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Intergovernmental Transfers: An Evaluation of Mechanism and Design of Transfers in Pakistan

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The 7th National Finance Commission (NFC) Award has seemingly put an end to the deadlock over revenue distribution among the constituents of the federation in Pakistan. This paper argues that though the 7th NFC Award's use of multiple indicator criteria for the distribution of resources is a step forward in the right direction, the distribution design still falls short on various counts. For example, the weight of 82 percent for the population share is on the higher side whereas the demographic structure of the population, an important indicator of the expenditure needs, does not figure up in the distribution design. Also, the basis of weights assigned to the four elements of the revenue distribution criteria is unknown and no rigorous exercise seems to have been undertaken to determine these weights. Similarly, matching grants, which are a key element of the distribution design elsewhere, are altogether absent in Pakistan. Furthermore, provinces still rely on large transfers from the centre which undermines the incentives of the provinces to generate their own revenues. The paper emphasises that there is a need to rethink the mechanisms for resource sharing as well as the institutional structure of the NFC itself.

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1. INTRODUCTION

Pakistan is a federal country with two constitutional tiers of the government—the federal government and the provincial governments; moreover there are some Federally Administered Tribal Areas (FATA) and the State of Azad Kashmir. As in many other countries, the federal government in Pakistan generates more revenues than its needs. Correspondingly, the provinces generate only a small percentage of the revenue required to meet their expenditure needs. This calls for transfers from the federal government to enable the provinces to carry out their functional responsibilities. The National Finance Commission is the institution responsible for devising the revenue sharing arrangement between the federal government and the provinces. The Commission recommends the sharing of the federal revenue with the four provinces namely Punjab, Sindh, Khyber Pakhtunkhwa and Balochistan.[1] The Commission is constituted every five years and has

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[1]The province of Gilgit-Baltistan was created after the latest Award (i.e., 7th NFC Award) had been announced and at present its expenditure needs are being directly met by the federal government.

representation (official as well as non-governmental) of all the stakeholders. The Commission does not have a permanent existence, however, it is allowed adequate time to work on the Award (i.e., announcement of revenue sharing arrangement). The provincial ministers of finance and other experts in the areas of finance and fiscal management typically man the NFC which is headed by the federal minister for finance. The 'Unanimity rule'—all the provinces and the federal government must agree—is the principle that the Commission follows in making its recommendations to the government. Several previous Commissions either faced deadlock or were forced to adopt the sharing arrangement prevailing at the time due to the failure to develop a consensus on any new sharing arrangement. The 'divisible pool' i.e., the revenue sources available for sharing is specified in the constitution and the President can add revenue sources to the divisible pool while notifying the establishment of the Commission. Two kinds of conflicts have often marred the proceedings of the Commissions. One, what should be the share of the federal government in the divisible pool? Two, what should be the elements of the criteria to be used for sharing the divisible pool among the provinces.

The seventh NFC Award was announced in December 2009 and became effective on July 01, 2010. The Award is seen as a landmark in the sense that it broke the deadlock that had constrained the National Finance Commissions, constituted in 2001 and 2006, to announce the awards. Two major changes contributed to ending the deadlock: reduction in the share of the federal government in the divisible pool by 10 percentage points and the introduction of a multiple indicator criteria (MIC) for the distribution of the divisible pool in place of the earlier criterion that was solely based on population. The distribution criteria prescribed by the 7th NFC is given in Table 1. For comparison, the criterion used by the immediately preceding Award has also been included in the table.

Table 1

Criteria for Distribution of National Revenue

	Presidential Order 2006	7th NFC Award
Provincial Share in Divisible Pool	46.25%	56% increasing to 57.5%
Grants and Subventions	3.75%	–
Indicators and Weights		
Population	100%	82.0%
Poverty		10.3%
Revenue Generation		5.0%
Inverse Population Density		2.7%
Given the Weights indicated above, the provincial share in the Divisible Pool works out as follows:		
Punjab	53.01%	51.74%
Sindh	24.94%	24.55%
Khyber Pakhtunkhwa	14.88%	14.62%
Balochistan	7.17%	9.01%

Source: Adapted from "Pulling Back from the Abyss: Third Annual Report", Institute of Public Policy, Beaconhouse National University.

At present the divisible pool includes the following revenue sources:

- Personal Income Tax
- Tax on corporate income
- Wealth Tax
- Capital Value Tax
- Taxes on sales and purchase of goods
- Custom duties
- Federal Excise Duty (excluding on Gas)

The reduction in the share of the federal government in the divisible pool has enabled the NFC to recommend transfer of greater funds to all the provinces. Even the province of Punjab, which in the past had shown preference for the retention of the population share criterion, has not been a loser despite the change in the distribution formula. The end of the deadlock coupled with the transfer of more funds to all the provinces have earned the award almost universal appreciation. This study aims at a critical evaluation of the 7th NFC Award in particular and the distribution design in general. The analysis will primarily focus upon the institutional arrangement for the distribution of funds and the formula for the distribution of available resources among the provinces.

