Strengthening Fiscal Federalism in Pakistan:

The Way Forward

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The Team

Muhammad Asif Iqbal, Project Leader

Muhammad Sabir, Principal Investigator

Research Support:

Shabbir Ahmed
Madiha Shekhani

Graphic Designing and Layout:

Rizwanullah Khan

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ACRONYMS

CCI	Council of Common Interest
CDL	Cash Development Loans
CE	Central Excise
CPEC	China Pakistan Economic Corridor
DGRO	Revenues and Grants-in-Aid (Amendment) Order
EPI	Extended Program on Immunization
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FGT	First-Generation Theory
FRDL	Fiscal Responsibility and Debt Limitation
FRLDO	Fiscal Responsibility and Debt Limitation Ordinance
GDP	Gross Domestic Product
GDS	Gas Development Surcharge
GDS	Gas Development Surcharge
GPI	Gender Parity Index
GST	General Sales Tax
HEC	Higher Education Commission
HFD	Horizontal fiscal disparities
IDRC	International Development Research Centre
IMF	International Monetary Fund
IPFCA	Interim Punjab Finance Commission Award
KPK	Khyber Pakhtunkhwa
LG	Local Government
LGA	Local Government Acts
NEPRA	National Electric Power Regulatory Authority
NER	Net Enrollment Rate
NFC	National Finance Commission
OZT	Octrai and Zila Tax
PFC	Provincial Financial Commission
PPP	Purchasing Power Parity
SGT	Second-Generation Theory
SPDC	Social Policy and Development Centre
SRB	Sindh Revenue Board
TORs	Terms of Reference
VAT	Value-added Tax
VFI	Vertical Fiscal Imbalance

EXECUTIVE SUMMARY

Fiscal federalism has featured quite extensively in contemporary debates on governance, especially across the developing world. Evolving from a strong theoretical foundation of decentralization of financial power and functions between different tiers of government, fiscal federalism offers a diverse set of arrangements for the design of fiscal institutions depending on the capacity and political context of a country. The subsequent division of responsibilities, resources, and power across various tiers of government lead to significant implications for social development.

Pakistan's federal structure of governance has been moulded over the course of a dynamic historical and political process. The 18th Constitutional Amendment was a milestone in the evolution of fiscal federalism in Pakistan, which devolved significant power and expenditure responsibilities from the centre to the provinces, especially in the arena of social services. Additionally, the 7th National Finance Commission (NFC) Award was also a ground-breaking endeavour, particularly with regards to intergovernmental fiscal transfers and introduction of multiple criteria for the horizontal distribution of divisible pool transfers. In spite of these major reforms, there have been no significant alterations in the structure of tax assignment in the country – it remains erratic and responsible for generating inefficiencies in the system, large vertical imbalances, and dependency of provinces on the central tier. There has been dialogue over a variety of aspects of fiscal federalism in Pakistan, such as revenue collection and sharing mechanisms, the impact of granting additional autonomy to provinces, and the structure of the NFC.

With these pressing issues under the analytical lens, this report aims to contribute to ongoing debates by reverting to the foundations of theories of fiscal federalism and linking them to the case of Pakistan. The analysis contains quantification of the financial impact of the 7th NFC Award and examining the effect of increased resource allocation to provinces on social development and gender equality. The report offers context-sensitive recommendations to revisit the tax assignment system and reduce dependency on fiscal transfers to strengthen fiscal federalism for sustained and gender-sensitive development.

In line with these objectives, chapter 2 begins by tracing the evolution of theories of fiscal federalism from First Generation Theory (FGT) to Second Generation Theory (SGT) and outlining the key tenets of both. It deconstructs the economic rationale beneath intergovernmental transfers and the functions of relevant institutional mechanisms. This discussion feeds into the pertinent objective of drawing solutions for unresolved debates on fiscal federalism in Pakistan's context. A prominent highlight emerged from this chapter is the usefulness of SGT that focuses on devolving tax assignment to sub-national governments; thereby, enlarging their revenue raising responsibilities. This not only helps in reducing corruption and setting sub-national governments accountable but also benefits them in providing services in line with the needs of the population, and diminishing dependency on fiscal transfers from the Centre; all aspects that can actively be employed to revisit tax collections mechanisms and expand provincial governments' capacity in Pakistan. Moreover, the analysis further displays the compatibility and utility of the SGT within Pakistan's context, since it offers a wide range of grant mechanisms which potentially provide options to finance the SDGs and CPEC projects.

Accordingly, Chapter 3 deals with tax assignment and subsequent fiscal imbalances. This discussion brings to fore the discrepancies in revenues and expenditures of Federal and Provincial Governments. Mechanisms of tax assignment, on both federal and provincial levels, remain largely unaltered. Provincial shares in total tax revenues are minimal, thereby, feeding the dependency on the federal arm of government. Devolution of the sales tax on services has gradually increased the provinces' share in taxes. However, in line with narrow provincial tax bases, trends of Vertical Fiscal Imbalance (VFI) indicate that a large proportion (more than 80 percent) of provincial expenditures is financed via intergovernmental fiscal transfers. In addition to being at odds with the tenets of SGTs, such an expanded VFI has contributed to inefficiencies in tax collection at both federal and provincial levels. Narrowing the gaps created by the VFI is a critical objective for the public finance sector and by drawing from theoretical underpinnings, opportunities for tax collection at the provincial level can be advocated for.

Chapter 4 delves into the structure of intergovernmental fiscal transfers and outlines the composition of and mechanisms instated in the NFC Awards. Article 160 of the Constitution of Pakistan regulates the role of the NFC and its main duty of allocating transfers through a formula-based revenue sharing mechanism and grants. This chapter presents a comprehensive history and comparison of various NFC Awards and Distributional Orders and analyses critical changes they have brought forth. The 7th NFC Award particularly stands out due to the adoption of new formulae for allocation of federal transfers and restructuring of the distribution formula to incorporate variables apart from population (such as backwardness, inverse population density and revenue collection/generation), respectively. Additionally, the consensus-based 7th NFC Award is also credited with the resolution of long-standing issues of the Gas Development Surcharge (GDS) and Hydroelectricity Profit along with devolving collection of sales tax on services.

Following from the critical changes brought forth by the 7th NFC Award, Chapter 5 addresses the magnitude of its impact on both Federal and Provincial governments. The consensus-based 7th NFC Award arrived in the wake of several inconclusive Awards and is a large achievement for fiscal federalism in the country. It allocated a higher share of federally collected taxes to provinces and altered tax collection mechanisms, mainly by transferring sales tax on services to the provinces. This chapter quantifies the fiscal implications of changes brought by the 7th NFC to the DRGO 2006. It particularly analyses the impact of the 7th Award on tax collection shares, public spending on social services, and fiscal deficits. This investigation critically brings forward the point that on a net provincial level these changes benefitted the relatively backward provinces the most; Balochistan and Khyber Pakhtunkhwa gained the most – on average 2.8 percent of FBR taxes each year – whereas, approximately 8 percent was reduced from the Federal Government's share. Opposed to expectations on the matter, this reduction has not mobilized the Federal Government to expedite its tax collection process to meet its expenditures, rather growth is observed to have declined after the 7th NFC. More critically so, the analysis dismantles the myth that increased shares for provinces have led to exponential growth in the federal budget deficit; we argue that the said deficit stems from the growth in current expenditures.

Chapter 6 steers the discussion towards the complex issue of debt management within a federation. Debt, having significant implications for macroeconomic stability and debt sustainability, is critical to speak of within Pakistan's national and geopolitical context. This chapter highlights the constitutional provisions relevant to borrowing powers and deliberates over fiscal responsibility acts and their implications. Additionally, this chapter slightly touches on the implications of the 7th NFC Award on the deficit and debt levels. Trends depict rather high (8.4 percent of the GDP in 2012 – 2013) budget deficits at the federal level, which has often been attributed to the 7th NFC; however, the discussion proceeds to underline the plethora of factors that explain this. It is recommended that to remedy this situation, the Federal government ought to focus on drafting structural reforms that contain current expenditures and install mechanisms for greater resource mobilization. In contrast, provincial governments were found to have low levels of development spending, budget deficits, and outstanding debts. Given this, the chapter suggests expanding the access of provincial governments to capital market and subsequently, their resource envelope.

Chapter 7 draws attention to the role of local governments as mechanisms for fiscal federalism in Pakistan. In line with both theories discussed initially, fiscal autonomy for local governments can strongly be supported due to the direct involvement of the third tier is provision of basic services. Stemming from this rationale, this chapter investigates the history and capacity of local governments in Pakistan, particularly, their system of financing. The history of local governance in the country has been variegated – a review of trends in fiscal decentralization reveal that fiscal empowerment of local governments has been heavily dependent on the discretions of provincial governments, which often have the tendency to centralize power leading to increased vulnerability of the third tier, as well as, province-wide differences in division of functions and resources. Steps to devolve power were taken with the appointment of Provincial Financial Commissions (PFC) under the Devolution Plan of 200l, to engineer and oversee the transfer of resources to the third tier. The recent wave of local government ordinances also talks about PFCs. However, discussion on implementation highlights the delay in constitution of PFCs. So far, only Khyber Pakhtunkhwa and Punjab have announced interim PFCs, while the others lag behind. As per the review, there is also variation in the vertical and horizontal distribution of resources, stemming from divergences in the formation of the divisible pool, retained and allocable shares, and the criteria for horizontal distribution. The chapter also sheds light on the sharing of resources through existing PFCs and their levels of support for local government empowerment. For instance, it is noted that Punjab's PFC allocated majority of resources to district education and health authorities (70 and 16 percent, respectively), whereas, only 12.8 percent is allotted to elected local governments.

Intergovernmental fiscal transfers and the structure of fiscal federalism as a whole are instrumental in the provision and delivery of social services. Thus, chapter 8 examines the trends in social sector development and correlates them with different periods the public finance sector has experienced under the tenure of various NFC Awards. Gender being a cross-cutting theme across various strata of social development, this chapter particularly investigates the impact of intergovernmental fiscal transfers on gendered social development in the country; it particularly examines indicators of education, health, and water supply and sanitation. Trends across sectors dictate a similar narrative – although the 7th NFC Award created the much-needed fiscal space for provinces that increased public spending across all three of the aforementioned social service sectors, this resource boom did not translate proportionally into impact on the spectrum of social development. The Gender Parity Index (GPI) in primary education further displayed stagnancy, after an initial period of growth from 2001 to 2011. Rather it is critical to note that gender inequality is noted to have worsened in Punjab and Sindh in 2014 – 2015, even in the midst of increased spending on primary education post-7th NFC Award.

The final chapter provides a summary of key messages emerging from the analysis on fiscal federalism in Pakistan and offers policy prescriptions with the objective to foster gender-sensitive, inclusive and sustainable development in Pakistan. While the report acknowledges that vertical and horizontal fiscal imbalances and inequalities are an integral part of fiscal federalism, the magnitude of both is relatively high in Pakistan compared to other federal countries. This situation requires solid measures to reduce them, one of the possible solutions for which is revisiting tax assignment and collection powers particularly associated with income and sales tax. This will not only help in reducing the vertical imbalance but also help in increasing the size of the tax pie by reducing loopholes and improving the tax-to GDP ratio. Another set of recommendations focuses on the role of intergovernmental fiscal transfers in fostering socio-economic development. Given that the higher transfers only translated in increasing public spending on social services, the desired socioeconomic development requires further devolution of social services at the local governmental level. This devolution will likely contribute to achieving SDGs and match well with CPEC. Finally, one of the lessons from deliberations of the 7^{th} NFC award is that burning issues can be resolved through fair, regular and meaningful negotiations. Similar practices are needed to break the present deadlock like situation in the 9th NFC.

1 Introduction

Fiscal federalism, a dynamic concept, has progressed both theoretically and practically over time and has been at the forefront of policy debates in many developing countries. Theoretically, it has evolved from the First Generation Theory (FGT) – arguing for greater decentralization of expenditures – to the Second Generation Theory (SGT) – advocating for greater tax decentralization via consideration of the political economy. The breadth of literature on the matter also documents strengths and weaknesses of the federal system of governance. Accordingly, one of its strengths is its diversity, in accordance with the nature and political set-up of the country. A look into the practices of federal systems reveals a large number of differences in the ways they allocate money, power, and authority across levels of government (Maite and Weingast, 2003). The design of fiscal institutions – that deal with allocation of taxing, spending and regulatory functions, along with revenue sharing arrangements among various tiers of government – has important implications for the efficient and equitable provision of public services (Shah, 2005).

In Pakistan, fiscal federalism has evolved in at least three of the following ways:

- The 18th Constitutional Amendment was instated in 2010; it has proven to be a milestone in the history of fiscal federalism by revisiting both revenue and expenditure assignment among different levels of government. Though, it did not make significant changes in tax assignment, it abolished the concurrent list and clearly outlined federal and provincial expenditure responsibilities. Consequently, provincial governments are now responsible for social service provision including education, health and the like.
- Another significant impact of the 18th Constitutional Amendment is greater institutionalization of the constitutional body – Council of Common Interest (CCI) – to discuss and resolve overlapping intergovernmental issues. Following this amendment, the CCI holds a separate and dedicated secretariat housed in the Inter-Provincial Coordination Division and has become more active by having regular quarterly meetings. This kind of institutional mechanism is essential for a vibrant fiscal federalism.
- The 7th National Finance Commission (NFC) award, concluded in 2009, was also a milestone as it made significant changes in the design of intergovernmental fiscal transfers from the federation to provinces. Under this award, the share of provinces in federal[1] taxes increased to 57.5 percent compared to only 37.5 percent under the 5th

[1] Taxes collected by Federal Board of Revenue (FBR).

NFC award in 1997, and 45 percent in the terminal year of DRGO 2006[2]. Moreover, the 7th NFC award successfully introduced multiple criteria for the horizontal distribution of divisible pool transfers among provinces, and rectified anomalies in de jure and de-facto transfer mechanisms.

Despite these developments, tax assignment in Pakistan remains more or less unchanged. The buoyant taxes such as income and corporate taxes and sales tax on goods are in the federal domain. Moreover, most of the provincial taxes are assigned through a bar in the federal list, which implies that part of the tax base falls under the federal domain and part in the provincial domain. For instance, while income taxes fall under the federal jurisdiction while agriculture income tax is a provincial tax. Similarly, sales tax on goods is a federal tax, whereas, sales tax on services is a provincial tax. This kind of division generally results in complications that hinder progress in tax reforms. Moreover, it creates a large vertical imbalance, as four provincial governments altogether collect less than 10 percent of taxes that finance only less than 20 percent of their expenditures. The outcome of such tax and expenditure assignment creates greater dependency of provincial governments on intergovernmental fiscal transfers.

While the 7th NFC award and the 18th Constitutional Amendment delegated more fiscal autonomy and transferred additional resources to the provinces, they generated debate on revisiting revenue sharing arrangements and the collection mechanisms of major taxes (Ara and Sabir 2010). Currently, discussions on fiscal federalism in Pakistan entail three sets of issues. The first relates to either pros or cons of granting additional taxation powers to the provincial governments. The second argument is about adding additional subjects in the domain of the NFC, like Gilgit-Baltistan in the list of sub-national governments, and a separate share for security-related and CPEC[3] expenditures. The third set of issues encompasses the structure of the NFC, technical vs. political aspects of the NFC, building capacity of NFC secretariat and the like.

Another emerging issue resulting from the 18th Amendment is that the minimum share of provinces in terms of proportion of the divisible pool has been constitutionally protected, which reduces the scope for revisiting vertical distribution of divisible pool. Thus, the federal government has no incentive to negotiate on the vertical share because the provincial share increased once, cannot be reduced in the future. There have also been some unusual developments regarding the constitution and scope of NFC. For example, the federal government skipped the constitution of the 8th NFC award and directly constituted 9th NFC, without any plausible explanation. Moreover, Azad Jammu and Kashmir, Gilgit-Baltistan and FATA were added in the Terms of Reference (ToRs) of the 9th NFC, which

[2] The Distribution of Revenues and Grants-in-Aid (Amendment) Order.

[3] China-Pakistan Economic Corridor (CPEC), which is a framework of regional connectivity.

have never been part of NFC. Also, the provinces have been complaining about the lack of interest on part of the federal government, which has delayed the finalization of 9th NFC Award. These developments have serious implications for the future of fiscal federalism in the country.

OBJECTIVES OF THE STUDY

Given the above backdrop, we consider fiscal federalism to be an important framework for the achievement of development goals of the country. The specific objectives of the study are as follows:

- To review the theoretical evolution of fiscal federalism and its institutional structure, and link it with fiscal federalism in Pakistan by revisiting tax assignment and dependency of provinces on fiscal transfers;
- To study the evolution in the design of the NFC Awards and quantify the financial implications of the 7th NFC Award; and
- To examine the impact of higher resource transfers to provinces after 7th NFC Award on social sector expenditures and understand the role of these expenditures on social development and gender equality.

This report is part of a research project entitled "A Comparative Study of Intergovernmental Fiscal Transfers in India and Pakistan", funded by the International Development Research Centre, Canada. It is envisaged that the findings will facilitate evidence-based policy discussions and policy formulations.

OUTLINE OF THE REPORT

In line with the aforementioned objectives, the report is organized in the following manner:

Chapter 2 briefly presents the theoretical evolution of fiscal federalism by reviewing the main contours of first and second-generation theories.

Chapter 3 presents an overview of tax assignment and the vertical fiscal imbalance since 2000. The analysis presents a strong case for not only revisiting tax assignments but also the collection responsibilities. The low tax-to-GDP ratio makes a compelling argument for increased focus on raising revenue by effectively and efficiently utilizing the federal fiscal structure of the country.

Chapter 4 outlines the institutional structure and historical narrative of intergovernmental fiscal transfers constituted through the NFC awards. It shows both the weaknesses and strengths of consensus-based political NFCs. One of the weaknesses is the lack of regularity in the NFC awards. There have only been four consensus-based awards since 1973. One of the strengths of the institutional structure of the NFC is greater political acceptability and ownership, along with the relatively generous attitude of federation towards federating units.

Chapter 5 quantifies the fiscal implications of the 7^{th} NFC award for the federal and provincial governments and deconstructs the causes of a higher fiscal deficit than what was anticipated after the 7^{th} NFC award.

Chapter 6 highlights issues pertaining to the role of local governments as an effective third tier of government. The constitution placed local governments under the domain of provincial governments that allowed diversity in local governmental experiences, reflected through variations in the local government acts of provincial governments.

Chapter 7 analyses the impact of additional transfers on social sector spending and makes an attempt to link higher expenditure on social services with gender-sensitive social development. Lastly, conclusion and presents key policy implications are presented in Chapter 8.

