

Nfc awards in pakistan economics essay



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Pakistan is a federation consisting of four provinces, federally administered tribal areas, northern areas and Islamabad Capital Territory. Pakistan is a federation but its government is highly centralized, so majority of the revenues are collected at the center and then re-distributed vertically between federal and provincial governments, and horizontally among provinces through National Finance Commission (NFC) awards. Then the provinces further re-distribute the resources to local governments through a revenue-sharing formula framed by Provincial Finance Commission (PFC). The criteria of revenue sharing has always been a bone of contention between the federation and the provinces. This is mainly because the federal government keeps a larger part of the revenues to themselves while provinces are left with fewer resources to carry on their development activities, that's why they face budget deficits very frequently. Moreover, there is a little autonomy and capacity for provinces to collect taxes on their own, so mainly they have to rely on the revenues relocated to them by the Federal government through NFC awards. The share provinces get from the Federal government is not sufficient to carry on the development projects, which is the reason they get into budget deficits very frequently. For proper service and delivery there is need of a higher share for provinces in NFC awards.

Systematic Resources transfers among governments occurs at 4 levels. Firstly, from federal governments to provincial governments through National Finance Commission (NFC). Secondly, from provincial governments to local governments through Provincial Finance Commission (PFC). Thirdly, from federal to local, and lastly from local to local. In this report, I will focus

mainly on systematic resource transfers from Federal to Provincial governments through National Finance Commission awards.

National Finance Commission is constituted under Article 160(1) of the 1973 constitution for the smooth and thoughtful revenue transfers between Federal and Provincial governments. Constitutionally, it is to be held every 5 years by the President of Pakistan to review the resource sharing mechanism for the equitable fiscal transfers between Central and Provincial governments. Certain taxes collected from provinces are added in the distribution pool and then re-distributed to provinces according to the revenue sharing formula. NFC decides what percentage of the total revenues will be retained by the Federal government and what share will go to the provinces. What taxes to include in the distribution pool has always been a question of debate.

The chairman of the commission is the Federal Finance Minister, and its members include all provincial finance ministers and experts to be nominated by the president of Pakistan in consultation with the provincial governors. The main charter of NFC is concerned with the following matters.

Distribution of specified taxes and duties between the federation and the provinces.

Payment of financial grants to provincial governments.

Borrowing power exercised by the Federal and Provincial governments.

Any other financial matter referred to the commission.

As per law, NFC was supposed to be constituted for smooth and equitable revenue transfers between the Federal government and provinces. But in reality, it faced difficulties which hindered its development. Only 7 NFC awards have been given up till now, of which 3 were conclusive. The rest 4 remained inconclusive because federal government and provinces couldn't reach an agreement on the distribution criteria of revenues, therefore an interim award was awarded by the President in this situation.

This paper will evaluate all the NFC awards in the history of Pakistan. Its related issues will be highlighted and improvements in the resource transfer mechanism will be recommended.

2. THE EVOLUTION OF NFC AWARDS

2. 1 PRE-INDEPENDENCE REVENUE SHARING (NIEMEYER AWARD)

Before independence of Pakistan, Niemeyer Award was followed in British India for the distribution of revenues between the Federal government and provinces, under the Government of India Act, 1935. All the financial matters between Federal and provincial governments were ruled by this act. Under this award, sales tax was a provincial subject, and 50 percent of the income tax collections were subjected to be redistribute. Even after the independence, Niemeyer award was followed till March 1952 with some adjustment in railway budget, sharing of income and sales tax.

2. 2 POST-INDEPENDENCE REVENUE SHARING (RAISMAN AWARD)

After the independence of Pakistan, Sir Jeremy Raisman was asked to devise a revenue sharing mechanism for allocation of revenues between federal and provincial governments. Thus he formed a revenue sharing formula called Raisman award in 1952. Considering the poor financial condition of the newly born state, a 50 percent share of sales tax was given to the federal government. Out of incomes of 50 percent income tax, 45 percent was given to East Pakistan, while the rest of the portion was given to the West Pakistan.