2. INSTITUTIONAL ARRANGEMENT FOR DISTRIBUTION OF RESOURCES

Though the 7th NFC Award has managed to break the deadlock that marred the proceedings of the previous two commissions, an important question that arises is: will the institutional structure of the NFC prevent deadlocks in the future? To answer this question it is important to put in perspective the reasons that led to previous deadlocks and the factors that helped to break out of the stalemate.

2.1. The Deadlock

Historically the divisible pool has been shared among the provinces on per capita basis. However since 1996 three out of four provinces have been demanding the inclusion of more elements in the distribution criteria. Each province demanded the inclusion of such elements that would entitle it to greater transfers from the divisible pool. With Karachi being the country’s hub of business activities and the provincial capital, Sindh demanded that revenue generation effort be made a part of the distribution criteria. On the other hand, Balochistan, the largest province in terms of geographic area, contended that its cost of public service delivery was relatively high due to low population density, therefore the element of geographic area (reflected in inverse population density) must be included in the criteria. Both Khyber Pakhtunkhwa and Balochistan argued that the higher poverty levels prevailing in the two provinces required greater transfers to alleviate their poverty. Punjab, the largest province in terms of population housed more than 60 percent of the country’s population when the deadlock arose in 1996. The province stood to gain from the distribution solely on per capita basis and understandably argued for the retention of this criterion. With each province insisting on including a different element in the distribution criteria a deadlock in the proceedings of the Commissions was imminent especially when the Commissions followed the 'unanimity rule'.

When the 6th NFC Award was being negotiated in 1996, objections were raised on the distribution criteria prevailing then, but these objections were not responded to and the Award remained pegged to the old formula. This was mainly due to the fact that the political party then in power at the centre drew its strength from the Punjab which was adamant on retaining the prevailing formula. The objections that were raised at the time of the negotiation of the 6th Award surfaced again with such intensity later on that these caused deadlocks over the NFCs of 2001 and 2006. Perhaps even the 6th award reflected the strength of the political party in power at the centre and the Punjab over the preferences of the other provinces. It is also noteworthy that the four Commissions that failed to announce the awards (or adopted the previous awards without any changes) were constituted during the military regimes (1979, 1985, 2001 and 2006) which demonstrates the capability of democratic regimes which provide a better environment for striking a compromise in situations where interests conflict.

2.1.1. *How the Deadlock Ended*?

Under the 7th NFC Award, each province is to get more transfers from the federal government than what it would have received under the previous distribution criteria. This was the key to opening the deadlock: with each province getting more funds, all the provinces were willing to go along even if some structural issues remained unaddressed. Moreover the 7th NFC Award accepted the long standing demand of the three smaller provinces for inclusion of their preferred elements in the distribution criteria. The 7th NFC Award managed to placate the province of Punjab by introducing a minimal change in the weight of the population share—82 percent, down from 100 percent. Moreover, this time around, the smaller provinces which had been demanding a change in the distribution criteria were a part of the ruling coalition at the centre. Efforts to keep the otherwise fragile coalition intact would also have played some role in putting the deadlock to an end. Finally, given the previous failures, all the stakeholders were under pressure to resolve the conflict. All these factors together helped to resolve the long standing conflict over the revenue sharing arrangement. Though the 7th NFC Award has ended the stalemate and moved forward, a key structural issue namely the 'unanimity rule' remains unaddressed making deadlocks in the future possible.

2.1.2. *The Unanimity Rule*

As mentioned earlier, the National Finance Commissions constituted in 2001 and 2006 failed to reach a consensus over the distribution formula and, perhaps, over the magnitude of the federal share in the divisible pool. The problem apparently lies in 'the unanimity rule' that the Commission follows in adopting its recommendations. What is the solution? Will the 'majority rule' solve the decision making problem. Perhaps not. The majority vote can avoid the deadlock in a narrow legal or administrative perspective but this may raise problems for the federation. Smaller provinces may complain of being the victim of federal hegemony. Alternatively, if the smaller provinces get together as a group in the NFC, then the federal government or the larger province (i.e. the Punjab) may feel deprived of their respective share in the resources. Therefore the 'unanimity rule' under the present institutional arrangement is not a choice but a necessity. The point is that notwithstanding the spirit of compromise shown by the federal government and the provinces while negotiating the 6th and the 7th NFC awards, the structure of the NFC itself has no mechanism to prevent a deadlock. As discussed later in the study, it is possible to address this problem by devising an appropriate institutional mechanism.

2.2. The Need to Rethink the Institutional Arrangement for the Distribution of Resources

The NFCs have a history of failures. Even though the constitution requires that there be an NFC Award every five years, only 8 Awards have been announced since independence. The 5th NFC Award, due in 1979 came in 1990—12 years after it should have been announced; similarly the 7th Award due in 2001 was delayed by 9 years. The Commissions were duly constituted in the intervening periods but these failed to reach a consensus over the recommendations. Clearly, something needs to be done to avoid possible deadlocks in the future. In this respect, useful insights can be gained from research on subjects like assignment of revenue resources to different tiers of the government and determination of weights for the different elements of the distribution criteria. There is not much evidence to suggest that overtime the NFCs in Pakistan have either conducted research on the questions at hand or have made enough use of research available on the subject.