2 Fiscal Federalism: Theoretical Evolution

Theoretical dynamism in fiscal federalism is reflected through its evolution from the First Generation Theory (FGT) to Second Generation Theory (SGT). The former relates to decentralization of expenditure responsibilities and centralization of revenue responsibilities by assuming benevolence of decision-makers for maximizing social welfare (Musgrave 1959; Oates 1972; Musgrave and Musgrave 1984; Oates 1999). In contrast, SGT deals with the political economy of fiscal federalism by questioning fiscal and political incentives attached to decentralization (Oates 2005; Weingast 2007, 2009, 2013). In practice, fiscal federalism has evolved from designing revenue sharing and grant distribution mechanisms to revisiting tax and expenditure assignments. However, a review of practices of fiscal federalism reveals country-wise differences. In general, developed countries have relatively autonomous and fiscally sustained sub-national governments in line with the theory of fiscal federalism, while in developing countries sub-national governments have less fiscal autonomy and narrow tax bases (Bahl and Cyan 2011).

This chapter provides an overview of key concepts of FGT and SGT, and then presents the economic rationale and theoretical foundations for intergovernmental transfers and a discussion on the institutional mechanisms. The objective of outlining this theoretical narrative is to draw lessons for fiscal federalism in Pakistan, grounded in solid theory. Moreover, this theoretical discussion helps trace out possible solutions for ongoing debates on fiscal federalism in the country.

FIRST-GENERATION THEORY OF FISCAL FEDERALISM

The first-generation theory (FGT) is normative in nature and assumes a 'benevolent' nature of federal and provincial decision-makers who maximize the social welfare of residents (Musgrave 1959; Oates 1972). It is largely based on three functions of government illustrated by Musgrave (1959) and Musgrave and Musgrave (1984). These include; (i) allocation of resources or provision of public goods and services, (ii) redistribution of income, and (iii) macroeconomic stabilization of the economy. Under these categories, FGT depicts a vision of fiscal federalism where the federal government is largely responsible for maintaining macroeconomic stabilization and providing an efficient level of national public goods in conjunction with sub-national governments. Sub-national governments largely support the federal government in redistribution of income and provide the level of public goods in line with the demand of the residents of their respective jurisdictions.

FGT strongly advocates for decentralisation of expenditure responsibilities for achieving 'efficiency' and 'equity' in the federation. In this regard, Oates' (1972) "decentralization theorem" serves as a foundation for greater decentralization of public goods and services. It states, "each public service should be provided by the jurisdiction having control over the minimum geographical area that would internalize benefits and costs of such provision" (ibid, p.55). Oates (1972) further supported the decentralized provision of public goods and services, on the grounds that it allows sub-national governments to cater to the needs of local residents in a better way, whereas, uniform provision by federal government leads to an inefficient utilization of goods and services across regions of the country. Due to inter-jurisdictional competition, decentralization may also lead to efficiency in the provision of public goods and services. Normative theoretical considerations strongly support decentralization on account of efficiency, accountability, manageability, and autonomy principles.

FGT favors centralization of revenue responsibilities for macroeconomic stabilization and income generation. The tax centralization principle in FGT largely hinges on the assumption that factors of production are mobile, which are likely to lead to 'beggar-thy-neighbour' under decentralization. It assumes that decentralization of taxes is likely to generate tax wars among sub-national governments, due to inter-jurisdictional competition that would be self-defeating and result in a reduction in taxation. Given that labour and capital are mobile factors of production, the scope of sub-national taxes under the FGT is limited to benefit taxes like property tax and user charges (Oates, 2005). The ultimate repercussions of centralized tax collection and decentralized delivery of public goods and services are vertical and horizontal imbalances. FGT emphasizes intergovernmental fiscal transfers as the key for addressing problems of vertical and horizontal imbalances.

The strong emphasis on intergovernmental fiscal transfers in FGT has been heavily criticized in subsequent literature. For instance, Shah (1998) argued that heavy reliance of sub-national governments' on federal transfers de-linked taxing and spending responsibilities and led to accountability problems at sub-national levels. Similarly, Bahl and Linn (1992) argued by citing the examples of developing countries where the provision of grants made the local governments less accountable for their fiscal decisions i.e. local governments may increase spending without increasing taxes. These studies documented a series of fiscal crises due to political economy considerations at the decentralized level of governments, which raised serious concerns over the efficiency argument of FGT and provided a strong basis for SGT.

SECOND-GENERATION THEORY OF FISCAL FEDERALISM

A survey of literature related to the Second Generation Theory (SGT) of fiscal federalism suggests that SGT, although builds upon FGT, incorporates various new aspects, including fiscal and political incentives particularly faced by sub-national officials (Oates 2005; Weingast 2007, 2009, 2013). In other words, SGT assumes that public officials have goals induced by political institutions that often systematically diverge from maximizing citizen welfare (Garzarelli 2004; Oates 2005; Qian and Weingast 1997; Weingast 2013). These powerful incentives built into existing fiscal and political institutions undermine the performance of the public sector and the entire economy.

SGT models place greater emphasis on the importance of revenue generation by sub-national governments (Maite and Weingast 2003; Rodden et al. 2003). Sub-national governments that finance a substantial portion of their own expenditures through their own revenues tend to be more accountable to citizens, more likely to provide the services desired by people, to provide market-enhancing public goods, and to be less corrupt compared to sub-national governments that are heavily dependent on fiscal transfers. While SGT covers a wide range of topics, this overview focuses only on tax assignment and intergovernmental fiscal transfers.

TAX ASSIGNMENT IN FISCAL FEDERALISM

Tax assignment in fiscal federalism has been widely studied under both the first and second generation theories, with a focus on its various aspects including efficiency, optimality and accountability in multi-tier government structures. This literature not only outlines different approaches to tax assignment, but also highlights characteristics of sub-national taxes. For instance, Bahl and Bird (2008) argue that the conventional model of tax assignment, which in effect assigns all significant revenue sources to central governments, is clearly inappropriate for countries in which sub-national governments account for a significant proportion of public sector spending. They suggested the following seven general characteristics for devolved taxes which are also in line with (Musgrave and Musgrave 1984):

1. The tax base should be relatively immobile, to allow local authorities some leeway in varying rates without losing most of their tax base.
2. The tax yield should be adequate to meet local needs and sufficiently buoyant over time (that is, it should expand at least as fast as expenditures).
3. The tax yield should be relatively stable and predictable over time.
4. It should not be possible to export much, if any, of the tax burden to non-residents.
5. The tax base should be visible, to ensure accountability.
6. The tax should be perceived to be reasonably fair by taxpayers.
7. The tax should be relatively easy to administer efficiently and effectively. The cost of efficient administration should be a "reasonable" proportion of revenue collections. (Bahl and Bird 2008, p. 9)

An overview of current models of tax decentralization outlines three general approaches used in tax assignment in a multi-tier structure (Martinez-Vazquez 2008). First, the 'tax autonomy' model – the assignment of taxing powers and tax administration responsibility falls exclusively on sub-national governments. USA and Canada provide the best examples of such kinds of tax assignment. Second, the 'tax sharing/transfer' model – the federal government may set the tax rate and base, and collect the taxes, but assign a portion of collections to the sub-national government. This model operates in most developing countries including Pakistan. Third, the 'piggyback taxes' model – sub-national governments' taxes are piggybacked on a federal government tax base. Under this approach, the sub-national government sets the tax rate, but the federal government defines the base and administers the tax. This model is prevalent in the Scandinavian and other Northern and Central European countries. This approach also operates in many developing countries including Pakistan.

There is an emerging consensus in the SGT that fiscal federalism in principle works best when taxes and benefits from public spending are as closely linked to each other as possible. The underlying rationale for this consensus is that the citizens residing in a particular political jurisdiction pay for what they get from the public sector and get what they pay for (i.e. benefit from the expenditures financed by the taxes they pay). Accordingly, residence-based individual income and payroll taxes and destination-based sales taxes are considered as the best choices for sub-national government taxes (Bahl and Cyan 2011). In line with the theory, these taxes are under sub-national governments in most industrialized countries and have resulted in much higher taxation power and revenue autonomy compared to developing countries. While highlighting four reasons for low sub-national taxes in developing countries, Bahl and Cyan (2011) state, "a fear at the central level that giving more discretionary taxing powers to local governments will lead to a crowding out of central revenues" (p. 278). In contrast, tax centralization has other problems such as tax accountability and efficiency. Despite this, "central governments generally do not want to give up taxing powers for political or perhaps macroeconomic reasons" (p. 278).

FISCAL IMBALANCES AND INTERGOVERNMENTAL FISCAL TRANSFERS

An overly centralized tax structure in a multi-tier government generally leads to low own tax revenues at a sub-national level, which is usually insufficient to meet constitutional expenditure responsibilities. This phenomenon, both in FGT and SGT, is referred to as a vertical fiscal imbalance (VFI) and also as the `fiscal gap' in earlier literature on fiscal federalism (Boadway and Hobson 1993). Martinez-Vazquez and Boex (2006), highlight the following reasons for vertical fiscal imbalance:

- The centre's fear to lose control over fiscal policy as a fiscal management tool.
- The perceived need for the centralized administration of the most significant taxes

- The assignment of the most elastic sources of revenues to the central government (even though local governments are often assigned responsibility for public services with a more elastic demand with respect to income);
- Fear of mismanagement or tax competition among local governments, or;
- Simply a reflection of the dominant political power of the central government. (p. 9)

Often VFI leads to horizontal fiscal disparities (HFD). These disparities are generated due to the difference between the revenue raising capacities and the fiscal needs of sub-national governments. The literature outlines various approaches to measure VFI and HFD, depending on the available data on fiscal needs and capacities. Often VFI and HFD are used as economic rationales for attaining intergovernmental fiscal transfers and grants.

Though, the main objective of the intergovernmental fiscal transfers is to address VFI and HFD, Bird and Smart (2002) describe their four aims:

i) Correcting the vertical fiscal imbalance: transfers are used to fill the gap between revenue-raising capacity and fiscal needs,

ii) Implementing federal public policy through sub-national governments: transfers make it possible to achieve the same result as, for instance, a minimum standard imposed by regulations, while leaving local governments more freedom in the choice of instruments,

iii) Compensating for jurisdictional spillovers: sub-national government units providing services to people living in other jurisdictions (and thus not carrying the fiscal burden) must receive adequate compensation. The rationale for transfer is both equity and allocative efficiency,

iv) Reducing horizontal fiscal disparities and harmonizing tax burdens: transfers mean bringing in additional resources to government units with a lower fiscal capacity or too heavy a revenue effort.

TYPES OF FISCAL TRANSFERS AND GRANTS

In order to achieve these objectives, literature on fiscal federalism suggests four forms of intergovernmental transfers and grants; (i) open-ended conditional matching transfers, (ii) close-ended conditional matching transfers, (iii) non-matching conditional transfers, and (iv) unconditional transfers. In conditional transfers, the federal government specifies the purposes for the funds to be used by the recipient sub-national government. Such transfers are often used to address concerns that are highly important to the federal government, but which might be considered less important by the sub-national governments, such as projects with inter-regional spill over effects.

Open-ended Conditional Matching Transfers

Open-ended conditional matching transfers and grants are a type of transfer where a higher level of government matches the lower level government's spending on a specific project with a specific percentage, without a ceiling. For instance, the federal government can match the provincial government's spending on health with a 50-percentage matching transfer. This implies that federal governments contribute equally to provincial government's expenditure on health without a ceiling.

Close-ended Conditional Matching Transfers

Close-ended conditional matching transfers and grants are a type of transfer in which where a higher level of government matches the lower level government's spending on a specific project, with a specific percentage to a maximum amount. For instance, a 50-percentage close-ended matching transfer in health implies that federal government contribute equally to provincial government expenditure on health till 50 percent or a pre-determined maximum amount.

Non-Matching Conditional Transfers

In non-matching block transfers, federal governments contribute a fixed sum of money with the stipulation that the grant is spent on specified public goods or services. In this case, the recipient government is not required to match the contribution of the federal government.

Unconditional Transfers

Unconditional transfers are the most common form of intergovernmental fiscal transfers. They are generally designed through a transparent formula for sharing federally collected taxes. Under unconditional transfers, sub-national governments have the autonomy to prioritize their spending according to the needs of their residents.

INSTITUTIONAL ARRANGEMENTS FOR FISCAL TRANSFERS

Shah (2005) provides an overview and evaluation of different institutional mechanisms that prevail in the design and implementation of intergovernmental fiscal relations. The study broadly classifies diverse institutional arrangements into five stylized models; (1) central government ministry/agency, (2) independent agency (grants commission) model, (3) intergovernmental forums, (4) national legislature, and (5) sub-national government forums (p. 1). Of these, the models of independent agency and inter-governmental forums are relevant to this study. Pakistan's NFC is a form of an inter-governmental forum model, while India's FC is a form of independent agency models. These institutional arrangements are often discussed during the NFC deliberations in Pakistan. According to Shah (2005), the evaluation criteria based on new institutional economics frameworks shows various advantages of the inter-governmental forum model over the independent agency model. For instance, transaction costs (such as participation and monitoring costs, legislative and executive decision-making costs, agency costs and uncertainty costs) in the intergovernmental forum model are low compared to those in the independent agency model. Moreover, an inter-governmental forum provides a framework for institutionalized political bargaining, and places a great premium on simplicity and "rough justice". Institutionalized political bargaining is the strength of inter-governmental forums and is likely to result in a compact political consensus on equalization standards. The simplicity and transparency in the design mechanism allow greater oversight and accountability. It provides an opportunity to engage citizens in the discussion on equalization and political feasibility of equalization standards.

In contrast, an independent agency aims at providing an independent, professional, transparent and rigorous design mechanism. However, it is generally costly, complex and has various agency problems like "mission creep", "incentives for complexity" and "impractical and costly oversight". The design mechanism suggested by independent agency lacks political consensus as both the divisible pool and allocation among constituent units are determined independently of the equalization standard. Shah (2005) summarised the comparison between the independent grant commission and intergovernmental forum in the following words:

> "*the independent grant commission is a poor substitute for an intergovernmental forum. Its usefulness as a complementary institution to an intergovernmental forum is also quite limited in view of high agency costs and its predisposition towards optimal as opposed to feasible reforms."* (Shah 2005, p.12)

KEY MESSAGES

- The review of the relevant literature highlights that SGT has put ample emphasis on the devolution of taxes and highlights various advantages of such devolution. For instance, greater revenue raising responsibilities on sub-national governments promote greater accountability of them and are likely to reduce corruption in the long-run. Given that provincial governments in Pakistan are collecting less than ten percent of revenues, SGT can be used for revisiting tax collection mechanisms and raising the capacity of provincial governments.

- SGT also offers a wide range of grant mechanisms that provide additional options to finance the SGDs, CPEC and security-related options without altering the provincial share in the divisible pool.

- Finally, the structure of the NFC as an intergovernmental forum is better than the independent agency model as outlined by the Shah (2005). However, it needs to be further enhanced by allowing ample time for regular deliberations to make future NFCs conclusive with consensus.

3 Tax Assignment and Fiscal Imbalances in Pakistan

Pakistan's tax system has undergone significant reforms over the last three decades, leading to the modernization of direct and indirect taxes. Some major reforms in direct taxes include the introduction of withholding taxes, rationalization of income and corporate tax rates, and introduction of self-assessment for filing income taxes. The developments in indirect taxation include rationalization of the customs tariff structure with a reduction of tariff bands and maximum rates, introduction of a tax on services, and efforts to introduce a value-added tax (VAT). However, federal and provincial tax assignments have remained unchanged since 1973. Even the 18th Constitutional Amendment (2010) did not modify federal and provincial tax assignments and was limited to explicitly endorsing sales tax on services such as provincial tax - which was already a provincial tax since its inception in 2000, but was collected by the federal government on behalf of the provinces.

REVENUE ASSIGNMENT AS PER CONSTITUTION

The 1973 Constitution designates revenue assignments between the federal and provincial governments. After the abolishment of concurrent lists through the 18th Constitutional Amendment (2010), revenue sources are assigned through classifications in the federal lists of subjects. A revenue source will belong to the federation only if it is mentioned in the Federal List; otherwise, it will be treated as a provincial revenue source.

Table 1: Federal Revenue Assignment as per Constitutional Provision

DIRECT TAXES	
• Taxes on income other than agricultural income	subject 47
• Taxes on corporations	subject 48
• Taxes on the capital value of the assets, not including taxes on immovable property	subject 50
INDIRECT TAXES	
• Duties of customs, including export duties	subject 43
• Duties of excise, including duties on salt, but not including duties on alcoholic liquors, opium and other narcotics	subject 44
• Taxes on the sales and purchases of goods imported, exported, produced, manufactured or consumed, except sales tax on services	subject 49
• Taxes on mineral oil, natural gas and minerals for use in generation of nuclear energy	subject 51
• Taxes and duties on the production capacity of any plant, machinery, undertaking, establishment or installation in lieu of the taxes and duties specified in entries 44, 47, 48 and 49 or in lieu of any one or more of them	subject 52
• Terminal taxes on goods, or passengers carried by railway, sea or air; taxes on their fares and freights	subject 53

Federal taxes under the Fourth Schedule, Article 70(4), of the Constitution of Pakistan are given in Table 1. The federal government has a constitutional right to collect taxes on corporations, income other than agriculture income, and capital value of assets, excluding taxes on immovable property. Among indirect taxes, the federal government has a constitutional right to collect taxes on the sales and purchases of goods (imported, exported, produced, manufactured or consumed), but not on the sales of services. The other major federal indirect tax, includes taxes on international trade i.e. export and import duties and excise duties.

The revenue assignment of provincial governments includes direct taxes on property, agriculture income, and professions. Among the indirect taxes, major provincial taxes include sales tax on services, excise duty on alcohol/liquor/narcotics, motor vehicle tax and stamp duty (Table 2).

Table 2: Provincial Revenue Assignment as per Constitutional Provision

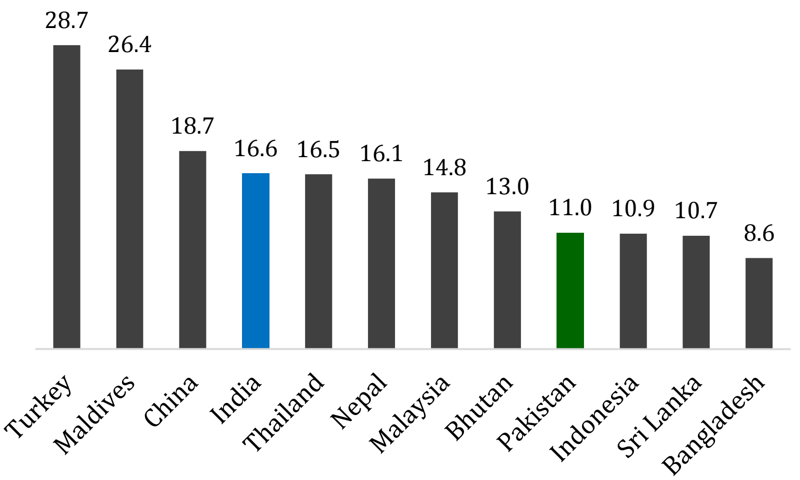
DIRECT TAXES	
Property tax	Residuary but there is bar in the Federal List (subject 50)
Capital gains tax on property	Assigned through bar on the federation in the Federal List (subject 50)
Agriculture income tax	Through bar on the federation in the Federal List (subject 47)
Tax on professions	Article 163 of the constitution
INDIRECT TAXES	
Excise duty on alcohol/liquor/narcotics	Assigned to province by bar on the federation in the Federal List (subject 44)
Sales tax on services	Assigned to province by bar on the federation in the Federal List (subject 49)
Motor vehicle tax	Residuary assignment
Stamp duty	Residuary assignment
Registration fee	Residuary assignment
Mutation fee	Residuary assignment
Natural gas excise duty	Article 161 of the constitution
Net hydro profits	Article 161 of the constitution
Electricity duty	Article 157(2) (b)of the constitution

It is worth a mention that most provincial taxes are assigned through a bar in the federal list, which implies that part of the tax base falls under the federal domain, whereas, the remaining tax base is in the provincial domain. For instance, while income taxes fall under the federal domain, agricultural income tax is provincial. Similarly, capital gains tax is a federal tax, whereas, the tax on capital gains on property is a provincial one. Similar tax base sharing is reflected in sales tax by dividing the tax base into goods and services. This kind of division generally results in complications that hinder progress in tax reforms.