2. 3 REVENUE SHARING UNDER ONE UNIT

During 1955, Sindh, Punjab, Baluchistan and Khyber Pakhtunkhwa were professed as one unit- The West Pakistan. East Pakistan and West Pakistan were declared as the two separate units. The two awards, of 1961 and 1964, distributed the revenue between East Pakistan and West Pakistan.

2. 3. 1 The 1961 Award

In this award, the share of East Pakistan from divisible pool was decided to be 64 percent, while that of West Pakistan was 46 percent. 30 percent of the sales tax was relocated to provinces on the basis of their respective collection. While the remaining duties on agricultural land and capital value tax on immovable property were given to the units as per their collection.

2. 3. 2 The 1964 Award

Under this award, the divisible pool consisted of sales tax, income tax, export duty and excise duty. 30 percent of the sales tax were relocated to each province according to its collection. The share of center and provinces

from the divisible pool was decided to be 35 percent and 65 percent respectively. While the share of East Pakistan and West Pakistan remained the same as in previous award i. e. 64 percent and 46 percent respectively.

2. 3. 3 National Finance Committee 1970

A committee was formed instead of a commission in April 1970 to devise a formula for revenue sharing between federation and the federating units. The divisible pool remained unchanged, though the federal and provincial governments share in the divisible pool was declared as 20: 80 respectively. 54 percent of the provincial share was given to East Pakistan, while the rest 46 percent went to West Pakistan. The distribution among the provinces of West Pakistan was: Punjab 56. 5 percent, Sindh 23. 5 percent, Khyber Pakhtunkhwa 15. 5 percent, and Baluchistan 4. 5 percent.

After the separation of East Pakistan, their revenue share was transferred to the provinces of West Pakistan. The revenue proportion remained the same, but the size of the pie was changed.

NATIONAL FINANCE COMMISSION 1973

The 1973 constitution made mandatory for the government of Pakistan to make a National Finance Commission every 5 years for fair revenue distribution between Federal government and the provinces. From that point of time, West Pakistan started its journey after the separation of East Pakistan. From 1974 onwards, all the awards have been given under the National finance Commission. In reality, NFC has not been constituted every 5 years, contrary to what the law demanded. Let's briefly go through the various NFC awards in the history.

First NFC Award 1974

After an increase in the number and amount of taxes between 1951 and 1970, there was a contraction in both in 1974, reducing the size of the divisible pool. The divisible pool only included income tax, sales tax, and export duty. The distribution ratio between federal government and provinces remained the same as 20: 80 respectively. The criteria for horizontal distribution among provinces was decided to be population. Punjab, being the biggest in population, was advantaged. Its share was increased from 56. 50 percent to 60. 25 percent. While the other three provinces suffered, Sindh suffering the most. The resource distribution among provinces is presented in the table below.

Table 1 1974 NFC Award-Provincial share

Punjab

Sindh

Khyber Pakhtunkhwa

Baluchistan

60. 25%

22. 50%

13. 39%

3. 86%

To combat the weak fiscal position of the provinces, Baluchistan and Khyber Pakhtunkhwa were granted aid of Rs. 50 million and Rs. 100 million respectively.

Second NFC Award 1979

The second NFC was constituted by the President general Zia-ul-Haq in 1979. But it held no meetings, consequently no award was given. Therefore, the award of 1974 was followed as an interim award. After census was held in 1981, the population ratios changed and so did the provincial share in NFC awards. The provincial share was adjusted according to the new census, which led some improved conditions in Baluchistan and Sindh, whereas the share of Khyber Pakhtunkhwa remained unchanged. The new provincial resource distribution according to the changed population is illustrated in the given table.

Table 2 1979 NFC Award- Provincial Share

Punjab

Sindh

Khyber Pakhtunkhwa

Baluchistan

57.97%

23.34%

13.39%

5.30%

Third NFC Award 1985

The third NFC was also constituted in Zia-ul-Haq regime in 1985. It held nine meetings in 3 years but failed to produce any fruitful results, mainly due to political instability. So the award of 1974 was followed till 1990.

