be based on objective factors over which individual units have little control. The last criterion is that the transfers should create appropriate ***incentive*** for sound fiscal management and, if possible, promote fiscal effort and control over expenditure. For example, there should be no transfer to finance deficits of sub-national governments.

IMPLICATIONS OF TRANSFER ON MAJOR ECONOMIC ISSUES

1. Regional Imbalances

Though 1991 NFC Award has benefited all the four provincial governments in Pakistan, the extent of benefit varies significantly across provinces. For example, the biggest province Punjab is among the major beneficiaries while a less developed and backward province NWFP has gained the least. This anomaly is perhaps a consequence of the lack of innovation in the revenue sharing formula and the exclusion of important considerations like backwardness, urbanization, land area etc. This situation has been exacerbated by the special grant structure announced which reverses the earlier practice when special grants were given to the two smaller provinces largely in recognition of their relative backwardness. If this imbalance on the recurring side is to be removed and horizontal equity across provinces ensured in future, it is important that development fund transfer to the provinces through the ADP should be based on an improved formula which takes into account regional imbalances so that the improvement in provincial finances can be sustained over time.

2. Decentralization

The 1991 NFC Award represents a big step forward in the process of decentralization in Pakistan. However, for the process of decentralization to be meaningful along with the purse strings, regulatory controls will also have to be released by the federal government. As such, there is a strong case for winding up of federal ministries in areas like education, health, housing, agriculture, local government and rural development etc. which essentially relate to provincial functions. Instead inter-provincial coordination functions could largely be performed by the Planning Commission. Simultaneously, all functions in the concurrent list of the Constitution, which had been taken over by the federal government, should be transferred back to the provinces. This includes university education, fertilizer subsidy, flood control, highways etc. Not only will this strengthen the provincial governments but it will also relieve the federal budget of the burden of expenditure on these functions. Given the improved financial position of the former they should be in a position to take on all functions constitutionally allocated to them. On top of all this, it can be argued that the process of decentralization and devolution of functions will be incomplete if simultaneously relationship between the provincial and local governments is also not altered. However, the former has not only encroached on the functions of the latter but they have also pre-empted their fiscal powers. After 1991 the provinces are better off financially. They should be willing to establish a system of grants and revenue sharing arrangements with local governments in taxes like motor vehicle tax, professions and callings tax etc. and involve them increasingly in the provision of local service like primary education, curative health, law and order etc. Strengthening of local governments is the last remaining step in the process of decentralization. Without this, the goal of involving people in the management of their affairs will remain largely unfulfilled.

3. Fiscal Effort

Despite change in the pattern of intergovernmental fiscal relations brought about by the NFC, there was a danger that the provinces may slacken further their fiscal effort and increase their current expenditure more rapidly to absorb the short run surpluses that they will enjoy following the award. Given the macro resource constraints that the country faces it was important that the provinces also economize on resources and play a role in the mobilization of additional resources. The NFC Award has made reference to the recommendations of the Tax Reforms Committee regarding generation of higher revenues from provincial source. The Committee had demonstrated that provincial own revenues can be almost doubled in three years by exploration of the revenue potential that currently exists in sources like the property tax, motor vehicle tax, irrigation charges, stamp duties etc. Even in the absence of discretionary changes in divisible pool, taxes by the federal government, the overall surplus on the revenue account of the four provinces combined in 1991-92 was Rs. 7 billion. If this amount was used in the development purposes the future tax capacity of the provinces would have been increase. But in all provinces, with different degree, the surplus was used for non-development purposes. For this reason, after two years of NFC Award, provincial budgets again went in deficit. Also an incentive mechanism may be instituted in the ADP allocations to the provinces whereby matching development grants are given to provinces equal to the additional revenues generated by them from their respective taxation proposals. This will ensure that the higher taxation is translated into higher level or better provision of services. The provinces will then find it politically more attractive to develop their own sources.

V. CONCLUSION AND SUGGESTION

Since independence six revenue sharing awards have been announced in Pakistan. The 1991 Award, which was due in 1979, was announced after a delay of twelve years. Two NFCs were appointed in 1979 and 1985 but no award was announced due to probably lack of consensus amongst members of the Commission. In 1991 the divisible pool was expanded through inclusion of new taxes. The 1974 NFC Award was adopted on the population basis to the detriment of Sindh, NWFP and Balochistan. It was quite natural that all the three provinces now demand adoption of a balanced approach while dealing with the 2004 NFC Award in order to be fair to all the provinces. However, Punjab is not prepared to follow any formula other than population. Sindh demands for multiple criteria and stands for the principle of revenue generation capacity. It has been pressing for this point ever since 1974 when the first NFC Award was declared. Sindh's argument is that the revenues generated in the province are mostly consumed in Punjab and other provinces. The NWFP demanded NFC Award on the basis of backwardness and Balochistan takes the old stand that area should be the basis. It can be said that the 1991 NFC Award represents a big step forward in the process of decentralization in the country. It rationalizes intergovernmental fiscal relations and not only improves the financial position of the provinces but also gives them considerably more autonomy. However, the full benefits could not be reaped because the provinces were not motivated to mobilize their own resources and the process of decentralization down to the level of the local governments was not achieved. However, the higher growth rate reflects, first, the impact of the frequent pay revisions announced by the federal government and, second, the very rapid growth in expenditure on law and order of over 27 percent annually by the government of Sindh in response to the problems in Karachi.