PAKISTAN'S COMPARATIVE POSITION ON TAX-TO-GDP RATIO

Pakistan is the fifth most populous country in the world. Its economy is the 25th largest in the world, in terms of purchasing power parity (PPP), and 42nd largest in terms of nominal GDP. It ranks 157 out of 179 countries in terms of tax-to-GDP ratio, which is much lower as compared to its economic ranking. Chart 1 presents a comparison of the tax-to-GDP ratio of selected developing countries, indicating that Pakistan is positioned among the lowest tax-to-GDP ratios. A comparison of Pakistan's Tax-to GDP ratio with India and Malaysia reveals under taxation of at least 3 percent of the GDP.

Chart 1: Tax-to-GDP Ratio in 2017 – A Comparison

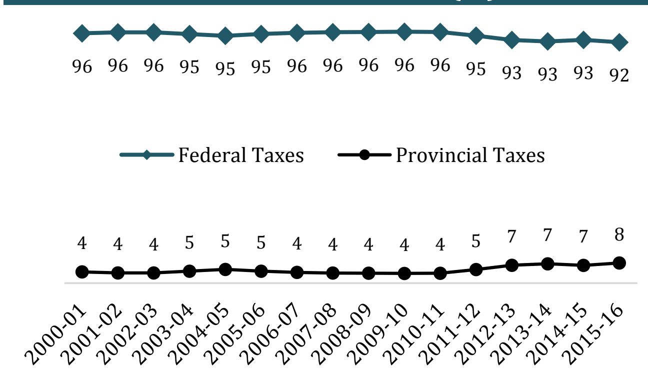


Source: Heritage Foundation (2017)

FEDERAL AND PROVINCIAL SHARES IN TAXES

Chart 2 shows the share of federal and the provincial governments in total tax revenues. Noticeably, the federal government collects more than 90 percent of total taxes in Pakistan. Prior to the 7th NFC Award, the provincial share was around 4 percent which increased to 8 percent in 2015-16. This suggests that provincial governments have a very narrow base of taxes and over-reliance on federal transfers. The buoyant sources of revenues, like sales tax on goods, income and corporate taxes are still under the domain of the federal government. From the perspective of sustainable public service provision, provincial governments require enough "own" revenues rather than being heavily reliant on federal transfers and grants. The gradual increase in provincial share in taxes is an outcome of devolution of the sales tax on services. Initially, the government of Sindh took the initiative to collect the sales tax on services by establishing the Sindh Revenue Board (SRB). Afterwards, government of Punjab and Khyber Pakhtunkhwa established their respective revenue authorities to collect this tax. Recently, the Government of Balochistan also established a revenue authority to collect sales tax on services. So far, the provincial

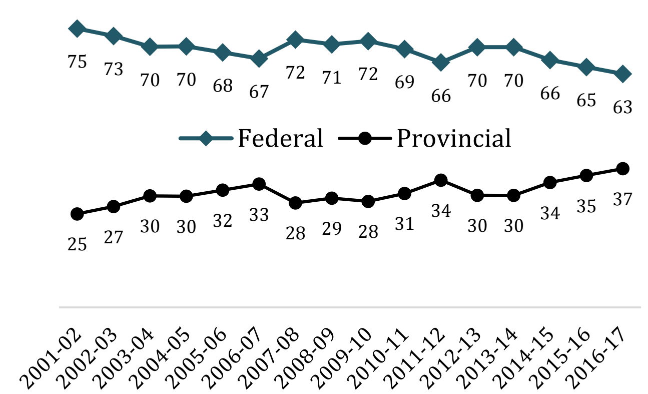
Chart 2: Distribution of Total Taxes (%)



Source: Pakistan Fiscal Operation (Various Years) revenue board and authority have performed much better in collecting sales tax on services. This provincial tax machinery also helps the federal government in the collection of withholding taxes, particularly those on motor vehicles.

FEDERAL AND PROVINCIAL SHARES IN EXPENDITURES

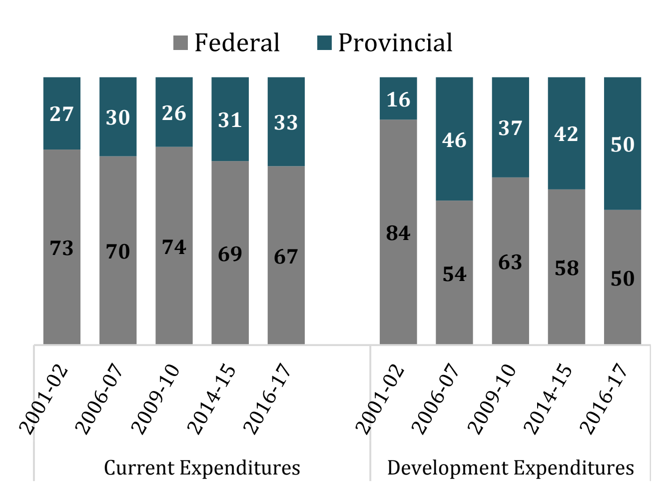
Chart 3: Distribution of Expenditures (%)



Source: Pakistan Fiscal Operation (Various Years)

Provincial governments are largely responsible for the financing of social service delivery such as education, health, public safety, and other social as well as economic services. Responsibility of provinces regarding public service delivery has increased after 18th Amendment, which is manifested in their growing share in total expenditures (federal and provincial combined) as shown in Chart 3. The share of the provinces in the total expenditure, on an average, remained 29 percent during 2001-02 and 2009-10. An increasing trend, however, is observed after the 7th NFC Award, where this share increased from 31 percent in 2010-11 to 35 percent in 2015-16. This increased level of provincial expenditure corresponds to the enhanced degree of functional responsibilities of the provinces after the 18th Constitutional Amendment. Given that provincial governments collect about 8 percent of the revenues, this growing trend in expenditures shows the importance of fiscal transfers.

Chart 4: Provincial Share in Current and Development Expenditures (%)



Source: SPDC estimates based on Pakistan Fiscal Operation (Various Years)

Chart 4 shows the combined share of provincial governments, in both current and development expenditures. It depicts that provincial governments contributed one-third of the current expenditures and half of the development expenditures in 2016-17. The higher share of federal government in current expenditure is a reflection of higher debt servicing obligations and defense spending. In contrast, provincial governments' current expenditures include a large amount of social expenditures in education and health.

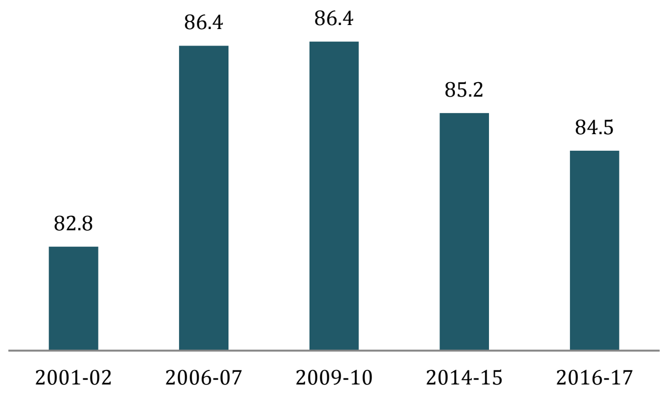
VERTICAL FISCAL IMBALANCE

There is a lack of consensus about the measurement of VFI in empirical literature. According to Eyraud and Lusinyan (2013) "transfer dependency" is one of the highly used criteria to measure VFI. They used the following formula to measure the VFI.

(p. 574)

In this formula, VFI is measured as one minus the ratio of sub-national governments' own revenues and own spending. In other words, it measures the share of sub-national governments' expenditures financed through intergovernmental fiscal transfers and borrowing. A higher ratio indicates higher dependence of sub-national governments on transfers and borrowing, and less on their own revenues. The same formula is used to measure the trend in VFI in Pakistan.

Chart 5: Trends in Vertical Fiscal Imbalance (%)



Source: Pakistan Fiscal Operation (Various Years)

Chart 5 shows the trends in VFI since 2001-02. It indicates that in 2001-02, almost 83 percent of the provincial expenditures were financed either through inter-governmental fiscal transfers or borrowings. In 2006-07, after the Presidential Distributional Order 2006, this ratio further increased to 86 percent. After the 7th NFC award, mainly due to the devolution of sales tax on services, it gradually declined to 84.5 percent in 2016-17. However, it has never been less than 80 percent throughout the period of analysis. This high of a VFI is an indication of higher dependency on transfers, which is against the spirit of second-generational fiscal federalism theories. On the one hand, this makes provincial governments less accountable and on the other, may likely to contribute inefficiencies in federal tax collection efforts.

According to Eyraud and Lusinyan (2013) reforms in various countries largely focus on narrowing the VFI. Given that Pakistan has a large VFI, narrowing it is an important objective for future reforms in the management of public finances in the country. This can be possible by providing a greater opportunity for tax collection to the provincial governments. The taxes with immobile tax bases are good contenders for tax devolution.

4 Intergovernmental Fiscal Transfers in Pakistan

Intergovernmental fiscal transfers are an integral part of the federal system of government. In Pakistan, these transfers are routed through the National Finance Commission (NFC) Awards, which are of great importance for both the federal and provincial governments. The NFC Award suggests the method for allocation of transfers through a formula-based revenue sharing mechanism, as well as through grants.

THE CONSTITUTIONAL PROVISIONS

Article 160 of the Constitution of Pakistan exclusively deals with the National Finance Commission (NFC) and contains 7 clauses. Clause 1 defines the timing, composition, and timeframe of the NFC. According to it, the NFC should be constituted every five years by the President of Pakistan. The NFC consists of 9 members i.e. federal and provincial finance ministers and four provincial members, generally referred to as non-statutory members. According to Clause 2, the NFC has the responsibility to make recommendations about: a) the distribution of the net proceeds of the taxes between the Federation and the Provinces; b) grants-in-aid to the Provincial Governments; and c) "the exercise by the Federal Government and the Provincial Governments of the borrowing powers conferred by the Constitution". Clause 3 outlines major taxes to be part of the NFC, which includes income and corporate tax, "taxes on the sales and purchases of goods imported, exported, produced, manufactured or consumed" and duties including federal excise duties. Clause 3 also has the two following sub-clauses:

> (3A) The share of the Provinces in each Award of National Finance Commission shall not be less than the share given to the Provinces in the previous Award.
>
> (3B) The Federal Finance Minister and Provincial Finance Ministers shall monitor the implementation of the Award biannually and lay their reports before both Houses of Majlis-e-Shoora (Parliament) and the Provincial Assemblies.

In short, these constitutional provisions protect the share of provincial governments in specified taxes and ensure biannual monitoring of the implementation of NFC recommendations.

AN OVERVIEW OF THE NFC AWARDS

Table 3 gives the chronology of NFC Awards in Pakistan. It shows that since 1974, there have been only four conclusive NFC Awards (1974, 1991, 1997 and 2009), in addition to Distributional Order in 2006 and 2015 – the latter slightly amended the 7th NFC award.

After the NFC Award of 1974, two attempts were made for the revision in the design of intergovernmental transfers but these were unsuccessful. After the NFC Award 1974, two attempts have been made for the revision in the design of intergovernmental transfers but these have been unsuccessful. The much-awaited NFC Award through consensus was then materialized in 1991. This was followed by the NFC Award 1997 constituted for a period of five years (1997 to 2002), but remained in practice till 2006, when a distribution order from the president of Pakistan replaced the NFC Award 1997.

Table 3: Chronology of NFC Awards

S. No.	Name	Status
First	NFC Award 1974	Conclusive
Second	NFC Award 1979	Inconclusive
Third	NFC Award 1985	Inconclusive
Fourth	NFC Award 1991	Conclusive
Fifth	NFC Award 1995	Inconclusive
	NFC Award 1997	Conclusive
Sixth	NFC Award 2002	Inconclusive
	Distribution Order 2006	-
Seventh	NFC Award 2009	Conclusive
Eighth	Distribution of Revenues and Grants-in-Aid (Amendment) Order 2015	-
Ninth	In progress	

On the distribution method, all the commissions up to the 4th NFC (1991) followed a 'gap-filling' approach by assessing the revenue receipts and expenditures based on the actual numbers, and recommending non-plan deficit grants to fill the financing gaps. This approach encouraged the provincial governments to: understate the predicted growth of their own tax revenues, increase their commitments on non-plan expenditure and run deficit budgets in the expectation that their financing gaps would be filled by grants from the Finance Commission. Apart from encouraging inefficiency, this approach also resulted in qualifying relatively better off provinces for such grants while disqualifying some of the poor provinces.

The 5th Finance Commission adopted a new formula for the allocation of federal transfers. This differed from the previous one on two grounds: (1) it was based on the new idea of the National Resource Picture and (2) it included all federal taxes in the divisible pool with revised shares for distribution. In addition, it provided constitutional subvention for two relatively backward provinces - Khyber Pakhtunkhwa (KPK) and Balochistan. Subsequent NFCs were constituted in 2000 and 2005, but the award could not be agreed upon. Finally, in the absence of any recommendation from the sixth Finance Commission, the Distribution of Revenues and Grants-in-Aid (Amendment) Order (DRGO) 2006 was issued by the president of Pakistan.

A major development in this regard was the 7th NFC Award of 2009 that significantly affected the resource distribution formula. Given the experience of several inconclusive NFC Awards, a consensus-based NFC Award after 12 years was in itself a big achievement. It was the first time that the distribution of resources among provinces was based not only on population, but also on other factors such as backwardness, inverse population density and revenue collection/generation. The 7th FC Award has also helped in resolving other issues such as Gas Development Surcharge (GDS) and Hydroelectricity Profit.

The financial implications of this Award for the federal and provincial governments are vast and long-lasting, with a substantial increase in transfers from the federal government to provinces due to the following five reasons:

1) The collection charges of the federal government have been decreased from 5 percent to 1 percent, thereby, enlarging the overall size of the divisible pool.
2) The federal government and all four provincial governments recognized the role of KPK as a frontline province against the war on terror. One percent of net proceeds of the divisible pool are, therefore, earmarked for KPK for the entire award period. For instance, in 2010-11, KPK received an additional amount of Rs15 billion against the additional costs it is bearing due to the war on terror.
3) The remaining proceeds of the provincial share of the divisible pool were increased from 46.25 percent to 56 percent in 2010-11 and then to 57.5 percent, for the rest of the award period. Indicating that the share of the federal government in the net divisible pool was 44 percent in 2010-11 and 42.5 percent during the rest of the award period.
4) The award ensures that Balochistan received at least Rs83 billion under divisible pool transfers. In case the estimated share of Baluchistan wasless than Rs83 billion, the balance funds would be contributed by the federal government.
5) GST on services collected in the Central Excise (CE) mode was also transferred to the provincial governments under the straight transfer mode – implying that revenues collected from a province would be transferred to that province on the basis of the collection. The budget of 2010-11, however, did not adhere to this principle.

In addition, the NFC Award 2009 also allows Gas Development Surcharge (GDS) arrears to be paid retroactively to Balochistan on the basis of the new formula and for the payment of the long-held up hydel profits to KPK.

The 7th NFC Award completed its tenure in June 2015; therefore, it was a constitutional obligation to initiate deliberation on the 8th NFC Award. However, instead of constituting the 8th NFC[4] federal government constituted the 9th NFC and the President issued Distribution of Revenues and Grants-in-Aid (Amendment) Order in June 2015. In fact, the order did not amend anything except endorsing the continuation of protected revenue for the province of Balochistan.

VERTICAL DISTRIBUTION OF THE DIVISIBLE POOL

Table 4 presents the formula for vertical distribution or the provincial share in the divisible pool of NFC awards. It indicates that until the NFC Award 1991, provincial governments received 80 percent of two major federal taxes "Sales Tax" and "Income and Corporation Tax", which were the most buoyant sources of revenues and were the focus of tax and tariff reforms initiated in the early 1990s. Also, the NFC Award 1991 increased transfers to the provinces by including federal excise duty on tobacco and sugar in the list of shared taxes.

Table 4: Provincial Share in Divisible Pool Taxes

Divisible Pool Taxes	NFC 1975	NFC 1991	NFC 1997	DRGO 2006	NFC 2009
Income Tax & Corporation Tax*	80	80	37.5	41.50 - 46.25	56.0 - 57.5
- Other Direct Taxes	-	-	37.5	41.50 - 46.25	56.0 - 57.5
Sales Tax	80	80	37.5	41.50 - 46.25	56.0 - 57.5
Central Excise Duty**			37.5	41.50 - 46.25	56.0 - 57.5
- Tobacco	-	80			
- Sugar	-	80			
Import Duties	-	-	37.5	41.50 - 46.25	56.0 - 57.5
Export Duties					
- Cotton	80	80	-	-	-

*Excluding taxes on income consisting of remuneration paid out of the federal consolidated fund.

**Excluding Central Excise Duty on Natural Gas

In contrast, the NFC Award 1997 included all federal taxes in the divisible pool and decreased the provincial share from 80 percent to 37.5 percent. This change was based on optimistic revenue targets of certain macroeconomic projections, such as 17 percent growth in nominal GDP, 11 percent domestic and external inflation rate and higher expectations of revenue collection as a result of successful implementation of tax and tariff reforms. However, these expectations did not materialize due to many external and internal shocks that largely affected the federal tax collection.

The vertical distribution in DRGO 2006 was based on a similar divisible pool. However, for the first time, it introduced a variable share of provincial governments that annually increased by 1.25 percentage points ranging from 41.50 percent in 2006-07 to 46.25

[4] 8th NFC was constituted without ToRs to fulfil constitutional requirement, but no deliberations were held.

percent in 2010-11. However, the award ended in 2010 with a provincial share of 45 percent. Subsequently, profound changes in the design if vertical distribution were made in 7th NFC, which have been discussed in earlier paragraphs.