Fourth NFC Award 1991

After a long time, NFC became successful in giving recommendation in 1991. NFC is supposed to announce an award every 5 years, but there was a gap of 17 years between the previous award of 1974 and the 1991 award. This award came with some improvements and expansion in the divisible pool. Central excise on tea, tobacco, and betel nut was added in the divisible pool. So the divisible pool consisted of income tax, sales tax, export duty, and excise duty. However, custom duty still remained with Federal government. Federal government also took the responsibility of financing the provinces in case of deficits. The Federal and provincial share remained to be at 20 percent and 80 percent respectively. It can be said that the 1991 award was so far the best deal for provinces. But this award could not make any development regarding the diversification in the revenue sharing mechanism. The sole criteria for revenue sharing among provinces remained to be population. Disagreements among provinces hindered the development in the resource sharing criteria.

However, if we look at the positive side, this award considerably expanded the volume of provincial share in the revenues collected by the Federal government by around 18 percent as compared to 1974 award. This was mainly due to the addition of excise duty on certain items in the divisible pool. The 1991 award was a step forward to fiscal decentralization and

provincial autonomy in the country. The 1973 constitution acknowledged the right of provinces to get royalty on natural resources on the basis of collection by each province. Royalty on gas and crude oil, development surcharge on gas, and profits from hydro-electricity were relocated to provinces in the form of straight transfers. As a result, the transfers to provinces increased from 28 percent (Rs. 39 billions) to 45 percent (Rs. 64 billion) of federal tax revenue. The share of each province under this award is given in the table below.

Table 3 1991 NFC Award-Provincial Share

Punjab

Sindh

Khyber Pakhtunkhwa

Baluchistan

57.88%

23.28%

13.54%

5.30%

Provincial share didn't have any changes because population was still the sole criteria for revenue distribution and no census was held since 1981. However, the volume of provincial share increased due to the inclusion of new taxes in the divisible pool. In addition to this, special grants were also

provided to provinces to meet their developmental needs. The amount of these grants is illustrated in table 4.

Table 4 1991 NFC Award-Provincial Grants

Amount/Years

Punjab

Sindh

Khyber Pakhtunkhwa

Baluchistan

Amount

1000

700

200

100

Next Years

3

5

3

3

(Rs. in million)

However there was an increase in the flow of funds to the Provincial governments, provinces were advised to generate their own funds, but the autonomy and funds generating capacity were not sufficient as needed.

Fifth NFC Award 1996

The 5th NFC award was announced in late 1996 by the care-taker government of that time. This award included all the federal taxes in the divisible pool. Which comprise: income tax, sales tax, capital value tax, wealth tax, excise duties (except the excise duty on gas charged at wellhead) and any other tax collected by federal government. Royalty on crude oil and development surcharge on gas were also relocated to provinces in the form of straight transfers. The incentive of matching grants was also given to the provinces but up to a certain limit; only if provinces exceeded their revenue target of 14.2 percent they would get matching grants. However, numerous objections have been made by the members of parliament elected to the provincial and federal governments following the 1997 general elections.

With the expansion of federal divisible pool, the federal-provincial ratio in this award changed radically. Earlier it was 20 percent for federal government and 80 percent for provinces. In this award, the ratios were changed to 62.5 percent for federal government and 37.5 percent for provinces. One reason for decreasing the provincial share in the divisible pool is the overestimation of GDP growth rate. During the period when this award was being exercised, the country faced internal and external upsets which negatively affected the economy. Some say that provinces would be in

a better financial situation if previous award of 1991 award was continued to follow that time.

The sole criteria for resource distribution continued to be population. No development was made in this area. Considering the miserable situation of Baluchistan and Khyber Pakhtunkhwa, special grants of 4 and 3.3 and billions rupees were awarded to them respectively for the next 5 years.

Sixth NFC Award 2000

The 6th NFC was constituted in year 2000 by the President General Pervez Musharraf. It held 11 meetings but could reach to any conclusions due to disagreements among the members of NFC. Provinces were demanding a share up to 50 percent, as well as diversification in the resource distribution criteria.

Another NFC was constituted on 21st July, 2005 during President Musharraf's regime. But it too, like the previous NFC, stuck in a deadlock among its members and failed to give any recommendations due to the conflicting demands of its members. After an unsuccessful attempt to generate consensus on the resource distribution mechanism, all the provincial Chief Ministers asked the President to give a fair and justified award which would be acceptable to all stakeholders. So General Musharraf amended the "Distribution of Revenues and Grants-in-Aid Order, 1997" by issuing Ordinance No. 1 of 2006. Thus after a deferral of 6 years, the 1997 award was amended and came into force on 1st July, 2006.