The present institutional set-up of the NFC lacking the mechanism to prevent a deadlock situation and the need for research on the issues involved in designing a suitable distribution mechanism call for revisiting the institutional structure of the body which is responsible for declaring the Award. The next section reviews the institutional arrangements used in different countries for making resource transfers to the sub-nationals with a view to drawing guidelines for devising an appropriate institutional arrangement for resource sharing among federal units in Pakistan.

2.3. Institutional Arrangements Used in Different Countries

Institutional arrangements used in different countries for devising the distribution criteria and making transfers from the federal government to the constituent units can be broadly classified into the following three categories:

(i) Central agency (central government's ministry),
(ii) Intergovernmental Forum,
(iii) Independent Agency.

2.3.1. *Central Agency*

The federal government on its own takes the decision regarding the distribution of revenue resources among the constituent units. Typically, the office of the president or prime minister or the ministry of home affairs or the ministry of finance assumes the sole or partial responsibility for the fiscal transfers to the constituent units. Countries that are relying upon a central agency to determine the amount of transfers include Kyrgyz Republic, Tanzania, China, Italy, Kazakhstan, Netherlands, Poland, Switzerland, Ukraine, Ghana, Zambia and Japan. The rationale for the central agency is that as the federal government is responsible for managing the national objectives, therefore the transfer decisions should be taken by the federal government. However, this approach negates the essence of decentralisation. Shah (2007) suggests that the constitutional restrictions on the ability of the federal government to override provincial preferences can limit the negative effects of this approach. Shah further suggests that as an alternative to the federal government's direct role in the distribution of federal revenues, a separate body could be entrusted the task of designing the fiscal relations among the various tiers of the government. The proposed body could either be independent or an intergovernmental forum or may be an intergovernmental-cum-civil society forum. Pakistan has such a forum. It is appointed by the President every five years.

2.3.2. *Intergovernmental Forums*

The intergovernmental forums are formed to recommend the distribution of the federal revenue among the federal government and the constituent units. These forums typically enjoy representation from all the stakeholders and provide room for some bargaining over the distribution criteria. The limits of the bargaining are defined by the constitution e.g., in Pakistan the revenue sources available for distribution are defined by the constitution. Shah (2007) prefers a simple distribution criterion which may render only approximate justice to each constituent unit over a complex criterion with complete justice. The study argues that quite often the constituent units have conflicting interests and a forum with conflicting interests cannot handle a complex distribution criterion. Countries that rely solely on intergovernmental forums include Germany, Indonesia and Nigeria. Pakistan also relies on such a intergovernmental forum with the difference that the Commission members also include experts from the civil society of each province. Countries like South Africa and India make use of an independent agency in addition to the intergovernmental forum.

2.3.3. *Independent Agency*

An independent agency is established by the central government to make recommendations to the government or the legislature on resource transfers to the constituent units. The members of the agency are experts in fiscal management. Some countries, for example India, draw a member from the judiciary as well. Typically, this kind of agency has an advisory position. Australia was the first to establish an agency for recommending resource transfers in 1933. Since then this institution has become popular in a number of countries including India and South Africa. The independent agency was established in Australia after some states had expressed dissatisfaction with the process of bilateral negotiations with the federal government on requests for special grants. A secession threat by Western Australia proved instrumental in the decision to set up an independent agency. Thus the origin of the independent agency has lessons for countries where one of the constituent units is dissatisfied with the resource distribution.

The objective of setting up an independent agency is to let the experts recommend the distribution criteria based on professional knowledge and rigorous analysis of the prevailing economic environment. The rationale for an independent agency is that it can disengage the distribution criteria from politics. Shah (2007), however, does not favour the independent agency on the ground that it tends to offer a complex solution to an otherwise simple task thus increasing the cost of devising the resource distribution criteria. Moreover, given the complexity of the distribution formula it becomes difficult for the ordinary citizens to monitor the performance of the agency.

2.4. Proposed Institutional Arrangement for Distribution of Revenues

The foregoing suggests that both the intergovernmental forum as well the independent agency have their merits and demerits. With the regional representatives on board, the intergovernmental forums can protect the regional interests more effectively but if these forums follow the unanimity rule then their proceedings are prone to deadlock. The independent agencies, comprising experts, can bring the required rigour into the revenue sharing exercise but these agencies tend to complicate problems that may have a simple solution. A better institutional structure for revenue sharing would be one where the two can supplement each other. Therefore we suggest that a two-tier institutional structure may be set-up in Pakistan to design revenue sharing among the constituents of the federation. The proposed two tiers are: (i) an independent body of experts and (ii) an intergovernmental forum.