HORIZONTAL DISTRIBUTION OF THE DIVISIBLE POOL

Table 5 shows the formula for the horizontal distribution of the divisible pool in the NFC Awards. It points out that the entire distribution of the divisible pool among provinces in the first three conclusive NFC Awards and in DRGO was based only on population. However, DRGO introduced two divisible pools: one is the largest divisible pool which relied on population as a sole criterion for horizontal distribution and other is used for distribution of 1/6th of the sales tax on new shares of 50, 34.85, 9.93 and 5.22 for Punjab, Sindh, KPK and Balochistan respectively. In contrast, the 7th NFC Award framed the distribution of the divisible pool based on four weighted factors. These include population (82 percent), poverty and backwardness (10.3 percent), revenue collection/generation (5 percent) and inverse population density (2.7 percent).

Table 5: Horizontal Distribution of Divisible Pool Taxes

Factors	NFC 1975	NFC 1991	NFC 1997	DRGO 2006*	NFC 2009
Population	**100%**	**100%**	**100%**	**100%**	82.0%
Poverty/Backwardness	-	-	-	-	10.3%
Revenue Collection/Generation	-	-	-	-	5.0%
Inverse Population density	-	-	-	-	2.7%

*Other than 1/6th of sales tax collected and distributed in lieu of Octroi/Zila Tax

NFC AWARDS AND STRAIGHT TRANSFERS

Straight transfers are not directly part of the NFC but are part of the separate Article 161 of the constitution, which outlines hydroelectricity profits, royalty on natural gas and crude oil, and excise duty on natural gas as straight transfers. Straight transfers were added in the NFC Award 1991 and since then have been a part of NFC negotiations and awards. The NFC Award 1991 added the Gas Development Surcharge (GDS) as a part of the straight transfers to be distributed on the basis of the province-wise share in gas production.

Historically, Balochistan had the highest share in gas production, however, that has declined from 70 percent to around 20 percent. Consequently, Balochistan's revenue from the GDS has also declined. Moreover, the cost of production of natural gas is lowest in Balochistan, which resulted in lower revenues from the royalties of natural gas production. Baluchistan raised these concerns in the 7th NFC award. After the detailed deliberations, it was decided that per unit revenues from royalties and GDS should be equalized. Since royalty is protected, the GDS amount is adjusted to equalize the per unit value. The 7th NFC award also gave grants to compensate for losses since 2000.

Another common feature of NFC awards is the discussion on profits from generation of hydroelectricity. The federal government and Khyber Pakhtunkhwa generally have differences in the computation of hydroelectricity profits that have even been addressed through third-party arbitration. Prior to the 7th NFC award, a claim of Rs100 billion by Khyber Pakhtunkhwa was accepted by the federal government after arbitration. The 7th NFC award provided a four-year roadmap to pay the amount to Khyber Pakhtunkhwa, through an instalment of Rs25 billion in each year for four years.

After the introduction of sales tax on services in 2000, a part of this tax was added to the list of straight transfer by calling it a provincial sales tax. The remaining sales taxes on services were collected under the Central Excise (CE) mode and treated like sales tax on goods.

The 7th NFC Award corrected this anomaly and transferred both the GST on services collected in CE mode and provincial GST services, to the provincial governments under the straight transfer mode – implying that revenues collected from a province would be transferred to that province on the basis of the collection. However, the 7th NFC award also allowed provinces to collect this tax by themselves. Now, sales tax on services is no longer a straight transfer and all four provinces collect GST services themselves.

GRANTS IN AID IN NFC AWARDS

Grants in aid have been a permanent feature of almost all NFC Awards. Table 6 provides a snapshot of Grants in Aid under different NFC awards. NFC 1975 awarded grants-in-aid only to Khyber Pakhtunkhwa[5] and Balochistan, while NFC award 1991 did to all four provinces. In both awards, the amounts were fixed and had a sunset clause. The NFC 1997 and the subsequent awards used a variable amount, either by assigning a percentage or linking with it divisible pool.

In addition, the 1997 NFC Award also introduced performance-based matching grants to encourage higher tax collection at the provincial level. It provided that if the provincial government achieved a minimum growth of 14.2 percent in Provincial receipts with fiscal efforts (including increases in tax rates, withdrawal of exemptions, imposition of new taxes and revision in rates of user charges), the Federal Government will pay to each province in the subsequent year, the matching grant subject to a specified maximum limit. The

[5] The then North West Frontier Province (NWFP)

matching grant had an upper ceiling of Rs500 million for Punjab and Sindh, and Rs100 million for Khyber Pakhtunkhwa and Balochistan.

DRGO 2006 separately awarded grants-in-aid to all provinces based on an unknown criterion. The base year amount was set at Rs27,750 million and future growth was linked to the net divisible pool. The 7th NFC award abolished all grants, except that it allowed Gas Development Surcharge (GDS) arrears to be paid retrospectively to Balochistan on the basis of the new formula and for the payment of the held-up hydel profits to KPK. In order to address losses to Sindh due to the abolition of the separate divisible pool for OZT grants[6], 0.66 percent of the provincial divisible pool was awarded to Sindh.

Table 6: Design of Grants/ Constitutional Subventions in NFC Awards

Factors	NFC 1975	NFC 1991*	NFC 1997	DRGO 2006**	NFC 2009
Punjab	-	Rs1000 million	-	11%	-
Sindh	-	Rs700 million	-	21%	0.66% of net PDP
Khyber Pakhtunkhwa	Rs100 million	Rs200 million	Rs3310 million	35%	-
Balochistan	Rs50 million	Rs100 million	Rs4080 million	33%	-

*For 3 years to Punjab, Khyber Pakhtunkhwa and Balochistan and for 5 years to Sindh
**Rs27,750 million for the first year and growing with net proceeds of divisible in the remaining years
PDP = Provincial Divisible Pool

[6] Octroi and Zila Tax (OZT), a local tax, was abolished by the federal government in 1999. Keeping in view the loss to the local governments, federal government increased the rate of General Sales Tax (GST) from 12.5 per cent to 15 per cent with the proviso that 2.5 percent of the GST will be given to local governments. This was discontinues in the 7th NFC Award.

5 Fiscal Implications of the 7th NFC Award

The 7th NFC Award transferred a higher share of federal taxes – collected by Federal Board of Revenue (FBR) – to provincial governments, thereby, having significant fiscal implications for federal and provincial governments. It also changed the mechanism of collecting taxes by transferring sales tax on services to the provinces. This chapter provides quantitative estimates of fiscal implications of the 7th NFC award, in comparison with DRGO 2006 for both federal and provincial finances, and highlights the magnitude of the change. The underlying assumption behind this comparison is if the 7th NFC award was not constituted, then the DRGO 2006 would likely continue. It also unpacks the impact of the 7th NFC award on tax collection, public spending particularly on social services, and fiscal deficits.

THE 7TH NFC AWARD AND GST SERVICES

An interesting implication of the 7th NFC Award is the acceptance of provincial rights over GST on services, in any mode. As per the Constitution, GST on services is a provincial tax, however, previously the FBR collected it under two heads: (1) GST services (CE Mode) and (2) GST services (provincial). While the latter was directly transferred to provincial governments after deducting collection charges based on population share, GST on services (CE Mode) was treated like GST on goods, which was distributed among the federal and provincial governments as any other divisible pool tax. The 7th NFC Award required the reversion of all revenue proceeds from taxation of services to provincial governments, after the deduction of collection charges. This had resolved the anomaly in the vertical distribution of GST on services. Consequently, both GST services CE Mode and provincial, added in straight transfers for the first two years after the 7th NFC Award. However, there was lack of consensus in the horizontal distribution of GST services.

Since the 7th NFC Award gives the right to provinces to collect GST on services, all four provinces have established their respective revenue board/authorities and are indigenizing the collection of sales tax on services. Sindh took the lead in setting up the Sindh Revenue Board (SRB) to collect GST on services at the provincial level in 2011. This was followed by Punjab setting up the Punjab Revenue Authority in 2012. Afterwards, Khyber Pakhtunkhwa and Balochistan too, established a revenue authority in the respective provinces. Therefore, revenues from GST services are no longer a divisible pool or straight transfer and are provincial own tax revenues.

This transformation of GST services from a mix of divisible pool and straight transfers to tax to provincial tax has financial implications for both federal and the four provincial governments. This is so far, a favorable situation for all provinces as GST collected by their own bodies is higher than their respective shares in the divisible pool and straight transfers, while the federal government has had negative financial repercussions. Since the GST on services is a de-jure provincial tax and de-facto practices prior to the 7th NFC award were constitutionally unjustified, their financial implications after the 7th NFC award are not included in the analysis.

FEDERAL AND PROVINCIAL REVENUES FROM DIVISIBLE POOL TAXES

Table 7 presents the net impact of the change in the design of the divisible pool due to the 7th NFC award, in comparison with DRGO 2006[7], both on the federal and provincial governments. It shows that in the first year after the 7th NFC award, more than Rs135 billion were additionally transferred to the provincial governments due to a 4 percentage point reduction in collection charges and 10 percentage point increase in the provincial share in the divisible pool. In relative terms, in 2010-11 almost 9 percent of the FBR taxes were additionally transferred to four provincial governments. After 2010-11, almost 10 percent of the FBR taxes were additionally transferred to four provinces[8].

Table 7: The 7th NFC Award Comparative Financial Impact of Divisible Pool Changes

	Federal Revenues	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan
Impact of change in Design due to the 7th NFC Award: Absolute Amount (Rs in Billion)					
2010-11 RE	-135.8	25.4	23.0	40.2	47.2
2011-12 RE	-180.8	43.8	33.2	54.1	49.7
2012-13 RE	-188.8	45.4	34.4	56.8	52.2
2013-14 RE	-223.1	51.1	38.4	64.8	68.7
2014-15 RE	-261.5	61.2	46.6	74.7	78.9
2015-16 RE	-305.2	75.3	58.0	89.6	82.3
2016-17 RE	-347.8	83.9	64.2	101.6	98.1
Relative Impact [As a percentage of FBR Taxes] (%)					
2010-11 RE	-8.7	1.6	1.5	2.6	3.0
2011-12 RE	-9.4	2.3	1.7	2.8	2.6
2012-13 RE	-9.6	2.3	1.7	2.9	2.6
2013-14 RE	-9.9	2.3	1.7	2.9	3.1
2014-15 RE	-10.1	2.4	1.8	2.9	3.1
2015-16 RE	-9.9	2.4	1.9	2.9	2.7
2016-17 RE	-10.0	2.4	1.8	2.9	2.8

Source: SPDC Estimates based on Explanatory Memorandum on Federal Receipts, Finance Division, Government of Pakistan (Various Issues)

[7] As per DRGO 2006, provincial share in 2010-11 was 46.25, which was raised to 56.26 percent in the 7th NFC award.

[8] In the remaining years provincial share raised to 57.5 percent while under DRGO 2006 maximum share was 46.25 percent

A look into province-wise net increases indicate that Balochistan and Khyber Pakhtunkhwa were the major gainers from the 7th NFC award, as they additionally received, on average, 2.8 percent of the FBR taxes each year. Before highlighting the reasons of this gain, it is important to recall that under DRGO 2006, distribution of divisible pool taxes was largely based on the population. The only exception was one-sixth of the GST that was distributed on a computed share, based on a hybrid of population and collection of Octrai and Zila Tax (OZT). Consequently, the share of each province in the divisible pool under DRGO 2006 was based on the population share as well as share in OZT collection. The 7th NFC award abolished separate shares for distribution of one-sixth of the GST goods as OZT grants.

Now the question is what explains the sizeable increase in revenues from the divisible pool for both Balochistan and Khyber Pakhtunkhwa? Balochistan's average share was 5.13 percent, which was a mix of population share of 5.11 percent and one-sixth GST share of 5.22 percent. Khyber Pakhtunkhwa's average share was 13.27 percent based population and one-sixth GST shares of 13.82 percent and 9.93 percent, respectively. The 7th NFC award raised Balochistan's share to 9.09 percent and Khyber Pakhtunkhwa's share to 14.62 percent. Moreover, the federal government guaranteed that any shortfall in FBR taxes will not affect Balochistan's revenue from the divisible pool and it will be compensated from federal share. For Khyber Pakhtunkhwa, the 7th NFC award granted an additional one-percent of the divisible pool to compensate losses due to war on terror. As a result, average shares of Khyber Pakhtunkhwa and Balochistan, based on revised estimates turned out to be 16.0 percent and 9.3 percent, respectively.

In contrast, the 7th NFC award reduced shares of both Punjab and Sindh. In DRGO 2006, average shares of both Punjab and Sindh were 56.33 percent and 25.28 percent, respectively. Punjab's share was based on population and one-sixth GST shares of 57.36 percent and 50.00 percent, respectively. Similarly, Sindh's share was based on population and one-sixth GST shares of 23.71 percent and 34.85 percent, respectively. Despite the decline in shares, both provinces had relatively higher divisible pool revenues in lieu of the 7th NFC award, due to decline in collection charges and increase in vertical shares from 46.25 percent to 56.25 percent in the first year and 57.5 percent afterwards.

The above comparative analysis clearly shows that with consensus, both Punjab and Sindh willingly agreed to reduce their shares in the divisible pool and the federal government not only compensated their losses, but also agreed to transfer additional resources. It can be concluded that the 7th NFC award is fiscally equalizing, as provinces with relatively weak tax bases gained more through non-discretionary, transparent mechanisms.

IMPACT OF THE 7TH NFC AWARD ON STRAIGHT TRANSFERS

As pointed out previously earlier that straight transfers are not directly part of the NFC but are part of the separate Article 161 of the constitution. However, straight transfers were added in the NFC Award of 1991 and since then have been a part of NFC negotiations and awards, and the 7th NFC award is not an exception to this. During the negotiations for 7th NFC Award, Balochistan demanded changes in the GDS distribution formula and Khyber Pakhtunkhwa asked for its profit from hydroelectricity. Since profit from hydroelectricity is a bilateral issue between the federal government and Khyber Pakhtunkhwa, it was addressed through federal grants.

GDS was added to the list of straight transfers in the 4th NFC award as a goodwill gesture from the federal government. GDS is the difference between the average prescribed price and consumer price. Prescribed price is based on the cost of production and distribution of the gas while consumer price is slightly higher than the prescribed price, notified by the federal government. Since 1991, horizontal distribution of the GDS was based on the production share of natural gas. Initially, Balochistan was the major producer of the gas and received the highest share from the GDS. Gradually, Balochistan's natural gas production share declined to around 20 percent, while Sindh's share increased to more than 70 percent, which was then reflected in each province's share in GDS.

In addition to GDS, there are two straight transfers based on the production of natural gas i.e. royalty and excise duty on natural gas. While the per unit value of excise duty is same for all provinces and wellheads, royalty is based on agreed per unit wellhead prices. Since Balochistan has relatively old wellheads and Sindh relatively newer ones, the per unit wellhead price in Balochistan is low. These differences in wellhead prices generate relatively higher per unit royalties for Sindh and low per unit royalties for Balochistan. Balochistan also claimed that cheap gas from Balochistan is generating the GDS, as it keeps average prescribed prices lower than average consumer prices.

The 7th NFC had detailed deliberations on the matter and involved National Electric Power Regulatory Authority (NEPRA) to draft a sustainable and agreed-upon solution. After detailed discussions, the 7th NFC award changed the GDS computation formula. The distribution of GDS under the revised formula is based on a notional per unit price, after combining both per unit GDS and royalty from natural gas. Given that royalty is protected through the constitution, the GDS is adjusted to equate differences in per unit province-wise average royalty. The revised formula was treated as a just formula since it equates the per unit revenues from GDS and royalty has negative impact on GDS to Sindh. While Sindh agreed to the formula, it asked for upward revision of excise duty on natural gas from Rs5.09 per MMBTU to Rs10 per MMBTU. The 7th NFC accepted this revision in consultation with NEPRA.

Table 8 shows the net province-wise impact of changes made in the 7th NFC award, compared to previous arrangements. Both changes have had a net positive impact on revenues from straight transfers to Balochistan. While, Sindh has experienced a negative impact due to the change in the GDS distribution formula, it has benefited from an upward revision of the excise duty, resulting in a net positive impact till 2015-16.

Table 8: The 7th NFC Award Comparative Financial Impact of Changes in Straight Transfers

	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan	Total
The 7th NFC Award Financial Impacts Straight Transfers: Absolute Amount (Rs in Billion)					
2010-11 RE	0.9	2.5	0.6	2.1	6.1
2011-12 RE	1.0	3.5	0.4	2.1	7.0
2012-13 RE	-0.1	2.5	0.8	2.9	6.1
2013-14 RE	-0.8	1.9	1.5	3.1	5.7
2014-15 RE	1.1	0.8	2.7	1.3	5.9
2015-16 RE	0.7	2.3	1.8	2.4	7.1
2016-17 RE	1.5	-1.9	1.4	5.8	6.9
Relative Impact [As a percentage of FBR Taxes] (%)					
2010-11 RE	0.06	0.16	0.04	0.13	0.4
2011-12 RE	0.05	0.18	0.02	0.11	0.4
2012-13 RE	0.00	0.13	0.04	0.15	0.3
2013-14 RE	-0.04	0.08	0.07	0.14	0.3
2014-15 RE	0.04	0.03	0.11	0.05	0.2
2015-16 RE	0.02	0.07	0.06	0.08	0.2
2016-17 RE	0.04	-0.05	0.04	0.17	0.2

Source: SPDC Estimates based on Explanatory Memorandum on Federal Receipts, Finance Division, Government of Pakistan (Various Issues)

IMPACT OF THE 7TH NFC AWARD ON GRANTS AND ARREARS

Another important domain of the NFC is to allow or withdraw grants/constitutional subventions to provinces. The 7th NFC award made four changes in grant/constitution subventions as compared to DRGO 2006. Firstly, it abolished the grants-in-aid to all provinces constituted under the DRGO 2006. Secondly, after revising the formula for distribution of GDS, awarded Rs10 billion and Rs2 billion separately to Balochistan to compensate for arrears of GDS. Thirdly, grant of Rs25 billion per year for four years was awarded to Khyber Pakhtunkhwa. This Rs100 billion grant was based on the arbitration between Khyber Pakhtunkhwa and the federal government on the arrears of profits from hydroelectricity generation. This arbitration also benefitted Punjab since the province received the corresponding amount in the form of grants for arrears of net hydel profits. Finally, Sindh was compensated through a grant of 0.66 percent of the provincial divisible pool to offset the decline in provincial share resulting from the abolition of separate shares, for the distribution of one-sixth of GST revenues generally referred as OZT grants. These grants under DRGO 2006 were deducted from the provincial shares. It was also decided that instead of the federal government deducting it from provincial shares and transferring them to local governments, the provincial government will transfer these to local governments through their divisible pool.

Table 9 presents the estimates of increased or decreased provincial revenues, due to the four changes mentioned above. The 7th NFC Award's decision to abolish grants to provinces benefitted federal government. Despite grants for arrears of net hydel profit to Khyber Pakhtunkhwa and Punjab, arrears of GDS to Balochistan, and OZT grants to Sindh, the federal government is the net beneficiary in the of the revision of grant mechanism. Consequently, during the post-7th NFC period, the savings in grants to the federal government ranged from Rs2.6 billion to Rs87.5 billion from 2010-11 to 2016-17. In relative terms, the federal government has been able to save 2.5 percent of FBR taxes since 2014-15. On average, Sindh, Balochistan and Punjab have experienced a decline in grants of roughly 50 percent, during the post-7th NFC Award period. Khyber Pakhtunkhwa was initially better off, however since 2014-15 experienced a massive decline in its revenues, due to the decline in grants.