Under this award, due to the constant demand from provinces, the provincial share from the divisible pool increase to 45 percent (share in total divisible

pool + grants), with gradual increase of 1 percent every year up till the next 5 years. All the taxes of 1996 award were included in the divisible pool. The grants to provinces were increased from Rs. 8. 7 billion to Rs. 27. 75 billion. Punjab and Sindh, which didn't receive any grant in the 1997 award, were also given grants of Rs. 3. 05 billion and Rs. 5. 83 billion respectively.

Seventh NFC Award 2010

The most recent NFC award of 2010 was given in the present democratic government. 2010 NFC award is a milestone in the history of Pakistan, which has bring improvements and variation in the resource distribution criteria. The demands of Sindh, Baluchistan and KPK have been recognized. The most prominent and distinguishing feature of this award is that it has followed a multi-dimensional revenue distribution criteria. In addition to population, other parameters have also been included, such as poverty, underdevelopment, and inverse population density criteria, as demanded by Sindh, KPK and Baluchistan. Baluchistan being the largest in area and scattered in population, demanded the criteria of inverse population density to include in the revenue sharing formula. While Punjab wanted population to remain the only criteria because it is in the province's advantage. Since 1973 constitution, it is for the first time that resources are not distributed among provinces according to the old population standards, but an advancement has been made in the resource sharing criteria.

The formulation of multiple criteria for resource distribution is a commendable step and a way further to fiscal autonomy of provinces. It has been measured as a success of democratic system and provincial partners. Economists have measured it groundwork for “ Fiscal Federalism” in

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Pakistan. No disputes came in the way of approval of 7th NFC award. It is marked by sacrifices and compromises by all the stakeholders for the sake of national unity and development. The big provinces exhibited flexibility in their approach to accommodate the demands of smaller and backward provinces. The center has sacrificed more than 10 percent of its share for provinces i. e. about Rs. 225 billion more were granted to provinces during FY 2011-12 budget [Pakistan Economic Survey (2011)]. All the stakeholders have decided to cut the cost of revenue collection to 1 percent (previously it was 5 percent) to increase the flow of real transfers to provinces.

Resultantly, the provincial share from the divisible pool increased from 47.5 percent to 56 percent in the first year and 57.5 percent for all the remaining years of the award.

This award is also significant in a way that all the provinces and center have shown a considerate behavior towards the most backward province Baluchistan. Acknowledging its special development needs, all the stakeholders have agreed to provide Baluchistan Rs. 83 billion (9.09 percent) of the provincial pool in the first year of the Award. Punjab has given up 1.27 percent, Sindh 0.39 percent, and KPK 0.26 percent of its share. Whereas Baluchistan has gained 1.82 percent. The federal government has given up more than 10 percent of its share for provinces, which has increased the flow of revenues to provinces. The number one beneficiary of this award is Baluchistan with an additional budget of 175 percent. While KPK, the second most benefitted, received 79 percent, Sindh 61 percent, and Punjab 48 percent additional budget. The resource distribution among provinces is illustrated in table 5.

Table 5 NFC Award 2010- Resource Distribution

Province**% Share in Divisible Pool under 7th NFC****% Change in Share****Additional Budget %**

Punjab

51.74

- 1.27

48

Sindh

24.55

- 0.39

61

KPK

14.62

- 0.26

79

Baluchistan

9. 09

+1. 82

175

Source: Pakistan Economic Review (2010)

If we talk about the distribution parameters, 82 percent weightage has been allocated to population, 10. 3 percent to poverty, 5 percent to revenue generation/collection, and 2. 7 percent to inverse population density. Table 6 illustrates the different parameters and its weightage against each province.