An independent body, comprising fiscal experts, practitioners as well as academicians, would constitute the first layer of this two-tier structure. Experts will be selected without regard to provincial affiliations and they would be full time/part time employees of the independent agency. The agency would have the mandate to recommend not only the sharing of the divisible pool but also to determine the revenue sources that should comprise the divisible pool. The agency would also have the mandate to recommend assignment of specific revenue sources to the federal or provincial government. The agency would have resources to conduct or commission research on the issues under consideration as well as to make use of existing research available on the subjects. The agency will commence its task two years before an Award is due and will have 16-18 months to conduct research, deliberate upon possible options and then make its recommendations. The agency will send its recommendations to the upper tier, the intergovernmental forum. The recommendations of the agency would carry detailed justification in their support especially if the advice deviates from the established formula. The recommendations would also be made public to encourage debate on the subject. The independent agency will not insist on arriving at a unanimous set of recommendations, a principle which in the past has caused deadlock in NFC proceedings. The notes of the dissenting members would form part of the independent agency's report.

The upper tier, the intergovernmental forum, will comprise the federal and provincial ministers of finance only. The experts need not be on the forum because the the expert work has already been done by the independent agency. The forum would review the recommendation of the independent agency and may or may not accept all or some of these. The forum would pay due regard to the political factors and other sensibilities that the independent agency would not have taken into account. Moreover the forum will also take into consideration the public debate on the recommendations of the independent agency. If the forum decides not to accept some or all of the recommendations of the independent agency, the forum and its individual members would have to offer their reasons or justifications for their point of views. The intergovernmental forum will then send its recommendation to the government for final approval and announcement of the Award.

This two step approach is likely to put an end to the deadlocks which have beset revenue distribution among constituent units in Pakistan. The proposed two-tier institutional structure is an improvement over the existing one for the following reasons:

- The experts drawn from the profession and the academia without regard to provincial affiliations and put in the position of a 'judge' are less likely to take a biased position.
- The experts being paid employees of the independent agency would do their assigned work according to the charter of the body rather than work as a lobby for a particular constituent unit.
- The knowledge that the recommendations of the agency will be debated publicly will induce the members to offer sound and practical recommendations.
- The experts' reliance on research will:
  - enable the independent agency to offer sound and practical recommendations.
  - make it difficult for the agency or the individual members to take unjustified positions.
- It would not be possible for the intergovernamental forum to easily ignore the recommendations of the independent body for the following reasons:
  - These would have the backing of eminent experts.
  - The recommendations would have attracted sufficient public debate by the time intergovernmental forum takes a decision on these.
  - The forum and its individual members will have to record reasons if they decide not to accept the recommendations of the independent agency.

3. DISTRIBUTION OF REVENUE RESOURCES

The federal revenues available for distribution among provinces have historically been distributed on a per capita basis. The 7th NFC Award accepted a long standing demand of the three provinces for the introduction of a multiple indicator criteria. The rest of this study examines the new distribution design in the light of the revenue distribution practices followed in other countries.

3.1. Resource Distribution Practices Adopted Internationally

Transfers from federal government to the sub-nationals take several forms. These are formula-based as well as discretionary and could be block unconditional, conditional or matching. The transfer programmes often aim at fiscal equalisation among the constituent units i.e., to enable the constituent units to provide the same kind of service with comparable level of taxation.

In Canada, transfers from the federal to provincial governments are unconditional and are given to only those provinces whose revenue raising capacity is below the national average. It is noteworthy here that revenue generation is highly decentralised with the share of provincial own-source revenue standing close to 80 percent of the total national revenue. It is only under this kind of revenue decentralisation that some provinces can manage to function without any equalisation transfers. The Indian system essentially involves distribution of funds on the basis of estimated expenditure needs and, to an extent, on the potential of the subnationals to generate revenues from their own sources. The finance commission of India primarily uses the gap filling approach for equalisation of fiscal capacity across states. The states are allocated shares in central taxes based on a formula and the difference between a state's budgetary expenditures and its revenues is filled through the grants-in-aid. It is argued that the gap filling methodology not only acts as a disincentive for the subnationals to raise own-source revenue but is a source of inequity as well. In Australia, the comprehensive nature of equalisation allows assessment of all the circumstances that affect the relative cost differences a state is faced with in delivering standard services. These include additional costs faced by a sub-national government in meeting requirements of large cities as well as in providing services in rural areas and remote locations. If a state's differential per capita revenue or expenditures is considered beyond the control of the state, for example, due to geography, it is compensated for that. The Australian approach to equalisation requires voluminous data across states at a high level of disaggregation. The Australian equalisation programme has been criticised on the grounds of efficiency, complexity and reliance on internal standards rather than best practices. It is argued that reliance on average internal standards in a sense rewards some states for maintaining lower standards. However, by and large, there is a general acceptance of the system. It is precisely because of carrying out a very thorough equalisation programme that federal government (known as the Commonwealth government) has been able to keep the states satisfied despite continuing with the large vertical fiscal imbalance (difference between revenue generated by the federal government and states).

In the United States, unlike other federal countries, there is no general form of revenue sharing. However around 600 grant programmes exist for state and local governments. The different forms in which grants are provided include project, categorical, and block grants. While some grants have matching component, others have structured formulas. Barring federal transfers for some specific purposes, the overall grant system is small relative to other countries. Though a degree of equalisation is built into grant programmes, however, in general, the intergovernmental transfers do not aim at equalisation despite wide differences in taxable capacity across states.