Table 9: The 7th NFC Award Comparative Financial Impact of Changes in Grants

	Federal Revenues	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan
The 7th NFC Award Financial Impacts Straight Transfers: Absolute Amount (Rs in Billion)					
2010-11 RE	2.6	-0.4	-4.7	7.2	-4.8
2011-12 RE	14.2	-1.8	-6.3	2.8	-8.9
2012-13 RE	14.6	-2.1	-4.8	2.0	-9.7
2013-14 RE	29.2	-8.2	-7.1	-1.0	-13.0
2014-15 RE	64.8	-9.2	-8.8	-29.3	-17.6
2015-16 RE	77.4	-10.8	-9.8	-34.4	-22.4
2016-17 RE	87.5	-12.2	-10.2	-38.7	-26.5
Relative Impact [As a percentage of FBR Taxes] (%)					
2010-11 RE	0.17	0.0	-0.3	0.5	-0.3
2011-12 RE	0.74	-0.1	-0.3	0.1	-0.5
2012-13 RE	0.74	-0.1	-0.2	0.1	-0.5
2013-14 RE	1.30	-0.4	-0.3	0.0	-0.6
2014-15 RE	2.52	-0.4	-0.3	-1.1	-0.7
2015-16 RE	2.52	-0.4	-0.3	-1.1	-0.7
2016-17 RE	2.50	-0.3	-0.3	-1.1	-0.8

Source: SPDC Estimates based on Details of Demands for Grants and Appropriations, Finance Division, Government of Pakistan (Various Issues)

AGGREGATE FINANCIAL IMPLICATIONS OF THE 7TH NFC AWARD ON PROVINCES

Having estimated the financial implications of changes in the divisible pool, straight transfers and grants, we are now in a position to assess the overall financial impact of the 7th NFC Award. Table 10 presents province-wise financial implications of the 7th NFC

Award in comparison to the DRGO 2006. It indicates that as per the revised estimates from 2010-11 to 2016-17, in relative terms, Balochistan and Khyber Pakhtunkhwa are the major gainers from the 7th NFC award, with an average per year increase of more than 2.4 percent of the FBR taxes, throughout the tenure of the NFC Award. In contrast, the 7th NFC award took away, on average, 8 percent of FBR taxes from the federal government. The relative picture substantiates the point made earlier that, the 7th NFC Award is fiscally equalizing as its provisions disproportionately benefit the relatively backward provinces more.

Table 10: The 7th NFC Award Comparative Financial Impact

	Federal Revenues	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan
The 7th NFC Award Financial Impacts Straight Transfers: Absolute Amount (Rs in Billion)					
2010-11 RE	-133.1	25.9	20.8	48.0	44.5
2011-12 RE	-166.6	43.0	30.5	57.3	42.9
2012-13 RE	-174.2	43.3	32.1	59.6	45.4
2013-14 RE	-193.8	42.2	33.2	65.3	58.9
2014-15 RE	-196.6	53.1	38.7	48.2	62.6
2015-16 RE	-227.8	65.2	50.5	57.0	62.3
2016-17 RE	-260.3	73.2	52.1	64.4	77.5
Relative Impact [As a percentage of FBR Taxes] (%)					
2010-11 RE	-8.56	1.7	1.3	3.1	2.9
2011-12 RE	-8.67	2.2	1.6	3.0	2.2
2012-13 RE	-8.81	2.2	1.6	3.0	2.3
2013-14 RE	-8.62	1.9	1.5	2.9	2.6
2014-15 RE	-7.63	2.1	1.5	1.9	2.4
2015-16 RE	-7.41	2.1	1.6	1.9	2.0
2016-17 RE	-7.45	2.1	1.5	1.8	2.2

Source: SPDC Estimates

LEVEL OF FISCAL EFFORT

Pakistan has a low tax-to-GDP ratio, where most of the buoyant taxes are in the domain of the federal government. It was generally perceived that a higher share of provincial governments in FBR taxes will put pressure on the federal government for resource mobilisation to meet its expenditure. Consequently, tax-to-GDP will increase due to these efforts. However, a look at the growth rate of FBR tax collection reveals that growth in FBR taxes declined after the 7th NFC Award. During 2006-07 to 2009-10, growth in FBR taxes was more than 16 percent, which declined to 13.8 percent during 2010-11 to 2016-17. A similar trend is evident from other tax revenues - growth has declined after the 7th NFC Award (Table 11).

Table 11: Level of Fiscal Effort by Federal and Provincial Governments						
						(Rs in Billions)
	DRGO 2006			7th NFC		
	2006-07	2009-10	ACGR	2010-11	2016-17	ACGR
Federal Government						
FBR Tax Revenues	847.2	1,327.4	16.1	1,550.2	3,361.0	13.8
Other Tax Revenues	70.2	116.5	18.4	115.0	286.4	16.4
Total Federal Taxes	**917.4**	**1,443.9**	**16.3**	**1,665.1**	**3,647.5**	**14.0**
Percentage of GDP	**8.8**	**9.8**		**9.2**	**11.4**	
Provincial Government						
Punjab	19.6	29.9	15.0	32.6	155.4	29.8
Sindh	14.0	21.6	15.5	27.5	144.5	31.8
Khyber Pahktunkhwa	2.4	2.3	-0.5	3.5	15.7	28.4
Balochistan	0.8	1.0	8.3	1.0	6.3	36.2
Total Provincial Taxes	**36.8**	**54.8**	**14.2**	**64.6**	**321.8**	**30.7**
Percentage of GDP	**0.4**	**0.4**		**0.4**	**1.0**	

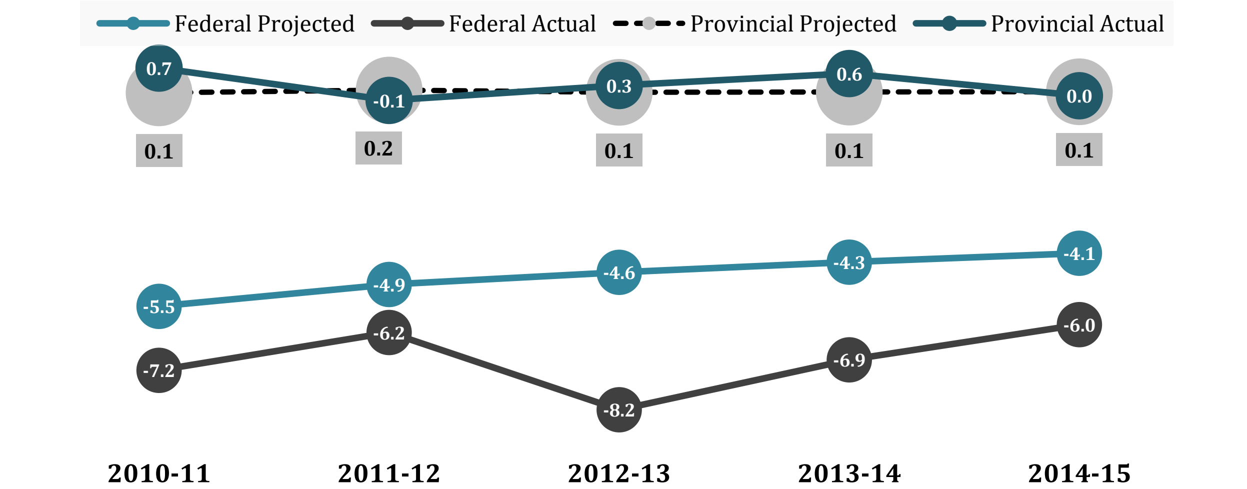
Source: Fiscal Operations, Finance Division, GoP (http://www.finance.gov.pk/fiscal_main.html)

In contrast, tax revenues of provincial governments have had an impressive growth of more than 30 percent after the 7th NFC award as compared to 14 percent during 2006-07 and 2009-10. The devolution of sales tax on services is the main reason for this phenomenal growth.

LEVEL OF BUDGET DEFICIT

The 7th NFC award projected the key budgetary magnitudes of both federal and four-provincial governments for 2010-11 to 2014-15. Based on these projections Chart 6 presents the actual and projected budget deficits of both federal and provincial governments as a percentage of the GDP. It indicates that during the post-7th NFC period, actual federal budget deficit surpassed the projected budget deficit with wild margins. For example, for 2012-13 the projected federal budget deficit was only 4.6 percent of the GDP, while the actual budget deficit was more than 8 percent of GDP. In contrast, the provincial budget balance shows a mixed trend. For instance, for 2012-13 NFC projected a combined provincial budget surplus of 0.1 percent of the GDP, while the actual budget surplus was 0.3 percent of the GDP. However, for 2011-12 for the similar projection, provincial governments altogether had a budget deficit 0.1 percent of the GDP, instead of a surplus (Chart 6).

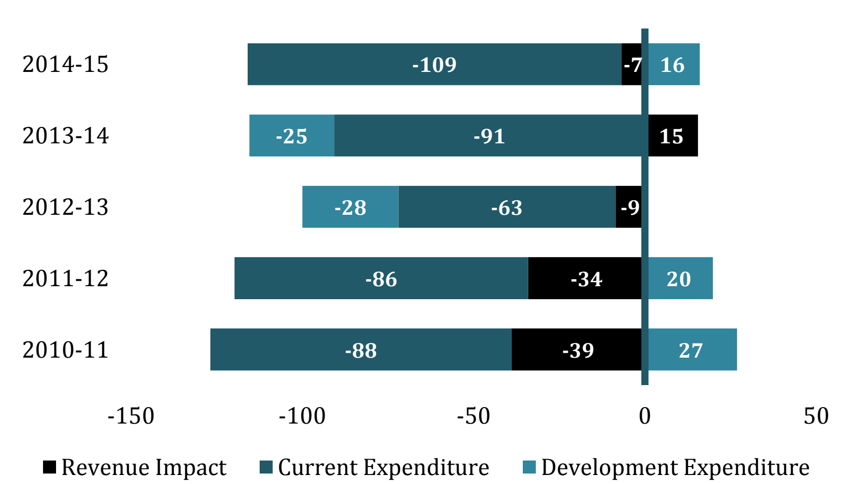
Chart 6: Trend in Federal and Provincial Budget Deficits (as a percentage of GDP) (%)



Source: SPDC estimates based on Report of the National Finance Commission 2009 and Pakistan Fiscal Operation (various issues)

It is generally argued that the higher share of provinces in the 7th NFC Award is the biggest cause of financial problems for the federal government, including massive growth in federal budget deficit. Chart 7 shows a deconstruction of the federal budget deficit into three components i.e. revenue, current and development expenditures impacts. Each component shows the net contribution of deviations in actual and projected amounts in an increase in the federal budget deficit, in percentage terms.

Chart 7: Causes of higher than the anticipated federal budget deficit (%)



Source: SPDC estimates based on Report of the National Finance Commission 2009 and Pakistan Fiscal Operation (various issues)

The decomposition results shows that shortfall in FBR revenues affected the provinces more than the federal government. As shown in Chart 7, the revenue impact is not very high, particularly after 2011-12. In the initial two years, the shortfall in federal revenues contributed to more than 30 percent of the federal budget deficit. However afterwards it was less than 10 percent and in fact, in 2013-14, it surpassed the projected amount. In contrast, in all the fiscal years during 2010-2015, current expenditure of the federal government overshot by more than Rs300 billion, compared to the projected amount. In 2013-14, the deviation was close to Rs700 billion, indicating that the federal government failed to curtail its current expenditures, despite the devolution of basic social services to provincial governments. In the case of federal development expenditure, the comparison of actual outlays and 7th NFC projections portrays a mixed pattern. It was less than the projected amount in 2010-11, 2011-12 and 2014-15, and more than the projected amount in 2012-13 and 2013-14 (Chart 7).

The above analysis clearly spells out that the biggest cause of a higher federal budget deficit is the tremendous growth in current expenditures. FBR revenue shortfall, along with higher federal transfers to provinces caused a slight deviation in the budget deficit, rather it is the higher than projected current expenditure that caused the growth in the budget deficit.

6 Fiscal Federalism and Debt Management

Debt management in a federal structure of governance is a complex issue. In many countries, sub-national governments have limited borrowing powers due to concerns regarding possible impacts on macroeconomic stability and debt sustainability. In Pakistan, the Constitution outlines borrowing powers of the national and sub-national governments. In addition to constitutional provisions, Pakistan has fiscal responsibility acts defining national fiscal deficit levels and borrowing limits.

This chapter discusses issues related to debt management in Pakistan. It lays out the constitutional provisions with respect to the borrowing powers in the country, followed by a discussion on the fiscal responsibility acts for public debt management. It also presents the implications of the 7th NFC awards' recommendations for the deficits and debt levels.

BORROWING POWERS OF NATIONAL AND SUB-NATIONAL GOVERNMENTS

Articles 166 and 167 of the constitution of Pakistan outline the borrowing powers of both federal and provincial governments. The 18th Constitutional Amendment, while did not change the borrowing powers federal government, enhanced the borrowing powers of provincial governments.

Article 166: Borrowing by Federal Government.

The executive authority of the Federation extends to borrowing upon the security of the Federal Consolidated Fund within such limits, if any, as may from time to time be fixed by Act of [Majlis-e-Shoora (Parliament)], and to the giving of guarantees within such limits, if any, as may be so fixed.

Article 167: Borrowing by Provincial Government.

(1) Subject to the provisions of this Article, the executive authority of a Province extends to borrowing upon the security of the Provincial Consolidated Fund within such limits, if any, as may from time to time be fixed by Acts of the Provincial Assembly, and to the giving of guarantees within such limits, if any, as may be so fixed.

(2) The Federal Government may, subject to such conditions, if any, as it may think fit to impose, make loans to, or so long as any limits fixed under Article 166 are not exceeded give guarantees in respect of loans raised by, any Province, and any sums required for the purpose of making loans to a Province shall be charged upon the Federal Consolidated Fund.

(3) A Province may not, without the consent of the Federal Government, raise any loan if there is still outstanding any part of a loan made to the Province by the Federal Government, or in respect of which guarantee has been given by the Federal Government; and consent under this clause may be granted subject to such conditions, if any, as the Federal Government may think fit to impose.

(4) A Province may raise domestic or international loan, or give guarantees on the security of the Provincial Consolidated Fund within such limits and subject to such conditions as may be specified by the National Economic Council.

Clause 4 of Article 167 was added under the 18th Constitutional Amendment. Given that National Economic Council (NEC) has appropriate representation of the provinces, it is inferred that the borrowing powers of provincial governments have been enhanced.

NORMS OF FISCAL RESPONSIBILITY IN PAKISTAN

The federal government of Pakistan is operating under the Fiscal Responsibility and Debt Limitation (FRDL) Act since 2005. The Act has, from time to time, been amended to add new roles over targets. It was last amended on 1st July 2017. The amended Act sets the following limits: (a) reducing the federal fiscal deficit net of foreign grants to 4 percent of the GDP during the three years beginning from 2017-18, and afterward maintaining it at three and half percent of the GDP; (b) ensuring that by June 30, 2019, the total public debt-to-GDP ratio does not exceed 60 percent; (c) ensuring that within a period of five financial years beginning from the financial year 2018-19, total public debt shall be reduced by 0.5 percent every year and from 2023-24 going up to financial year 2032-33, a reduction of 0.75 percent every year to reduce the total public debt to fifty percent of the estimated GDP, and thereafter maintaining it to fifty percent or less of the estimated gross domestic product; and (d) not issuing new guarantees (including renewal) beyond two percent of the GDP in any year.

Every year as required, the Debt Policy Coordination Office of the Ministry of Finance, Government of Pakistan, submits to the national assembly a debt policy statement indicating the trends in public debt and the extent of adherence to the FRDL Act. However, the FRDL Act does not contain any provisions specific to provincial governments.

DEBT-DEFICIT DYNAMICS POST 7TH NFC AWARD

Historically, provincial governments have engaged in very limited direct borrowing, not only because of the degree of fiscal prudence, but also due to limited access to the banking system and the capital market. During the 70s and 80s, provincial governments floated some long-term market loans as part of the permanent debt. This practice has largely been discontinued. The federal government has also been making cash development loans

(CDLs) to the provincial governments. The latter have argued that interest rates charged by the former were high in relation to the cost of borrowing. Currently, most of the loans to the provinces are in the form of foreign assistance.

The 7th NFC made no recommendations on borrowing, except for emphasising that both governments would develop and enforce mechanisms for maintaining fiscal discipline through legislative and administrative measures.[9] The budgetary magnitudes show a mixed trend in fiscal balance after the 7th NFC award. Accordingly, the federal government has relatively high budget deficits as a percentage of the GDP, which reached to 8.4 percent of the GDP in 2012-13 (Table 12).

Table 12: Post 7th NFC Award Federal and Provincial Fiscal Balance

(Rs in Billions)

	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Punjab	48.1	-9.0	10.9	55.6	19.3	101.2	-5.0
Sindh	20.5	-28.5	41.4	41.4	17.2	50.6	-61.5
Khyber Pakhtunkhwa	50.3	-3.7	-4.2	43.0	-38.2	4.6	-74.9
Balochistan	15.6	19.1	14.8	9.5	5.3	-14.7	-21.9
Four Province Combined	**134.5**	**-22.1**	**62.9**	**149.5**	**3.5**	**141.7**	**-163.2**
Federal Government	**-1,296.5**	**-1,277.8**	**-1,880.7**	**-1,753.3**	**-1,637.8**	**-1,703.1**	**-1,778.5**
Fiscal Balance as a percentage of the national GDP (%)							
Federal Government	-7.1	-6.4	-8.4	-7.0	-6.0	-5.9	-5.6
Four Province Combined	0.7	-0.1	0.3	0.6	0.0	0.5	-0.5
National Fiscal Balance							
National Fiscal Balance	**-6.4**	**-6.5**	**-8.1**	**-6.4**	**-6.0**	**-5.4**	**-6.1**

Source: Fiscal Operations, Finance Division, GoP (http://www.finance.gov.pk/fiscal_main.html)

Apparently, this high of a deficit can easily be attributed to the 7th NFC award. However, during this period other domestic and external factors also played an instrumental role in driving the high federal budget deficit. For instance, in 2010, a natural catastrophe in terms of a devastating flood put dual pressure on public finances of the country. On the one hand, it reduced the pace of economic growth and negatively affected revenue mobilization. On the other, relief efforts created demand for extra spending. In 2012-13, in order to address the issue of circular debt – that partly caused a shortfall in energy production – the federal government instated a huge power sector subsidy, which pushed the budget deficit to a higher level. Apart from these one-time shocks, the federal government has been unable to mobilize resources through direct and indirect taxes. Simultaneously, the envisaged impact of the 18th Amendment is not visible on the federal current expenditures. During the first year of the 7th NFC award, the federal government has increased the salary of employees by 50 percent. Instead of reducing the number of ministries due to transfers of functions to

[9] 7th NFC Award, Paragraph (3) of the Miscellaneous Section.

provinces in lieu of the 18th Amendment, the federal government has increased the divisions.