Table 6 NFC Award 2010-Revenue Sharing Formula (in percentage)

Parameters

Weight

Punjab

Sindh

KPK

Baluchistan

Population

82

57. 36

23. 71

5. 11

13. 82

Poverty/backwardness

10. 30

23. 16

23. 41

25. 61

27. 82

Revenue Collection

5

44. 0

50

1. 0

5

Inverse Population

2. 7

4. 34

7. 21

81. 92

6. 54

One of the greatest achievements regarding this award is that it has aimed to reduce disparities among the provinces. This award benefits the two relatively more backward provinces, Khyber Pakhtunkhwa and Baluchistan, as compared to Sindh and Punjab. Before this award, provinces were getting Rs. 550 billion. But in the first year of enforcement of this award provinces got more than Rs. 850 billion, and in the next 5 years this amount will increase up to 1250 billion. The greatest achievement of this award is the reduction in inequalities regarding revenue collection in Sindh and Punjab, gas development surcharge from Baluchistan, and hydel profits from KPK. Considering the role of Khyber Pakhtun Khwa in war against terrorism, it has been provided a share of 1 percent from the divisible pool.

4. DEVELOPMENT OF NFC AWARDS OVER TIME

Financial resources play the fundamental role in the development of any country. A well thought-out resource distribution is necessary for the development of backward areas so they can be at par with the national growth and progress. The current state of revenue distribution in Pakistan has evolved over time. Various improvements and advancements have been made in the revenue sharing formula since the formation of National Finance Commission. In this section I will analyze the impact of various NFC awards on the fiscal decentralization of the country.

In Pakistan fiscal federalism has always been an issue which has never received a serious approach. Out of Seven NFC awards, only four have come up with additional parameters of revenue sharing between the federation and its units. Federal government has taken a less systematic approach to decentralize fiscal powers and functions and made the provinces depend on the center. This has negatively affected the performance and efficiency of provinces to work effectively. In a federation, the basic functions of Central government are maintaining law and order, defense matters, making a sound foreign policy, communications, currency management, general administration, debt servicing, industrial development, and work on public welfare including health and education. The rest of the matters fall within the sphere of Provincial and local governments. But not much effort has been put by our politicians to devolve powers and functions to lower tiers of government.

With the passage of time, federal government has over-stretched itself into such matters which are of purely provincial nature, like irrigation, construction of roads, agricultural development, culture and tourism, youth affairs, and rural development. This has increased financial and administrative burden on the center. Federal government has taken too much responsibilities on its shoulders which certainly require more finance. If government is aiming toward devolution of power from center to provincial and local level, these tiers of government must be empowered and enabled to generate their own finance. Federal government generates 93 percent of the resources, while its share in the total expenditure makes up only 72 percent. On the other side, the total expenditure of provinces is 28 percent,

and they generate merely 7 percent of the resources. It results in heavy dependency on the center. The argument behind the higher collection by the federation is based on the achievement of equity, efficiency, economy, and the federal government's ability to levy and collect [Kardar (2006)]. As most of the resources are already used up by the Federal government, provinces are left with less opportunities to generate their own resources. Resultantly, provinces have to rely heavily on the resources transferred to them by the center.

If we closely look at the historical trend, we can easily understand that the journey of fiscal federalism in Pakistan has always been uneven. Fiscal federalism has always been a dilemma. It is interesting to note that out of seven NFC awards given after 1973 constitution, only few came up with additional parameters to share the revenues with the provinces. Only 3 out of 7 NFC awards were conclusive, the remaining 4 were inconclusive due to disagreements among the members of the commission.

Historically, the problem of revenue distribution has never been taken seriously by our politicians and it always faced difficulty because consensus of all the parties involved is must for a new NFC award to be enforced. The resource distribution mechanism/criteria has always been a bone of contention among the provinces. Population, being the sole distribution criteria in all NFC awards (except the recent one) has always been a matter of friction among provinces. This shows a lack of coordination in our policy making. Sindh, Baluchistan and KPK have always demanded the diversification in revenue sharing formula with the inclusion of other factors with population, like poverty, backwardness and revenue generation

capacity. Whereas Punjab has stressed over population to remain the sole criteria for revenue distribution because Punjab, being the most populated province, has always got the larger piece of pie in NFC awards. It is interesting to note that Pakistan is the only country in the world which follows one-dimensional formula for revenue distribution. Otherwise everywhere in the world various dimensions are used in view of the needs and economic conditions of the provinces. Due to inflexibility in the resource distribution formula, disparities among the economic conditions of people could not be reduced and diversified needs of provinces could not be catered as it should have been.