- The provincial governments were asked to self-finance a component of their development programmes.
- Provincial revenues from own sources have not demonstrated the same buoyancy as in the period prior to the announcement of the 1991 NFC Award.
- Part of the fall in the growth rate is due to the poor performance of the largest source of revenue, *e.g.* stamp duty in Punjab due to slump in the real estate market in the province. Whereas other taxes like motor vehicle tax, tax on professions, trade and settings etc. excises, have shown greater buoyancy despite the fact that the growth rate of the economy has declined in the 1990s and many tax basis have been stagnant specially in Sindh.

The growth rate of development expenditure has declined to 14 percent after 1991, from 15 percent prior to 1990-91. During the last four years prior to the award, provinces accumulated a revenue deficient of about Rs. 12 billion. This situation improved dramatically four years after the award. During these four years, *i.e.* 1991-92 to 1994-95, provinces successfully granted a combine revenue surplus of Rs. 23 billion, thereby reducing their dependence on federal development loans and as it was diverted to finance activities in the provinces.

In short, the post-1991 NFC era is not one of total success but one in which gradually steps are being initiated in the right direction and the provincial finances are being placed on a sounder footing. Hence, for the derived results in the structure of provincial finance to take place, it is important that the environment created by the 1991 NFC Award should remain intact.

It can safely be stated that the 1991 NFC Award resulted in some favourable structural changes in provincial fiscal behaviour which if carried over could lead to substantial improvement in provincial financial management. The substitution if mandatory, revenue account transfers for distorting *ad hoc* grants and development loans will encourage economy in provincial expenditure increase in provincial own fiscal effort and higher self-financing in provincial development programmes. Simultaneously, decline in cash development loans has implied lower debt servicing liability for the provinces. The provinces are demanding 50 percent of the share from the federal divisible pool which is unacceptable to the Federal Government.

The last NFC recommended the President that the divisible pool should consist of taxes which include (*i*) taxes on income including corporation tax but not including taxes on income consisting of remuneration paid out of the Federal Consolidated Fund, (*ii*) Wealth Tax, (*iii*) Capital Value Tax, (*iv*) taxes on the sales and purchases of goods imported, exported, produced, manufactured or consumed, (*v*) export duties on cotton, (*vi*) custom duties, (*vii*) federal excise duties excluding the excise duty on gas charged at wellhead which will represent a straight transfer to provincial governments on the basis of collection and (*viii*) any other tax which may be levied by the Federal Government. The provinces were allowed, in the 1991 Award, the following share in the divisible pool on the basis of population according to the 1981 Census: Punjab 57.88 percent, Sindh 23.28 percent, NWFP 13.54 percent and Balochistan 5.30 percent. The NFC Award that Nawaz Sharif Government hammered out in 1991 was projected at that time to be a consensus document but later when Nawaz Sharif Government was ousted in 1993, Punjab and Sindh raised several objections to the formula. From the Punjab's point of view, Rs. 9.5 billion allotted to the NWFP was far in excess of what the province actually should have received according to its population. Punjab believes that its share of Rs. 11 billon is not in commensurate with the ratio of its population and contribution in the divisible pool of taxes. These issues are not easy to resolve. For the upcoming NFC Award the National Finance Commission (NFC) is supposed to find a formula acceptable to the federal government as well as the four provinces to divide and allocate the country's revenue earnings. The current formula is based on the population figures of the four provinces. The Government of Punjab wants the current formula to continue for another five years while the governments of the NWFP, Sindh and Balochistan want to review the basis of allocation. Also the problem of dividing the revenue is not new. It started with the creation of Pakistan and the first financial award was given in December 1947 by Sir Jeremy Raisman which was adopted, after many years, in 1951. since then there have been seven financial awards but even the composition of the divisible pool has not yet been determined to the satisfaction of all the provinces. The 1997 NFC Award, for a period of 5 years, provided 37.5 percent of the federal divisible pool for the provinces to be distributed among the provinces on the basis of population. The main issues relating to the 6th Award are now well known. First, the provinces want their share in the divisible pool to be raised from 37.5 percent to 50 percent. The previous five awards have been distributed on the basis of population. Punjab wants population basis to continue while the other three provinces are reluctant to follow this formula any more and have their own proposals on alternative basis. Balochistan and NWFP desire area and level of development of the province to be the basis. Sindh wants revenue generation to be the basis of distribution of divisible pool. The financial status of provincial governments largely hinges on federal transfers to the provinces made through the National Finance Commission (NFC) Award. The 1997 NFC Award changed both the size of the divisible pool and the share of the federal and provincial governments in the divisible pool. It is observed that the shortfalls in federal transfers to the provinces largely impacted the provincial social sector expenditures more than the other provincial expenditures during the four year period after the 1997 NFC Award. This finding is contrary to the objectives of the 1997 NFC Award, according to which the social services expenditures are the priority expenditure and should have been protected in case of any shortfall in revenues (Sabir, 2004).