In contrast, to reducing the overall national budget deficit, the federal government has put pressure on provincial governments to generate surpluses. One such example of this pressure is an incentive grant mechanism under the advice of IMF. The Government of Pakistan signed a Memorandum on Economic and Financial Policies for 2013/14 –2015/16 with the IMF on August 19, 2013, which contained a list of "Prior Actions and Structural Benchmarks under Extended Fund Facility". One of the prior actions mentioned in the list is "Impose a balanced budget requirement on provinces and agree with provinces to save additional revenues generated by the program." In compliance with this action, the memorandum contained an assurance from the federal government which states that "… an agreement has been reached at the level of the Council of Common Interest to assure that it is used for deficit reduction or saved. In addition, the government has tightened the balanced-budget requirement on provinces, and provided incentives for them to maintain surpluses (prior action)."

An analysis of the Council of Common Interest's (CCI) decision in this regard revealed that the federal government, in consultation with the provinces, had decided that provinces would be allowed the rate of return on their minimum surpluses at the latest T-bills rate, maintained for a minimum of three months. As per this decision, the federal government distributed more than Rs3.8 billion during 2013-14 as an incentive grant on marinating provincial surplus. This explains the budget surpluses at provincial levels during 2013-14 to 2015-16 (Table 13).

Table 13: Incentive Grant on Maintaining Provincial Surpluses

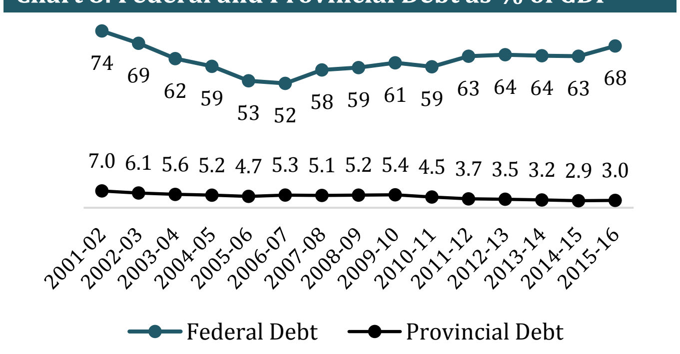
(Rs. in Million)

	2013-14	2014-15	2015-16
Punjab	556.5	3,592.9	1,684.9
Sindh	2.3	480.9	836.6
Khyber Pakhtunkhwa	1,504.4	4,279.2	1,197.7
Balochistan	1,801.9	2,980.0	2,000.5
Total	**3,865.1**	**11,333.1**	**5,719.6**

Source: Federal Details of Demands for Grants and Appropriations (various years)

The provincial governments used these surpluses to early retirement of expensive debt from federal government. As of June 30, 2011, the combined outstanding debt of the four provinces is estimated at less than five percent of the national GDP, with the share of external debt at approximately 70 percent. Interest payments constitute

Chart 8: Federal and Provincial Debt as % of GDP



less than four percent of revenue receipts. As of June 30, 2016, the combined outstanding debt of the four provinces is estimated around three percent of the national GDP, with the share of external debt increased to more than 80 percent. In other words, due to improvement in debt management at the provincial level, provinces have a low level of overall debt with a high proportion of external debts. These external debts routed through the federal government and are in the form development assistance from multilateral and bilateral donors. In contrast, federal debt started rising after a decline to 52 percent of the GDP prior to the 7th NFC award and federal gross public debt reached to almost 68 percent of the GDP as on 30th June 2016.

In conclusion, provincial governments have low levels of development spending, budget deficits, and outstanding debt. Given the low level of outstanding provincial debt, there is perhaps a case for enhancing the access of provincial governments to the capital market. Besides enlarging the provincial resource envelope, this will expose such governments to market discipline, greater reporting requirements, and fiscal transparency. However, it is important to ensure sustainability of sub-national debt if problems of financial insolvency are to be avoided in the medium to long run, leading to a situation where the federal government has to engage in bailout operations as 'lender of the last resort'. Moreover, excessive provincial borrowing could jeopardise adherence to the macroeconomic and fiscal framework of the country. To avoid such hypothetical conditions, the future NFC may set fiscal rules for setting borrowing limits.

In contrast to the provincial government, federal government has a relatively high level of public debt, which is more than the limit suggested by the amended FRLDO 2005. Instead of blaming the NFC awards for the growing debt level, the federal government needs to focus on structural reforms that require current expenditure containment and greater resource mobilization.

7 Fiscal Federalism and Local Government in Pakistan

Both first and second-generation theories of fiscal federalism argue for greater fiscal autonomy at sub-national levels, including the local government. In fact, strong theoretical arguments are available in support of fiscal autonomy at the third-tier of government since it is directly involved in the provision of basic services, including fire fighting, water and sanitation, basic health, education and the like. For instance, the argument of welfare gain states that the delivery of services will be more efficient if administrative functions are being performed by elected governments. The rationale underpinning this argument is that the allocation of public resources at a local level is more likely to conform to public welfare priorities (Oates, 1972 and Teibot, 1956).

Despite this theoretical importance, local governments have had a chequered history in Pakistan. In the past, various attempts were made to implement a fully functional Local Government (LG) system, without sustainability. This chapter provides an overview of the LG system in Pakistan along with highlighting key features of LG financing in the country.

HISTORICAL OVERVIEW OF THE LOCAL GOVERNMENT SYSTEM

In Pakistan, local governments have been a somewhat neglected tier of government, with the exception of the Devolution Plan 2001. The history of decentralized governance in the country had a unique feature until 2010 since all the local government reforms were initiated by non-representative military regimes. The first local government (LG) system was introduced under the Basic Democracy Ordinance (1959) by the military government. While this ordinance assigned some functions, ranging from basic health, social welfare to infrastructure to the LG, a few could be performed due to lack of fiscal capacity. The system was rolled back after the change of government[10].

Under the military regime of General Zia-ul-Haq, the Local Government Ordinance 1979 was promulgated. Under this ordinance, local government elections were held and basic municipal functions were transferred to local government bodies. The system operated till 1993. The next LG system was initiated under the Devolution Plan 2001, yet again by a military government, whereby, the local governments were given unprecedented fiscal autonomy. During this period Provincial Finance Commissions (PFCs) were constituted for the first time in all the provinces of Pakistan. These commissions formulated a transparent mechanism for both vertical (distribution of resources from province to all districts) and

[10] People's Local Government Ordinance 1972 and 1975 were passed but never implemented. The Constitution of 1973 endorsed the importance of local government institutions under Article 32.

horizontal distribution (among the districts). However, this system was discontinued in 2008.

In 2010, the 18th constitutional amendment declared LG as the third tier of government by adding Article 140A Local Government, which states:

> *Each Province shall, by law, establish a local government system and devolve political, administrative and financial responsibility and authority to the elected representatives of the local governments.*

Each province now has the discretion to devise its own local governmental system. An overview of LG ordinances indicates variations in the LG system across provinces, in terms of structures, functions, and fiscal powers. Variation also exists in the status of implementation of the LG system in each province. For instance, these ordinances contain provisions for establishment of PFCs; however, so far only two provinces have announced PFCs.

LOCAL GOVERNMENT FINANCES AND OCTRAI AND ZILA TAX

Historically, Octroi and Zila Tax (OZT) was the main source of revenue for local governments. Apart from OZT local governments have limited taxation powers and heavily relied on provincial grants for the financing of local government services. While the urban immovable property tax is a local government tax, it is collected by the provincial government. In 2001, a set of formula-based transparent PFC Awards were announced for the first time. These awards were used as the basis for transferring resources to the local government from 2002-03 to 2009-10.

The Octroi and Zila tax (OZT) was abandoned in 1999. To offset the loss of revenues of the local councils it was decided to levy 2.5 percent additional sales tax (over and above the existing GST of 12.5 percent at that time) for payment to provincial governments as grant-in-aid. This issue was also discussed in the meeting of the Chief Executive Committee held on 22nd January 2002 wherein following decision was made:

> *"COS to the President should coordinate with the concerned authority to ensure that 2.5% GST imposed in lieu of octroi is transferred to TMAs to enable them to maintain service delivery".*

From 1999, the federal government provided a grant to local governments through provincial governments, till 2006. The OZT grants were transferred separately to provincial governments based on their base year amount, which was much lower than the actual collection under one-sixth of GST goods. On the demand of the provinces, these grants were enhanced to one-sixth of the sales tax and were added in the divisible pool of transfers under DRGO 2006. From 2006-07 to 2009-10, the NFC transfers to provinces clearly mentioned the OZT grants in the divisible pool as one-sixth of the GST. However, the equivalent amount was deducted from the provincial share in the divisible pool instead of grants from federal government, and was directly transferred to local governments.

During the deliberations for the 7th NFC Award, it was decided that there was no need to create two divisible pools; one for OZT grants and other for horizontal distribution of revenues. Therefore, OZT grants were merged in the provincial divisible pool and their share was appropriately adjusted. Under this scenario, Sindh was the only province which had a loss in revenues from the divisible pool. Therefore, the 7th NFC Award gave an additional OZT grant to compensate OZT losses to Sindh. However, this development transmitted the wrong signals that federal government has abolished the OZT grants. The reality is that OZT grants were previously deducted from provincial shares and directly transferred to local governments, whereas, provincial government did not have any significant role except receiving it from the federal government and forwarding it to local government without any deduction. In other words, from 2006-07 to 2009-10 local government grants were provided by the provincial governments and not the federal government. The merging of OZT in the divisible pool did not imply that OZT grants were abolished and one-sixth of the GST was reduced. One-sixth of the GST is the right of the local governments even in the absence of the PFC award or any other local government grants and transfer mechanisms.

PROVINCIAL FINANCE COMMISSIONS

PFCs were introduced in Pakistan under the Devolution Plan of 2001 and local government ordinances of the provinces. A review of PFC awards during 2003 to 2010 indicates large variations in vertical and horizontal distributions of resources. These variations range from the formation of divisible pool, retained and allocable shares, and the criteria for horizontal distribution.

Vertical Distribution

While PFCs were constituted under provincial local government ordinances that had similarities, the PFCs have not been uniform in their approach towards the definition of divisible or the shareable pool of resources. All the provinces included federal transfers in the divisible pool, but differed in other elements such as provincial own revenue and tax revenue. For example, PFCs of Punjab and Balochistan included federal transfers and all of the province’s own source revenues into the provincial divisible pool; Sindh included federal transfers and only tax revenues, while Khyber Pakhtunkhwa included federal transfers and provincial own source revenues after excluding priority expenditures.

Moreover, PFCs also recommended separate shares for current and development budgets. A bulk of the current divisible pool was allocated to finance salary expenditures while the development share aimed towards building local infrastructure.

Apart from divisible pool transfers, PFC also recommended the distribution of grant-in-aid like OZT grants and assistance of foreign donors for local governments, like funds from ADP's Devolved Social Services Programme. Another important feature of the PFCs was to directly recommend grants for Town Municipal Administration and Union Administrations. Generally, these grants have had specific objectives and can be classified as general purpose, equalization, development, and tied grants. However, more than 50 percent of the transfers were directed towards district governments.

Horizontal Distribution

In contrast to the NFC awards, the PFC awards used a number of criteria for horizontal distribution. These included population, poverty/backwardness, tax collection, deficit/transitional transfer, performance benchmarks, service infrastructure, development need, area, human development index, equal share and lag in infrastructure. However, population had the highest share in all the PFCs, ranging from 50 to 75 percent. Different provinces used different criteria for horizontal distribution. Sindh was the only province that included transitional transfers to bridge the gap between budgeted expenditures and allocated share in transfers. It also initiated the performance benchmark for resource distribution. Furthermore, in 2004-05 for the first time Sindh distributed resources by creating development indices on the tehsil level, which was replicated by Punjab.

Interestingly, the provinces included several elements in their PFC criteria in line with the position they took on the NFC. For instance, in order to strengthen its case of including tax collection as a criterion in NFC, Sindh was the only province that introduced tax collection for horizontal distribution. Balochistan used area as an indicator for horizontal distribution to make a strong case for adding area as a criterion in NFC award. In contrast, Khyber Pakhtunkhwa and Punjab followed the lag infrastructure and development need, respectively.

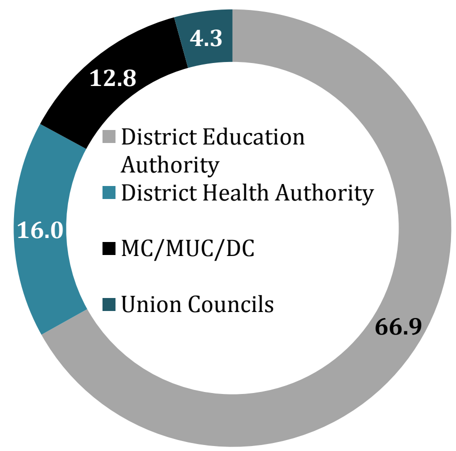
CURRENT STATUS OF PFC AWARDS

The second generation of PFC awards was expected after the promulgation of Local Government Acts (LGAs) by all the provincial governments, in accordance with the 18th Constitutional Amendment (2010). These Acts clearly spelt out the structure and mechanism of PFCs. However, only two provinces – Punjab and Khyber Pakhtunkhwa – have been able to announce interim PFC awards so far.

The divisible pool in Punjab consists of the net proceeds of the Provincial Consolidated Fund. Punjab allocated 37.5 percent of the divisible pool to local government, other than the 6.5 percent in special grants. The divisible pool in Khyber Pakhtunkhwa consists of all provincial revenues including federal transfers, after deducting obligatory expenditures that contain charged expenditures, debt servicing, pension, subsidy, contribution to GP fund and pension fund, and law and order (police). 60 percent of the provincial divisible pool is allocated to the local government while 40 percent is for the provincial government.

Chart 9 presents the horizontal distribution under the Interim Punjab Finance Commission Award (IPFCA), 2017. It shows that almost 70 percent of the local government share is allocated to the District Education Authority[11], while another 16 percent is to the District Health Authority. Only 12.8 percent is allocated to the elected local governments such as Metropolitan Corporations, Municipal Corporations, Municipal Committees, and District Councils.

Chart 9: Horizontal Distribution under Interim PFC Award Punjab, 2017 (%)



Source: Punjab Finance Commission Award (2017)

IPFCA named divisible pool transfers as general-purpose grants. These grants aim to achieve fiscal equalization through equitable horizontal distribution for reducing the gap in the provision of comparable level of public services. The criterion for distribution of the grants is based on a mix of population, per capita expenditures in base year, and various need indicators.[12] Poverty and inverse population density are common indicators while the rest differ across different authorities. For instance, education related indicators are used to distribute resources for the District Education Authority. Apart from general purpose grants, the Award specifies three other grants namely the transition grant, development grant, and grants for union councils, which will receive 4.3 percent of the divisible pool.

Apart from general purpose grants, IPFCA specifies three other grants namely the “transition grant”, “development grant” and grants for union councils. As per the award, the representatives of union councils will receive 4.3 percent of the divisible pool. The share of union council is based on a unified Rs3.60 million, for each Union Council per year.

[11] In Punjab, district education and health authorities have been created under LGO 2013, which is a parallel structure to the elected local bodies. Chief Executives of the authorities are appointed by the provincial government while elected representatives of local bodies are also members of the authorities.

[12] These include inverse population density, share of school-going-age children in the population, poverty rate, girls’ middle-class enrolment, and out-of-school children, share of population less than 9 year of age and greater than 65 years of age, share of women population aged between 15 to 49 years, and share of population without access to improved drinking water sources on premises.

The horizontal Distribution under Khyber Pakhtunkhwa PFC Award 2016-17 consists of four distinct criteria 1) Salary, ii) Non-Salary, iii) Development Grants and iv) Grant to Local Councils. The distribution of salary and non-salary is based on actual expenditures of local governments, while development grants have four criteria for horizontal distribution namely population (50 percent), lag in infrastructure (20 percent), poverty (25 percent) and revenue base (5 percent). Grants to local government are based on OZT grants and linked to one-sixth of the GST.

In summary, the review of fiscal decentralization at local government brings forth one strong message that fiscal empowerment of local government is heavily dependent on the discretions of provincial governments. The experience so far indicates that provincial governments have a greater tendency of centrality of expenditure powers for the provision of public goods and services, and control of resources. This results in vulnerability of the local government, as well as province-wide differences in sharing of functions and resources. In that context, a one size fits all decentralization approach is also not desirable. However, analysis shows that differences in approaches of various PFCs are not really based on rationale and the objective of fiscal decentralization. For instance, economic theory provides strong arguments for decentralized primary education and health services; however, these are not devolved services as per new local government acts, at least in two provinces, namely Sindh and Balochistan. Moreover, these services are under provincial control through authorities in Punjab.

As far as operational aspects are concerned, it is observed that despite the statutory provisions, there is delay in the timely constitution of PFCs in the provinces. So far, only Khyber Pakhtunkhwa and Punjab have announced the PFC award, while Balochistan and Sindh are lagging behind. In order to revamp decentralized provision of basic public services three steps are needed: ensuring one-sixth of GST as OZT grants to district government; timely announcement of PFC awards; and devolve property tax collection to local governments.

8 Role of Transfers in Gender Balanced Social Development

Intergovernmental fiscal transfers constituted through the NFC awards play an instrumental role in the financing of social services in Pakistan. Provincial governments are principally responsible for the provision of social services such as, education, health, water and sanitation; hence transfers provide them a financial lifeline. Historically, Pakistan has spent a very low share of its GDP on the social sector due to relatively low share of provinces in divisible pool taxes. However, this situation was corrected by the 7th NFC Award in 2009. Resultantly, it was expected that higher transfers would not only translate into higher social service expenditure in general, but would also contribute towards creating a gender balance in social development.

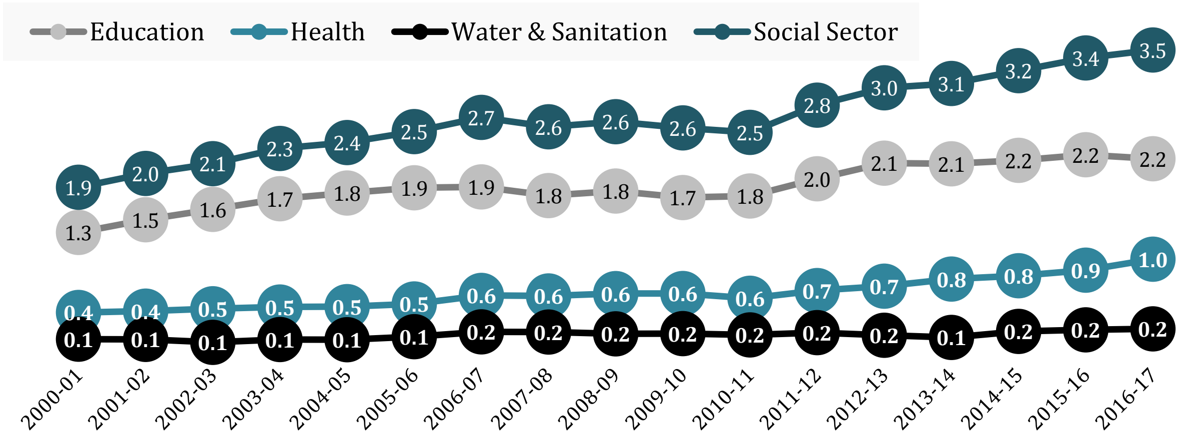
Guided by above assumption, this chapter presents the trend in social sector expenditures as percentage of the GDP covering a period from 2000-01 to 2016-17[13]. It then attempts to link social sector expenditure with intergovernmental fiscal transfers and to gender balanced social development. While social services contain various public services, analysis presented in this chapter is limited to three services namely education, health, and water supply and sanitation.