In Germany, the intergovernmental transfer system is highly egalitarian. The unique feature of the German system is that richer states transfer money to the poorer states. In practice, the states, whose taxable capacity is below the national average, receive transfers from the states with taxable capacity above the national average. The transfer programme is designed in a manner that fiscal capacity of the below-average state is brought to 90 percent of the national average. These interstate transfers are unconditional.

The transfers from the federal governments to the provinces typically attempt to equalise fiscal capacity and in some cases fiscal needs as well (United States is an exception). The amount of transfers in a number of countries is determined on the basis of some formula. Indicators like population share, poverty, demographics, fiscal effort and population density are typically used to determine fiscal needs and capacities. 'Population share' is not considered a good indicator of fiscal needs and is used only in a handful of countries. Even the countries that use population share as the criterion for revenue distribution typically accord a rather low weight to it in the distribution formula e.g., India. Nigeria, with transfers based solely on the basis of population, is an exception. Pakistan, with 82 percent weight for population share, stands close to Nigeria.

Transfers are also used to achieve certain national objectives, for example, education and healthcare for all. One of the typical characteristic features of the transfer programmes is the use of conditional and matching transfers for the provision of healthcare, education and social security. The use of conditional/matching transfers for these services reflects the importance attached nationally to the provision of these services. The aim is to provide the specified services to all up to a certain minimum level defined by the society. Such choices are made through a variety of collective choice mechanisms such as voting for electoral promises of the political parties/candidates.

In Canada, besides the equalisation transfers, the other major forms of transfers are the equal per capita transfers which are nominally divided into two components—the Canada Health Transfer (CHT) and the Canada Social Transfer (CST) which include welfare and post secondary education. Only minimal conditions are attached to the payments. To be eligible, the provinces cannot impose residency condition on welfare payments and health insurance programmes have to follow general criteria including access, affordability and comprehensiveness.

In Australia, huge transfers from the federal government to the states are made under the special purpose programmes (SPPs). These SPPs are intended to support the implementation of some national priority and these are in addition to the transfers from the united pool of funds determined in the manner described earlier. The largest SPPs are in the areas of education, health, social security, transportation and housing. SPPs constitute a significant proportion of the total assistance from the federal government to the states. This proportion has varied from 25 percent of the total federal assistance in early 1970s to 50 percent in 1990s. The majority of the SPPs are subject to conditions—the conditions designed to ensure the achievement of national objectives. These conditions include general policy conditions that the amounts so transferred be spent on designated purposes only. Sometimes the transfers require matching expenditures from the state's own sources for the same purpose. Such grants are determined through bilateral negotiations between the federal government and the concerned state as well as negotiations at some forum where all states are represented. In the United States, grants for health and income security constitute the major purposes for which transfers are made to the state and local governments. These grant programmes are discretionary at the national level and are determined through the annual budget process. The interstate highway system is financed jointly by the federal and state governments with federal government typically funding 90 percent of the construction cost. Other major grant categories include education and transportation. In South Africa, in recent years the share of conditional specific purpose grants, which are discretionary in nature, have exhibited sizable growth in the total transfers to the provinces. The discretionary nature of the conditional grants has made the transfers system less transparent.

3.2. Analysis of the Revenue Distribution Design

3.2.1. *Fiscal Equalisation: What Method to Use*?

The subnationals typically encounter a fiscal gap—the difference between expenditure needs and the revenue means. The gap may arise either because a region does not inherently enjoy the potential to generate revenues or because the taxing powers are centralised with the federal government. Whatever the reason for the fiscal gap, leaving the gap unattended has economic as well as political ramifications. The gap may cause large fiscal disparities among the regions which could be politically divisive for the federation. This threat cannot be taken lightly. Since 1975 more than 40 countries have been created and a deeper analysis of the independence/liberation movements would reveal that fiscal disparity, among the regions of a nation, was at the heart of many if not all movements. Evidence suggests that addressing the fiscal gap helps curb the feeling of deprivation and therefore forestalls cessation threats. Australia and Canada have successfully thwarted cessation attempts by bridging the fiscal gap of the sub-nationals and through various autonomy measures. The primary tool of fiscal equalization, are intergovernmental transfers, in the form of revenue sharing and grants [Bilin (2005)]. The typical methods of determining the size of transfers from the federation to the sub-nationals include:

(1) Equalisation of fiscal capacities and fiscal needs,
(2) Fiscal capacity equalisation,
(3) Need criterion,
(4) Population share criterion.

The method of equalising the fiscal needs as well as the fiscal capacity recognises that both may vary across regions. This method of equalisation seeks to address the net variation in the fiscal need and fiscal capacities of the regions. The method of equalising fiscal capacity only assumes that the per capita fiscal needs are more or less equal across regions. This method aims to transfer more funds to the region whose fiscal capacity is below the national average. Both these methods require voluminous data on revenue generation, actual as well as potential, as well as minute details of the expenditure needs. The two methods are therefore difficult to use in developing countries.