In the above section, we have discussed each NFC award in detail, its pros and cons, and the percent allocation to provinces under each award. There are substantial disparities in the living standards amongst provinces, and also among the rural-urban areas of each province. Although the removal of discrepancies between urban and rural areas is the responsibility of Provincial Finance Commission, but without provision of adequate amount of resources/funds by the center, provinces will not be able to work on development and reducing inequalities at local level. If we compare the real per capita GDP of all the provinces, we find out that Khyber Pakhtunkhwa has been facing highest inconsistency among rural and urban income, next to Sindh and Punjab. While the gap between rural and urban income in Baluchistan is lesser, the reason is lack of development in its urban areas. Its urban areas are less developed as compared to that of other provinces, because of lesser economic opportunities in cities.

If we look at the historical trends, the first NFC award of 1947 had fewer taxes in the revenue pool. But in 1991 award, some improvements were seen in the revenue distribution. More taxes were made part of distribution pool. In addition, the right of provinces to get royalty on natural resources was given to them on the basis of collection by each province. The divisible pool was further expanded in 1996 award by the inclusion of all the federal taxes. 1996 award moved a step forward towards fiscal decentralization. It also introduced the incentive of matching grants to provinces. But if we look at the grey areas of this award, the expansion of distribution pool resulted in the contraction of provincial share. The federal-provincial share in the pool changed drastically from 20: 80 to 62. 5: 37. 5 percent respectively. So practically, no significant developments were observed in actual revenue transfers to provinces. Consequently, provinces fell short of funds and trapped in budget deficits. Considering the miserable situation of Baluchistan and Khyber Pakhtunkhwa, special grants of 4 and 3. 3 and billions rupees were awarded to them respectively for the next 5 years.

Due to the constant pressure and demands from the provinces, government increased their share in the revenue pool to 45 percent in 2006 interim award. Just the provincial share was increased, no innovation was made in the resource sharing mechanism and it was still at its old population standards. Baluchistan and Khyber Pakhtun Khwa were demanding revenue distribution on the basis of poverty. The poverty ratio in Baluchistan is 37 percent and that of Khyber Pakhtunkhwa is 44 percent. However, no diversification was made in the distribution criteria.

One of the main reason which hindered the development of NFC awards is the conflicting demands of provinces over the resource sharing mechanism. The criteria of revenue dispersal between the center and provinces has always been a matter of conflict between these two tiers of government. Four out of seven NFC awards remained unproductive and unsettled amid this hostility. The complaints of the provinces were heard when the central government agreed to give provinces 40 percent share in the divisible pool with addition of 1 percent every year till the next 5 years. But there is an argument from Federal government's point of view that whenever the share of provinces has increased it gave rise to non-development expenditure which is unproductive. The reason is provincial governments don not have specific development programs in place as well as capacity to raise the living standards of people. The poverty ratio in Baluchistan is 37 percent and that of Khyber Pakhtunkhwa is 44 percent, but provincial governments failed to formulate an appropriate strategy to reduce these disparities.

This relates to the issue of political economy and public choice. Our electoral system can bring about such a state in which the federal government can be taken over by the larger province due to its majority seats in the National Assembly. Although, in Senate all provinces have equal representation but Senate has power only to discuss on the policy matters, but the decision making right resides with the National Assembly. So it is the National Assembly who has the constitutional supremacy to devise a reasonable resource sharing formula. Furthermore, the federal government does not want to give up its powers to provinces and let them grow autonomously as it will reduce their control on policy matters. This could be seen as since

independence, 10 awards have been recommended for justified resource sharing between the center and provinces, but out of them only 3 (1974, 1991, and 2010) initiated by elected governments. The most significant development of the year 2010 was 7th NFC award which brought about some innovation in the revenue sharing criteria. After the independence of Pakistan, It was for the first time that a diversification was brought in the revenue sharing mechanism and some other factors were taken into account with population, like backwardness/ poverty, area and revenue collection. The long-ignored demands of provinces were accepted. With