TRENDS IN SOCIAL SECTOR SPENDING

Chart 10 shows trends in the total social sector expenditure of both federal and provincial governments as a percentage of GDP from 2000-01 to 2017. It shows three interesting patterns. Firstly, while the combined social sector expenditures have uneven growth patterns, they increased from a meager 1.9 percent of GDP in 2000-01 to 3.5 percent of GDP in 2016-17. As expected, part of this growth is attributed to the increase in transfers after the 7th NFC Award. However, the pre-7th NFC pattern shows an anomaly. During 2001-07, these expenditures depict a growing trend without change in the design of intergovernmental transfers. In contrast, after having the relatively higher and growing share in divisible pool under DRGO, social sector expenditures as a percentage of GDP showed a declining trend. Secondly, public spending on education has been deriving the trend in social sector expenditures, as on average more than 70 percent of these expenditures are on education. Finally, combined public spending on health and water supply and sanitation is less than one percent of the GDP until 2013-14.

[13] These choices are based on the data limitations. Since 2000-01 Pakistan has had a consistent database of macroeconomic, public finance and social sector indicators, due to rebasing of GDP and compilation of public finance and social sector database under Pakistan Fiscal Operations and PRSP progress reports.

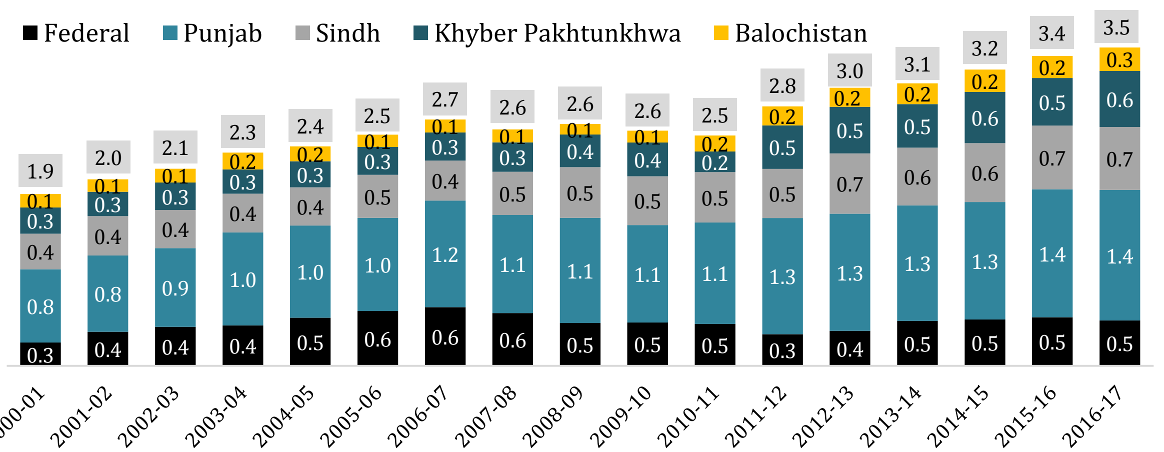
Chart 10: Public Spending on Social Services (as a percentage of GDP)



Source: SPDC estimates based on Report of the National Finance Commission 2009 and Pakistan Fiscal Operation (various issues)

Chart 11 probes the roles of federal and provincial governments in the financing of social sector expenditures, by showing federal and province-wise public spending on social services. It is evident that after the 7th NFC award, growth in social services expenditures has been derived by the provincial governments. Social sector spending of the provincial governments increased from 2.1 percent of the GDP to 3 percent of the GDP, during the post 7th NFC period, while federal government spending hovered around less than half percent of the GDP. Chart 9 also provides an explanation of anomalous growth in social sector spending pre-7th NFC award period. During this period federal government and Punjab derived this growth, which is partly attributed to various vertical programmes and formation of local governments under devolution plan. Federal government the established Higher Education Commission (HEC) and initiated various schemes under Education-For-All and National Commission on Human Development. Local government received grants on one-sixth of the GST apart from PFC transfers.

Chart 11: Province-wise Public Spending on Social Services (as a percentage of GDP)

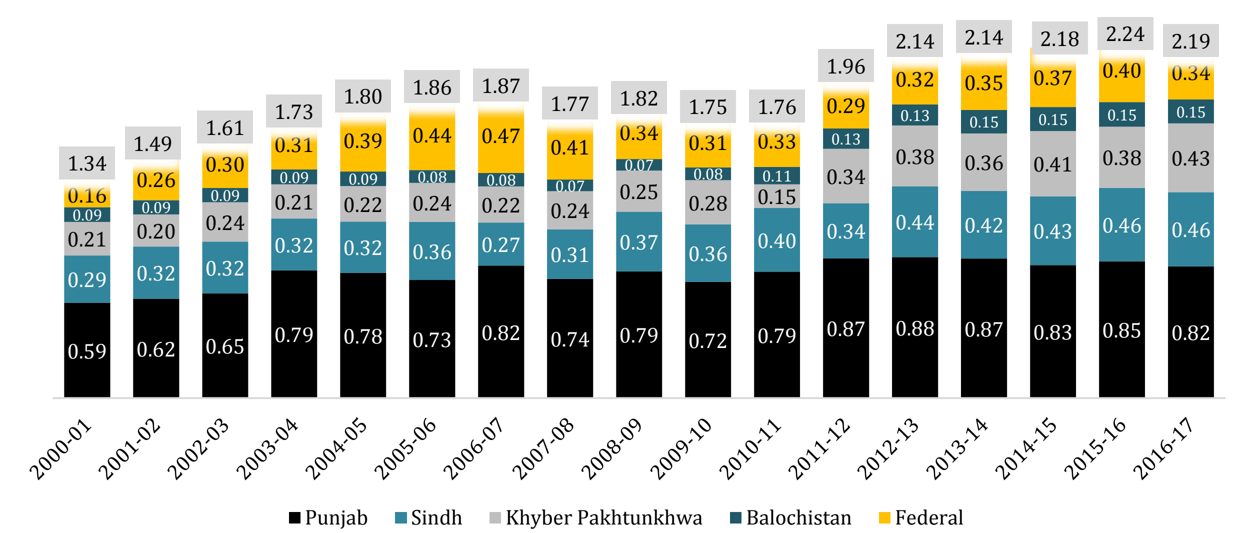


Source: SPDC estimates based PRSP budgetary Expenditure and Pakistan Economic Survey (Various issues)

Public Spending on Education

Chart 12 shows federal and provincial public spending on education as a percentage of the GDP. It points that public spending on education was only 1.3 percent of the GDP in 2000-01, which increased to 1.9 percent of the GDP in 2006-07. This increase was largely due to change in focus of the government from primary and secondary education to higher education. The federal government generously funded the HEC and provided scholarships for foreign education.

Chart 12: Province-wise Public Spending on Education (%age of GDP)



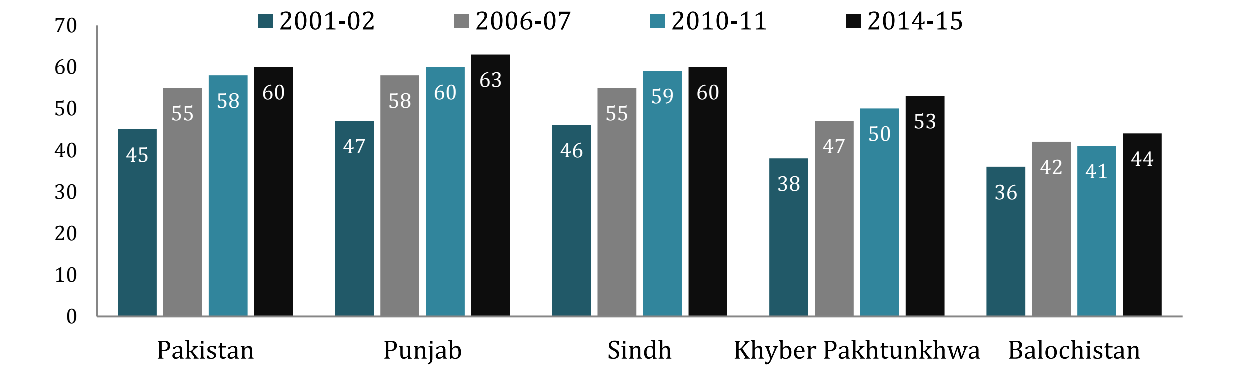
Source: SPDC estimates based PRSP budgetary Expenditure and Pakistan Economic Survey (Various issues)

After the 7th NFC Award, public spending on education gradually increased to 2.2 percent of GDP in 2014-15 and then became stagnant. Provincial governments are the main contributors to this growth. Since, provincial governments largely focus on primary and secondary education, public spending on education (as a percentage of GDP) on these sectors increased sharply as opposed to tertiary education after the 7th NFC. The province-wise trend shows that public spending on education increased greatly in Balochistan and Khyber Pakhtunkhwa.

Education Outputs and Outcomes

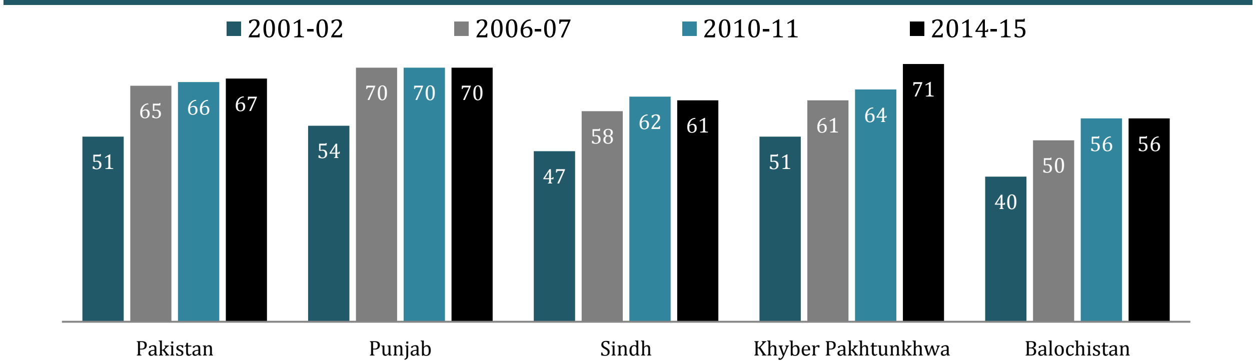
Enrollment and literacy rates are considered as output and outcome indicators of education. While enrollment rates are treated as flow measures, literacy rates represent a stock measure. In order to link literacy rate with NFC transfers, Chart 13 shows the trend in literacy rates during four distinct points of time. During 2001-02 to 2006-07, overall literacy rate in Pakistan increased from 45 percent to 55 percent. This growth by 10 percentage points came at the time when the provincial share in divisible pool was relatively low and fixed. Afterwards, although public spending on education increased, it did not translate in to the much anticipated increase in literacy rate. Even after the 7th NFC award, literacy rates increased only marginally, from 58 percent to 60 percent. Similar growth patterns are seen in Punjab, Sindh and Khyber Pakhtunkhwa, where the literacy rate increased by nearly 10 percentage point during 2001-02 to 2006-07 and only marginally (by one to three percentage points) in the subsequent years.

Chart 13: Trend in Literacy Rate – 10 years and above (%)



Source: PIHS 2001-02, PSLMS 2006-07, 2010-11 and 2014-15, Pakistan Bureau of Statistics, GoP

Chart 14: Trend Net Enrolment Rate- Primary (%)



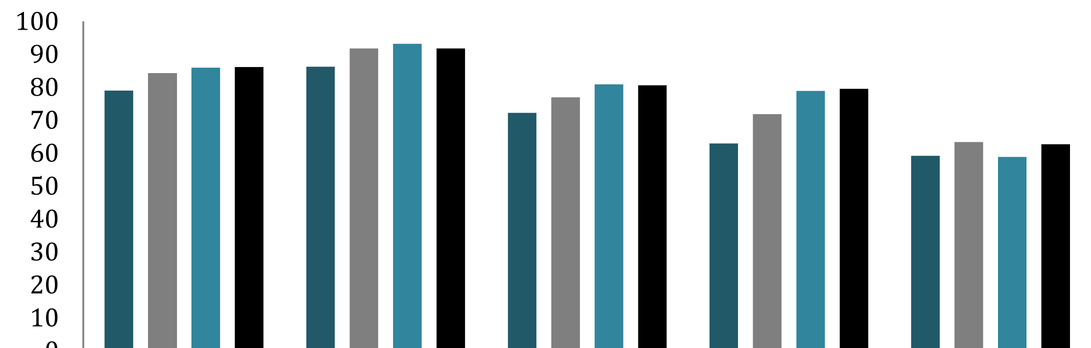
Source: PIHS 2001-02, PSLMS 2006-07, 2010-11 and 2014-15, Pakistan Bureau of Statistics, GoP

Chart 14 shows trends in the net enrollment rate (NER) at primary education. It highlights an anomalous pattern in NER that is relatively inconsistent with trends in public spending on primary education. For instance, in 2001-02 the overall NER in Pakistan was 51 percent which increased to 65 percent in 2006-07. During this period, the provincial share in divisible pool was fixed and two additional resources had been transferred to the provinces i.e. one-sixth of the GST on goods and GST on services. It must be noted that the share in GST services was not high in magnitude compared to the resources transferred through the 7th NFC award. Despite this increase in provincial resources, the overall NER stayed stagnant. The province-wise trend portrays even a bleaker picture. For example, in Punjab after a massive increase of 16 percentage points during 2001-02 to 2006-07, NER remained stagnant during rest of the years, hovering around 70 percent. In Sindh and Balochistan after an initial increase of 10 and 9 percentage points, respectively, NER depicted a negative trend. So far, Khyber Pakhtunkhwa is the only province that shows a growing trend in NER; however, the pace of this growth is relatively slow compared to that in the initial period.

Gender Parity in Education

Gender Parity Index (GPI) – a ratio of Net Enrolment Rate (NER) of girls divided by NER of boys – is the indicator to track gender equality in primary education, through household surveys. Chart 15 illustrates that GPI in primary education indicated an improvement in Pakistan, over the period 2001-02 to 2010-11 (increased from almost 79 percent to 86 percent) but remained unchanged afterwards. Province-wise comparisons indicate a worsening of gender inequality in two populous provinces (Punjab and Sindh). The decline in 2014-15 is counter intuitive due to the increase in public spending on primary education after the 7th NFC award. Balochistan shows a mixed trend in GPI that hovers between 59 and 63 percent. After the 7th NFC award, the GPI in Balochistan showed an improvement of 3 percentage points. Khyber Pakhtunkhwa is the only province that shows a gradual improvement in gender parity (Chart 15).

Chart 15: Gender Parity in Primary Education (%)



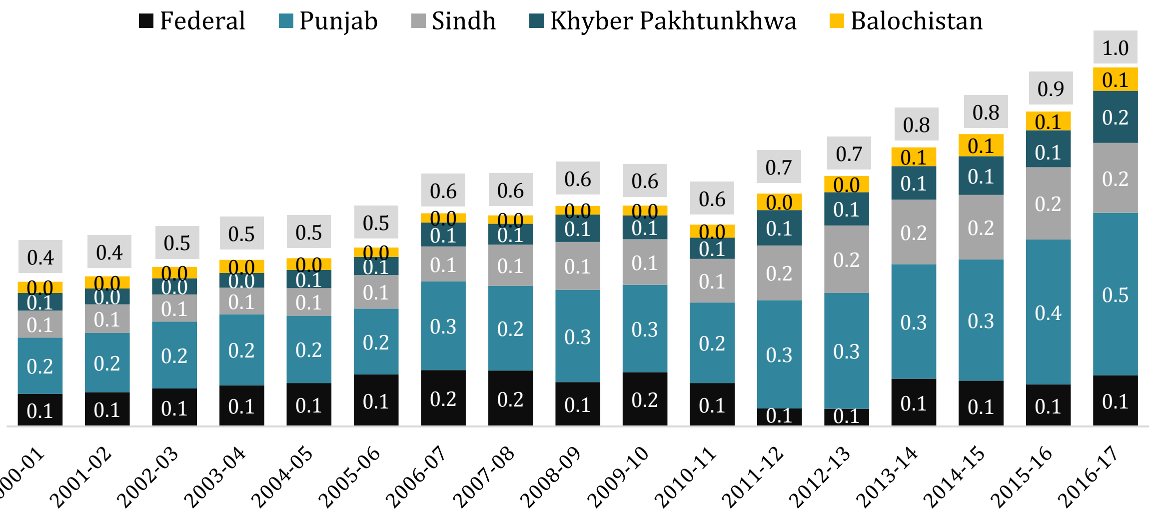
	Pakistan	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan
2001-02	78.9	86.2	72.2	62.9	59.2
2006-07	84.3	91.8	76.9	71.8	63.3
2010-11	85.9	93.2	80.9	78.9	58.8
2014-15	86.1	91.8	80.6	79.5	62.7

Source: PIHS 2001-02, PSLMS 2006-07, 2010-11 and 2014-15, Pakistan Bureau of Statistics, GoP

Public Spending on Health

Chart 16 shows federal and provincial public spending on health as a percentage of GDP. It indicates that public spending on health in Pakistan was a meagre 0.4 percent of the GDP in 2000-01, which increased to 0.6 percent of the GDP in 2006-07. This increase, though nominal, was largely an outcome of the federal government's focus on health facilities including preventive measures, while provincial governments allocated greater resources for general hospitals and clinics. Since, local governments were also partners in provision of health services, an increase in health spending at provincial level can be attributed to both provincial and local governments. Interestingly, the increase in public spending on health is more visible in Punjab and Sindh compared to Khyber Pakhtunkhwa and Balochistan. Similar to education, after the 7th NFC Award, public spending on health gradually increased and reached one percent of GDP in 2016-17.