The need indicator criterion recognises that fiscal needs may vary across regions. This criterion seeks to estimate the expenditures of the subnationals on certain major fiscal needs using statistical and econometric techniques. These estimates are then used to compute the total fiscal need of the region. To estimate the expenditure on a certain need, say healthcare, the need index is developed using possible factors that may influence the healthcare such as the demographic profile of the region, the historical evidence on common ailments and the expenditures thereon. A certain weight is then assigned to healthcare needs keeping in view the value of the index and the historical share of the healthcare expenditure in the total expenditure. Need indicators typically used to estimate fiscal needs of the subnationals include: population, per capita income, unemployment rate, population density, geographical area, infant mortality, life expectancy, school enrolment rate and infrastructure. The multiple indicator criterion (MIC) adopted by the 7th NFC is similar in spirit to the need indicator criterion. However the MIC includes fewer indicators than are typically included in the criterion. The weight determination exercise for the individual elements of the MIC does not seem to be supported by a detailed and rigorous exercise and the weight of the population share is too large.

The last of the four fiscal equalisation methods mentioned above is the population share criterion which has been in vogue in Pakistan until 2009. Ma (1997) argues that the use of population share criterion is least effective at securing equalisation of fiscal needs across regions. The population share criterion assumes that per capita expenditure needs are equal across regions. However, in practice, the per capita expenditure needs may vary, due to differences in population density, geography, history, resource endowments and the level of development. Moreover, the remote location or the difficult terrain of an area may increase the cost of delivering public services. The metropolitan character of a city may also call for incurring above average expenditures.

3.2.2. *The Absence of Matching Grants from the Distribution Design*

The provinces in Pakistan are free to use the transfers from the federal government in the manner they deem fit. Such block unconditional transfers, though in accord with the spirit of the provincial autonomy, do not provide any guarantee that funds will be used to provide a minimum level of public service, especially in respect of essential needs like healthcare and education. Thus, with unconditional block transfers the level of public service in respect of essential needs may vary across jurisdictions. The question then is, what is more important?—provincial autonomy or homogeneous minimum national standards across provinces for essential social services.

The merits of provincial autonomy notwithstanding, there are strong arguments for setting uniform minimum national standards for essential social services like healthcare and education. The conventional wisdom that inequality is essential for economic growth [Kuznets (1955), Lewis (1954)] has been convincingly challenged in recent decades [Galor and Zeira (1993); Easterly (2007)]. Raising the living standards of lagging regions is now considered important for aggregate economic prosperity as well as for political stability. Moreover the homogeneous national standards encourage mobility of goods, services, labour and capital across jurisdictions. The uniform standards also increase the market for the goods of any region and allow the regions to gain from their respective comparative advantage. Establishing relatively homogeneous standards calls for incurring greater expenditures in regions that are below the national average. Conditional or matching grants can be used to achieve uniform standards across jurisdictions. A region that lags behind, say on healthcare indicators, can be induced by the federal government to improve healthcare services by conditioning the transfers with the kind of measurable improvement that is desired.

Conditional or matching grants, especially for social needs like healthcare and education, are a key element of the transfer programme in the developed countries. This is despite the fact that the revenue mobilisation is fairly decentralised in these countries—United States, Canada and a number of other countries. The rationale for conditional transfers, besides the uniform national standards, is that the subnationals in an effort to woo businesses into their jurisdiction may impose lower tax burden on them. This may ultimately result in under provision of essential public services. Conditional grants ensure that essential services will be provided to the required minimum level.

Conditional grants could be administered in a variety of ways. Conditions may be imposed on the subnationals either with respect to inputs (i.e. expenditures) or outputs (i.e. desired results). The input grants may encourage the sub-nationals to engage in wasteful expenditure to show higher numbers. This kind of adverse incentive cannot be related to output based grants. Therefore the output based grants are preferable unless the measurement of output is highly difficult. Conditions would be imposed not on the specific use of grants but on attainment of standards in quality, access and level of service. Matching grants allow the subnationals to access transfers if they spend a certain specified percentage on a specific service from their own sources. Such grants are termed open-ended when there is no limit to transfers from the federal government on this count. Close-ended programmes, on the other hand, put a maximum cap on matching transfers. The close-ended programmes are favoured over open-ended grants because these can be designed while taking into account the budget constraint of the federal government.

The literacy rate of Khyber Pakhtunkhwa and Balochistan is significantly lower than that of Punjab and Sindh (Table 2). It is obvious that the two lagging provinces need to spend more on education to bring their literacy rate closer to the other two provinces.

Table 2

Literacy Rate (Provincial Profile)

Age	Punjab	Sindh	KP	Balochistan
Literacy Rate	59	59	50	45

Source: Demographic and Health Survey of Pakistan (2006).