In the light of the above analysis, the following suggestion may be useful for the future. The backward provinces may be provided with the soft loans facility. However, it is also recommended to incorporate backwardness and poverty specifically in the allocation of shared transfers. The issues with the sharing of the divisible pool should also be taken care of, such as the taxes of the local origin like income tax and sales tax should be included in provincial revenue generation potential.

"The forthcoming NFC Award will be in the larger interest of the country and aimed at economic recovery and increase in industrial and agricultural production and exports" stated by the government authorities in one of the meetings which is encouraging for the upcoming NFC Award.

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ANNEXURE I

Comparison of 1990 NFC Award and 1997 NFC Award

	1990 NFC Award	*1997 NFC Award*
Divisible Pool		
(*i*)	The divisible pool consists of income tax, sales tax, excise duties on tobacco and sugar and export duty on cotton.	The divisible pool consists of income tax, sales tax, wealth tax, which may be levied by the federal government, export duty on cotton, customs duties and federal excise duties excluding the excise duty on gas.
(*ii*)	Distributed between the federation and the provinces in the ratio of 20:80.	Distributed between the federation and the provinces in the ratio of 62.5:37.5.
(*iii*)	Share of the provinces determined on population basis as per 1981 Census (Punjab 57.88%).	Pending the adoption of next National Population Census, the share of the provinces will continue to be on population basis as per 1981 Census (Punjab 57.88%).
(*iv*)	Net proceeds of taxes arrived at by deduction of 5% collection charge by the Federal Government.	Net proceeds of taxes arrived at by deduction of 5% collection charges by the Federal Government.
Straight Transfers *Net Profits on Hydel Power Stations*		
(*v*)	Paid to the provinces according to location of stations in accordance with CCI decision dated 12.1.1991.	Paid to the provinces according to location of stations in accordance with CCI decision dated 12.1.1991.
Net Proceeds of Development Surcharge on Natural Gas		
(*vi*)	Transfers to the provinces distributed on production based at wellheads after deduction of 2% collection charges by the government.	Transfers to the provinces distributed on production based at wellheads after deduction of 2% collection charges by the government.
Royalty and Excise Duty on Natural Gas		
(*vii*)	Paid to the provinces under Article 161 (1) of the Constitution.	Paid to the provinces under Article 161 (1) of the Constitution after deduction of 2% collection charges by the Federal Government.
Royalty from Crude Oil		
(*viii*)	Net amount paid to the provinces according to production.	Net amount paid to the provinces according to production.
Special Grants/Subventions		
(*ix*)	Annual grants to province: Punjab Rs. 1000 million (for 3 years) Sindh Rs. 700 million (for 3 years) NWFP Rs. 200 million (for 3 years) Balochistan Rs. 100 million (for 3 years)	Annual grants for a period of five years: NWFP Rs. 3310 million Balochistan Rs. 4080 million This would be increased by 11%/annum subject to subsequent adjustment in line with actual inflation rate of each year.
Other Recommendations		
(*x*)	Provinces to take case of their current expenditure and debt service. Any reve-	Provinces to meet the rupee requirement for their development expenditure from

	nue surplus generated by the provinces would be utilized for financing development programme without affecting their normal share in PSDP.	their own revenue surpluses. No CDL will normally be extended by the Federal Government.
(*xi*)	Provinces may float market loans or obtain ways and means advances from SBP in case of temporary imbalances.	Provinces may float market loans or obtain ways and means advances from SBP in case of temporary imbalances.
(*xii*)	The federal and provincial governments should exercise economy in non-development expenditure.	The federal and provincial governments should exercise maximum economy in expenditure and ensure that NFC projec tions for expenditures are not exceeded.
(*xiii*)	The federal and provincial governments should increase their revenues.	The federal and provincial governments should increase their revenues.
(*xiv*)	The ratio between excise duty and development surcharge on gas should be improved in favour of excise duty.	The ratio between excise duty and development surcharge on gas should be improved in favour of excise duty.
(*xv*)	Net sales tax on domestic consumption should be collected by the provinces. Collection of net sales tax at retail level should be entrusted to the provinces.	Matching grants for fiscal efforts. In case of 14.2% annual growth in provincial receipts, matching grants will be given by the Federal Government upto a maximum of Rs. 500 million each in case of Punjab and Sindh and Rs. 100 million each in case of NWFP and Balochistan. Provincial government will not normally borrow from the SBP beyond the ways and means ceilings allowed by the SBP. Deduction at source of WAPDA dues of the provincial governments be discontinued. Provincial finance departments would be responsible for payments on behalf of priority connections only. Wheat subsidy should be eliminated gradually. The federal and provincial governments should strengthen local bodies institutions by sharing of revenues and decentralizations of functions. A monitoring committee headed by the Federal Finance Minister and comprising the provincial finance ministers and provincial finance secretaries will be set up to monitor implementation of the Award. The committee will meet once in every quarter.