Chart 16: Province-wise Public Spending on Health (as a percentage of GDP)



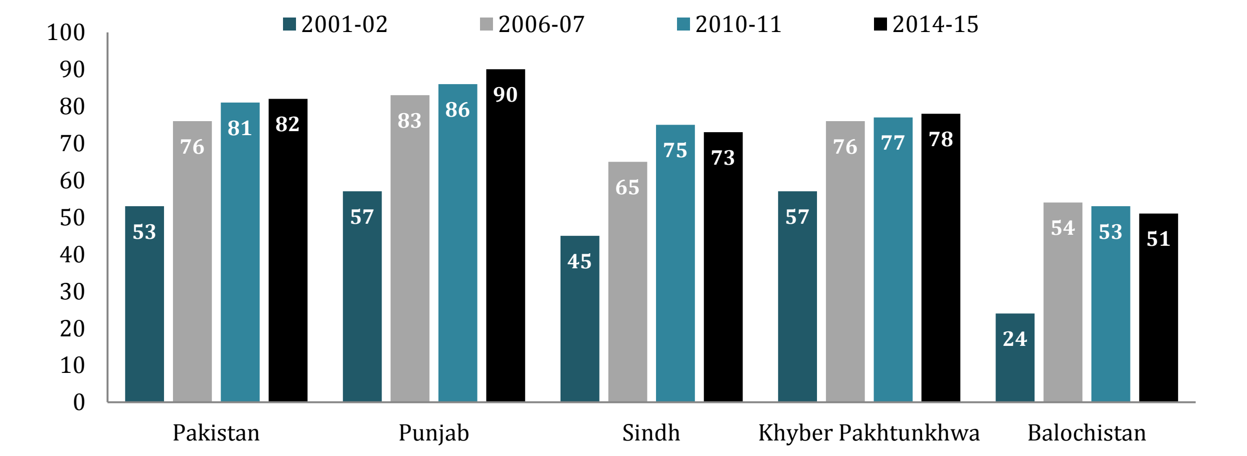
Source: SPDC estimates based PRSP budgetary Expenditure and Pakistan Economic Survey (Various issues)

Provincial governments again are the main contributors to this growth, which reflects the spirit of the 7th NFC Award and the 18th Constitutional Amendment. There is a sizeable increase in all the provinces' public spending on health. In contrast, there is a decline in public spending on health as a percentage of GDP at federal level, in the following year of the 7th NFC award. Given that the federal government is responsible for preventive measures, including the Extended Program on Immunization (EPI), this decline is alarming.

Progress in Child Immunization

Immunization coverage is one of the indicators used to assess the success of health policies being practiced in a country. Chart 17 shows child immunization rates for major diseases in Pakistan and its provinces. It reveals that immunization coverage of children aged one-year to under two-years is gradually improving. In 2001-02, slightly more than half of children in this age group had immunization coverage that increased to 82 percent in 2014-15. Similar to education, the growth is high during periods of elected local government. Province-wise comparisons highlight that Punjab is ahead of the other provinces, whereby, 90 percent children in this age bracket were fully immunized in 2014-15. In Khyber Pakhtunkhwa the share of immunized children is gradually improving, 78 percent children were immunized during the same period. Sindh after a progress till 2010-11, shows a decline of 2 percentage points in the post 7th NFC period. A more or less similar trend is visible in Balochistan where after initial growth, child immunization coverage declined, where alarmingly almost half of the children did not receive full immunization in 2014-15. In terms of gender parity, while boys have relatively high immunization coverage compared to girls, the differences are not statistically significant and minutely differ by province.

Chart 17: Trend in Full Immunization (%) *(12-23 months base on recall and record)*



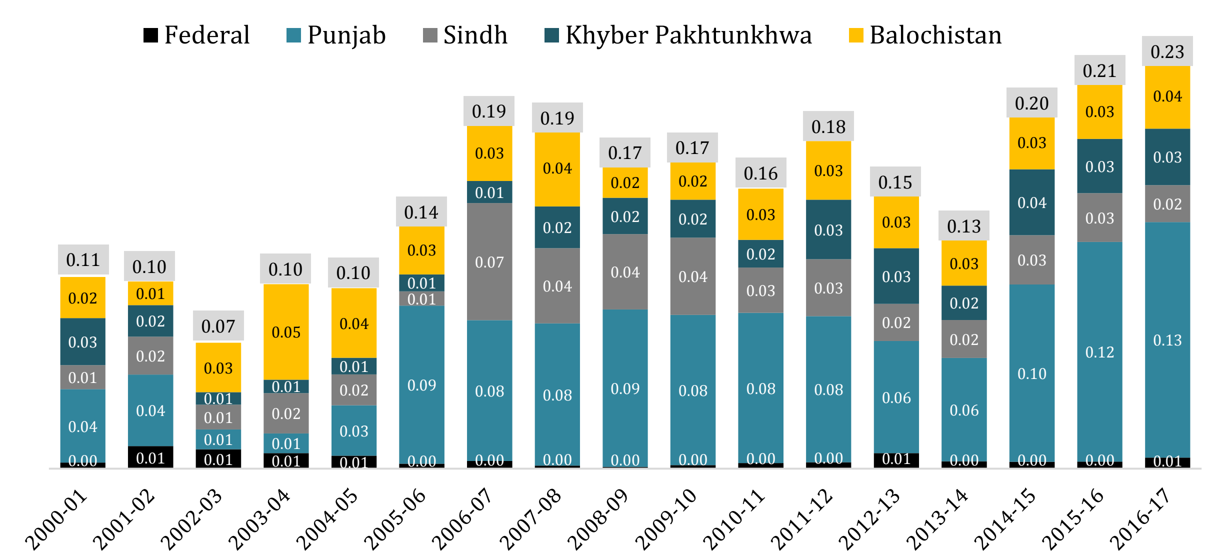
Source: PIHS 2001-02, PSLMS 2006-07, 2010-11 and 2014-15, Pakistan Bureau of Statistics, GoP

Public Spending on Water Supply and Sanitation

Chart 18 shows federal and provincial public spending on water supply and sanitation, as a percentage of GDP. It shows that in 2000-01 this spending was only 0.11 percent of the GDP, which increased to 0.19 percent of the GDP in 2006-07. This increase can be attributed to the PFC awards and presence of elected local governments at provincial levels. The growth was more pronounced in Sindh. There was also a sizeable increase in public spending in Balochistan and Punjab, which can be attributed to the urban municipal services in these provinces. In contrast, public spending on water and sanitation declined in Khyber Pakhtunkhwa and also at the federal level.

After the 7th NFC Award, public spending on water supply and sanitation increased to 0.23 percent of GDP till 2016-17. There is a sharp decline in public spending on water supply and sanitation in Sindh. Given the scarcity of water in Karachi and other urban areas, this decline is alarming. Compared to the increase in public spending on both education and health, public spending on water supply has not increased accordingly. One of the explanations to this could be the absence of elected local governments.

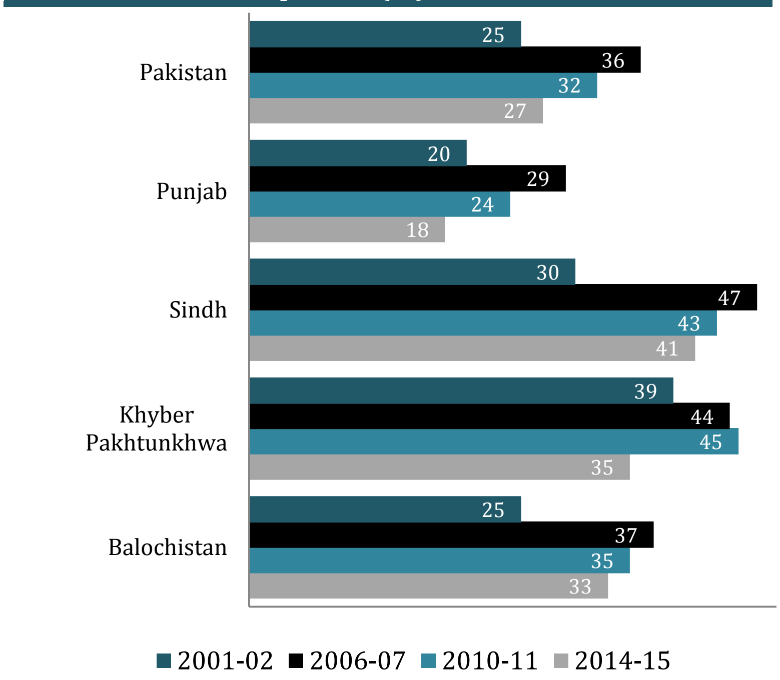
Chart 18: Province-wise Public Spending on Water & Sanitation (as a percentage of GDP)



Source: SPDC estimates based PRSP budgetary Expenditure and Pakistan Economic Survey (Various issues)

Access to Drinking Water

Chart 19: Access to tap water (%)



Source: PIHS 2001-02, PSLMS 2006-07, 2010-11 and 2014-15, Pakistan Bureau of Statistics, GoP

To analyze the corresponding impact of public spending on water and sanitation, access to tap connections is used as a proxy for improved availability of drinking water. Chart 19 indicates that the share of tap connections in Pakistan as a source of drinking water increased from 25 percent in 2001-02 to 36 percent in 2006-07, indicating an increase of 11 percentage points. However, during 2006-07 to 2010-11, it showed a decline of 4 percentage points. The corresponding decline can be attributed to decline in public spending on water and sanitation. After the 7th NFC award, while the public spending on water and sanitation increased, it did not translate into an increase in access to tap water. This again confirms that the elected local government, with transparent finances, played a greater role in the provision of water services.

To conclude, the 7th NFC Award provided the much needed fiscal space to the provincial governments. It was expected that this fiscal space would be used for the betterment of the needy population, particularly, of backward provinces and be a source of increase in expenditures on the social sector that will ultimately help generate momentum in gender equitable social development. The available fiscal indicators show an improved situation, as public spending on three social services has increased as a percentage of the GDP. However, higher resources have failed to generate the much needed momentum in social development in Pakistan. It can therefore be inferred from this trend that the 7th NFC Award so far has not had a significant impact on social development in the county. In other words, higher spending also needs corresponding governance reforms. A look into historical trends indicates that elected and empowered local government can play an instrumental role in generating momentum social development in Pakistan.

9 Conclusion and Policy Recommendations

As per the 1973 Constitution, Pakistan is a federation with a three-tier government structure including federal, provincial and local government. The constitution clearly outlines revenue and expenditure assignments of the top two tiers of government and prescribes greater fiscal empowerment of the third tier under the provincial chapter. Despite this constitutional clarity, fiscal federalism practices in Pakistan show a mixed trend that is inconsistent with the theory of fiscal federalism. While the theoretical foundation of fiscal federalism is itself an evolving concept, second-generation theories explicitly advocate for greater sub-national own taxes and revenues. It is envisaged that sub-national own revenues not only enhance fiscal efficiency but also promote accountability in the system.

In contrast to the prescription in theory, tax assignment in Pakistan is heavily skewed in favour of federal government as most buoyant sources of revenue are in the federal domain. The 18th Constitutional Amendment and the 7th NFC award authorize provinces to collect sales tax on services – a provincial tax as per the constitution. This devolution has resulted in an improvement in the share of provincial own revenues in total revenues. Moreover, provincial taxes have finally reached to one percent of the GDP. In contrast to revenues, provincial governments collectively finance half of the development expenditures and one-third of the current expenditures. This creates high vertical imbalances and increases the dependency of provincial governments on intergovernmental fiscal transfers, as the main source to finance their more than 80 percent of their expenditures.

A look into intergovernmental fiscal relations in Pakistan since 1973 indicates that a large part of provincial resources is channelled through National Finance Commissions (NFCs). These transfers aim to address vertical imbalances and horizontal inequalities. As per the constitution, NFC is an intergovernmental forum that requires consensus from all members and has a life of 2 to 5 years. In the absence of the consensus, the president can announce a resources distribution order on the behalf of NFC.

Since 1973 only four consensus-based awards have been announced, each with unique features. For instance, the 1991 NFC award introduced straight transfers and excise duties on sugar and tobacco whereas the 1996 NFC award brought all FBR taxes excluding collection charges in the divisible pool and slashed the provincial share from 80 percent to 37.5 percent. In contrast, the 7th NFC award reduced collection charges from 5 percent to 1 percent and increased the provincial share in the divisible pool to 57.5 percent. It must be noted that apart from four consensus-based awards, there have been unsuccessful attempts as well, which resulted in presidential distribution orders on behalf of the NFC. These presidential orders mostly endorsed previous awards and hardly added any clause to add or endorsed grants. However, the 2006 presidential distribution order is an exception. It changed the provincial share, added an unknown formula-based grant for all provinces and separately assigned the one-sixth of sales tax on goods to provinces in the provincial divisible pool.

Till 2009, divisible pool transfers were largely based on the single criterion of population, to address horizontal fiscal inequalities. While population is a good proxy for fiscal needs, it does not address fiscal needs generated due to large area, high poverty and concentration of the financial sector and businesses hub that generate higher revenue collection. The 7^{th} NFC award added this consideration in the horizontal distribution of divisible pool transfers and transformed it from single to multiple criteria.

The 7^{th} NFC award has had a positive impact on provincial revenues and provided the much-needed finances for social development. As per estimates, the 7^{th} NFC award additionally transferred seven and a half percent of FBR taxes per year to provincial governments. At the time of constituting the 7^{th} NFC award, it was envisaged that both federal and provincial governments will substantially enhance their resource mobilization efforts; the federal government was expected to curtail its current expenditures and reduce the fiscal deficit to a manageable level of around 4 percent in the terminal year. However, the trend in key budgetary magnitudes reveals an entirely opposite picture. There has not been much momentum in FBR taxes, in fact, their growth declined in the post-NFC period compared to the pre-NFC period. Similarly, the anticipated decline in federal current expenditures is not reflected in actual current expenditures either. Consequently, the federal budget deficit was higher than expected. In contrast, provincial governments generated budget surpluses during most of the post-NFC period. To encourage provincial surpluses, federal government introduced an incentive grant, equivalent to the interest rate of T-bills for maintaining a surplus balance for three months.

The unfortunate part of the fiscal federalism in Pakistan is the treatment of local government. Elected local governments in Pakistan have had a chequered history. They enjoyed greater fiscal autonomy under the Devolution Plan of 2001. The recent legislation by provinces also outlines revenue and expenditure assignments and recommends Provincial Finance Commissions (PFC) for intergovernmental fiscal transfers, from provincial government to local governments. However, so far, only Punjab and Khyber Pakhtunkhwa have announced an interim PFC award. A large part (86 percent) of the recommended revenues under Punjab's PFC is allocated to the District Education and Health Authorities and only 14 percent to elected representatives of local governments. In

Khyber Pakhtunkhwa, a large part is allocated for the salary budget. Such division of resources reduces the scope for efficient devolution of service delivery at the grassroots level.

Intergovernmental transfers have played an important role in the socioeconomic development of the country. In Pakistan, improvement in selected education and health indicators is visible since year 2000. An important message emerges from the analysis is that the pace of social development has been relatively high during fully functional elected local governments. Afterwards, there a slowdown or halt in socioeconomic development has been observed, despite large increases in the quantum of public spending on social services. Gender disparity in socioeconomic indicators has also reduced due to the increase in public spending on the social services in Pakistan.

POLICY RECOMMENDATIONS

The theoretical arguments and experiences of other countries suggest that sub-national governments are an integral and responsible part of the federal system of government. The following recommendations have been furnished with the objective of strengthening their role to foster inclusive and sustainable development in Pakistan.

- Pakistan largely uses unconditional transfers, constituted through NFCs to address the vertical imbalance. The results show a positive impact of unconditional transfers on socioeconomic development. Therefore, it is recommended that the future NFCs should continue instating untied transparent intergovernmental transfers to address vertical imbalances.
- The 7th NFC in Pakistan used multiple criteria to address horizontal fiscal inequalities. The review of NFC awards indicates that these multiple criteria played a pivotal role in addressing horizontal disparities. Therefore, it is recommended that multiple criteria for horizontal distribution of resources need to be continued in future.
- Experience of other countries showed the benefit of integrating gender-sensitive criteria in the design and mechanism of fiscal transfers for achieving development outcomes. Therefore, an explicit gender-sensitive criterion should be considered for the horizontal distribution of resources.
- A low tax-to-GDP ratio in Pakistan can be attributed to the divided tax collection powers between the federation and federating units, thereby, generating inefficiencies. To minimize tax collection losses, these collection powers require restructuring. For instance, income and corporate taxes are in the federal domain, while income tax on agriculture is in provincial domain. This division provides an opportunity to declare income from other sectors as agriculture income to evade

taxes. Therefore, it is suggested that all income taxes should be collected by the federal government. It is to be noted that this recommendation is aimed to reduce anomalies in tax collection, which do not require amendments to the constitution. The federal government should transfer agriculture income tax to the respective province, after deducting collection charges.

- Similarly, sales tax on goods is a federal tax, while sales tax on services is a provincial tax. These divided collection powers are also generating inefficiencies in tax collection. Given the performance of provincial revenue authorities and boards in collecting sales tax on services, it is recommended that provincial governments should collect both sales taxes on goods and services. This will help in reforming sales tax in truly VAT mode as provincial governments can tap wholesale and retail sales tax and reconcile it with sales tax collected from factories. The provincial government should transfer sales tax on goods to the federal government that can be distributed afterwards, as per the spirit of the NFC award.

- The absence of official estimates of provincial GDP hinders meaningful analysis of the tax capacity of the provinces. Therefore, it is recommended that federal and provincial governments work together to produce official estimates of provincial GDPs.

- Provincial governments in Pakistan have appropriate legislation for inter-governmental fiscal transfers from provinces to local governments. However, in practice, PFCs are irregular, delayed and non-existent in some cases. For better social service delivery, strengthening of the PFCs is recommended as per the existing legislation.

- Local level data in Pakistan is sketchy; therefore, the collection of credible data based on local finances is essential for any meaningful analysis of financial and operational performance.

- Pakistan has been engaged in large-scale mega-projects like CPEC, which is required for macroeconomic development and building infrastructure for SDGs. While these projects are national priorities, they often generate externalities. Province and local governments are often reluctant to finance them due to these externalities. It is recommended that national governments play an instrumental role through tied transfers for compensation of externalities stemming from such national priorities.

- Progress on the SDGs in a federal country is a shared responsibility of all tiers of government. Since a large number of SDG goals come under the domain of sub-national governments, strengthening their resource position is of critical importance. Considering the existence of large vertical fiscal imbalances, strengthening the federal fiscal system would help improve the resource position at the sub-national level.

- Literature on fiscal federalism documents growing evidence that large vertical fiscal imbalances are a threat to fiscal stabilization and efficiency. Therefore, the overall level of own-taxes of both provinces and local governments should be increased. Particularly, strengthening local government fiscal autonomy by appropriate tax assignment is needed.
- Given that meaningful discussions and negotiations are keys to strengthen fiscal federalism, NFC should be given an appropriate time and regular meetings to discuss all burning issues at length and reached consensus. It is recommended that NFC should be constituted at least two- year prior to its due date.

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Social Policy and Development Centre
Head Office: C-99, KDA, Scheme No.1, Off. Karsaz Road
P.O. Box 13037, Karachi-75400, Pakistan
Tel: (92-21) 111-113-113 | Fax: (92-21) 3453-4285
E-mail: spdc@spdc.org.pk

Islamabad Office: 209, 2nd Floor Emirates Towers,
F-7 Markaz, Islamabad
Tel: (92-51) 2099146

www.spdc.org.pk