The use of elements like poverty and inverse population density as indicators in the distribution formula is based on the fact that some provinces lag behind others in the level of development. Greater funds have been transferred to the provinces under the 7th NFC Award on grounds of higher cost of delivery (reflected by Inverse Population Density) and poverty. Increase in literacy could be an ideal way to alleviate poverty on a long term basis. The block unconditional transfers do not guarantee that the additional funds will be used to alleviate poverty or, for example, will be spent on increasing access to education in the sparsely populated Balochistan. The two provinces could have been made to spend more on social services had the incremental transfers been conditioned upon certain improvement in literacy rate, enrolment rate or the patient-doctor ratio. A mix of general purpose and matching grants would better serve the cause of development in Pakistan.

3.2.3. *Demographic Structure and Distribution Criteria*

The demand for public services for different age groups is different. For example, the population aged 5-20 needs education while the elderly require greater healthcare. If the age structure of the population varies across regions then, to provide equal level of services, the expenditure will vary across regions. The estimated province-wise age structure of population in Pakistan, as of 2006, shown in Table 3, depicts that the school age population is relatively greater in the provinces of Khyber Pakhtunkhwa (KP) and Balochistan while elderly population is greater in Punjab and Sindh.

Table 3

School/College Age Population (Percent)

Age	Punjab	Sindh	KP	Balochistan
School Age (5–19 Years)	38.2	39.1	41.8	41.7
Elderly (60 Years and Above)	7.0	5.0	5.8	4.3

Source: Demographic and Health Survey of Pakistan (2006).

Given the province-wise demographic structure of the population, it is clear that the need to spend on education is greater in KP and Balochistan while the need to spend on healthcare is greater in the remaining two provinces. This will be true even if we assume equal per capita expenditure on these services across provinces. The foregoing suggests that to provide more accurately for the expenditure needs of the provinces the demographic structure should be accounted for in the distribution formula. However, the demographic structure is not an element of the multiple indicator distribution criteria adopted by the 7th NFC Award.

3.2.4. *Weights of the Multiple Indicator Criteria*

The 7th NFC Award has assigned certain weights to the four elements of the multiple indicator criteria. There could be no two opinions that the methodology for the determination of weights should be widely known in the interest of transparency and public debate. However, this is not the case. It is unknown what role the historical expenditure patterns, statistical tools and research have played in the weight determination exercise and to what extent rough calculations and political manoeuvres have influenced the weights. The weights influenced by political compromises are likely to prove less stable as there could be a demand for revision with the change in the power configuration.

To illustrate how the weights should be computed one could compute the per pupil cost of education for a school located in some remote area of Balochistan and compare this with the corresponding cost for some school located in the central Punjab. The difference in the two costs could form the basis for the weight of inverse population density. This example is only illustrative and of course the cost differential would have to be examined in greater detail to construct the weight. Similar exercises could be undertaken to compute the weights of other elements of the criteria.

3.2.5. *Weight of Population Share*

The previous distribution criterion was criticised primarily on the ground of revenue sharing solely on the basis of population. With the assignment of 82 percent weight to the population share no major change has been effected in the distribution formula. Thus all the arguments put forth to criticise the previous formula are still valid. Very few countries make transfers to subnationals on the basis of population share and the ones that do accord it a small weight, for example 10-20 percent in India. A problem with the use of population share criterion is that the provinces may question the credibility of the population census. Nigeria, where transfers are solely on the basis of population, has encountered such problems. Perhaps in an effort to avoid the problems of the sort, India is still using the population figures of 1971 to distribute revenue according to weightage assigned to population.

3.2.6. *Poverty as an Element of Multiple Indicator Criteria*

It is generally argued that revenue distribution should not be based on indicators that are likely to generate perverse incentives. Poverty level is one such indicator. The use of poverty as an indicator acts as a disincentive for the provinces to alleviate poverty because the poorer a province, the greater its entitlement under the NFC Award. Moreover, the estimates of poverty levels in Pakistan have been questioned for accuracy. This has prompted the 7th NFC to use the average of the estimates generated by the three different agencies. Including 'poverty' as an element in the revenue distribution criteria will make the provinces stakeholders in the poverty estimation exercise. How this would influence the estimates is difficult to tell. It may add to the controversy about the accuracy of the estimates but, on a positive note, the possibility is that the estimation exercise may become more transparent and less questionable, given the potential gains and losses of the different stakeholders.

3.2.7. *Provincial Resource Mobilisation*

The National Finance Commission presently does not enjoy the mandate to offer advice on the provincial revenue generation but still designing the revenue distribution mechanisms hinges on the extent of own-source revenue generated by the provinces—if the provinces generate more own-source revenues the reliance on federal transfers decreases.

The intergovernmental fiscal relationship in Pakistan is highly imbalanced. The provinces account for around 35 percent of all government expenditures but they generate merely 8 percent of the consolidated national total tax revenue which is only 0.5 percent of the GDP. The need to improve provincial resource mobilisation is but obvious. (A comparison of the intergovernmental fiscal imbalance is given in Table 4. Though six years old the comparison still shows that decentralised revenue generation in Pakistan is among the lowest in the world).

Table 4

Imbalance between Revenue and Expenditure in Countries at the Sub-national level

	Revenue	Expenditure
Australia	31	46
Brazil	31	46
Canada	56	63
India	34	55
South Korea	5	50
Germany	35	63
Pakistan	8	28

Source: Adapted from Watts (2005), cited in Beaconhouse National University (2010).

In the context of fiscal relationship between the federal government and the provinces the primary issue is how the fiscal needs of the provinces should be met? Whether the federal government should collect a larger part of the revenue and then transfer it to the provinces through some transfer mechanism or the provinces should be allowed to generate more revenues on their own and rely on the federal government only to cover the shortfall. The latter approach may have several advantages as discussed below.[2]

The low revenue mobilisation on the part of the provinces should be viewed in the perspective of the national tax effort. The aggregate tax-to-GDP ratio in 2009-10 was 10.5 percent and has been on the decline for over a decade (it was 12.5 percent in 1996). This is significantly lower than the average for developing countries (15 percent) as well as developed countries (35 percent). The tax-to-GDP ratio is much better even in the South Asian countries like Sri Lanka (16 percent) and India (14.5 percent) [Nabi and Shaikh (2011)]. According to Bhal, *et al.* (2008), the present state of revenue decentralisation and its future prospects present a dismal picture. Though the provinces have access to as many as 15 tax bases, the effective yields are very low. The tax bases are considerably eroded due to exemptions and are undervalued, incomplete and dated. Moreover, while the broad based taxes like personal income tax, tax on corporate profits, sales tax on goods and custom duties are with the federal government, the hard to collect taxes are with the provinces: sales tax on services and the tax on agricultural income—the former is administratively difficult and the latter is politically sensitive.

Though most of the broad based taxes have been assigned to the federal government but the incentive to mobilise revenue at the central level may not be as much as it could be at the provincial level. The fact that 57 percent of what is collected does not remain with the federal government may dampen its incentive to increase collection from the revenue sources that are to be shared with provinces. Moreover, with access to money creation and foreign aid, the federal government may not be as hard pressed for cash as the provinces are—provinces cannot create money and they have only recently been allowed to borrow abroad, but only under restrictive conditions.

Though the conventional wisdom suggests that broad based taxes like the personal income tax and the tax on corporate profits should be with the federal government, some federal governments in developed countries are successfully sharing these taxes with the subnationals. The federal government in Pakistan shares the tax revenue with the provinces but only through the NFC Award, not the tax bases.

The devolution of taxes has several advantages. If the provinces are allowed to share the broad based tax bases like personal income tax and tax on corporate profits with the federal government this would solve the free rider problem. The provinces would make an effort to generate more from the two tax bases because the revenue would belong to them. Moreover, better revenue generation by one province can generate a strong demonstration effect, encouraging other provinces to emulate the example set by the high revenue generating province. To accomplish the sharing of the tax bases, the federal government may reduce its tax rate on corporate profits and personal income to make room for the provinces to levy tax on these bases. For example, a reduction of 10 percentage point in corporate tax rate will allow the provinces to tax corporate profits at the rate of 10 percent. The revenue loss that federal government will incur would be offset by the reduced transfers to the provinces under the NFC Award. Overall the national tax revenue is likely to increase due to this kind of sharing because of the greater incentive of the provincial governments to collect more taxes.

[2]This discussion draws on the chapter on 'Provincial Resource Mobilisation' in Fiscal Decentralisation in Pakistan, Pakistan Institute of Development Economics.

The devolution of taxes like income tax to the provinces in Pakistan is criticised on the ground that the provinces do not have the requisite administrative capacity for the purpose, which with all its machinery and power even the federation finds difficult to collect. Increase in collection cost due to the loss of scale economies is yet another argument against decentralisation of revenue generation. Here one can learn from the Canadian example. In Canada though the taxes have been devolved in the sense that the provinces are free to set their own rate structure, a single Canadian Revenue Agency collects the income tax on behalf of the provinces [Boadway (2007)]. A system on these lines can also be developed in Pakistan. The collection of provincial revenue against the tax bases being shared with the federal government can be assigned to the federal government for a certain charge. The collection of taxes by the Federal Board of Revenue, on behalf of the provinces will take care of the supposedly low collection capacity in the provinces and a higher aggregate collection cost under the devolution.

3.2.8. *Revenue Generation Effort*

The 7th NFC has included revenue generation (more commonly known as tax effort) as an element of the resource distribution criteria. This is a welcome development. However, the 10 percent weight assigned to revenue generation is not enough to induce the provinces to increase their tax effort. The effort made by the provinces to generate tax revenue is accounted for in a number of countries while determining the size of transfers. The objective is to encourage the provinces to generate more own-source revenue by rewarding the existing revenue generation. Own-source revenue generation has a number of advantages. It reduces dependency on the federal government and improves governance at the regional level. Moreover, each province can levy taxes in accordance with the preferences of the electorate for the level and kind of public service required.

Moore (2000) argues that nations that mostly rely on unearned income (defined as foreign aid or income from natural resources) are typically poorly governed. The reason is simple: with easy access to money the rulers do not have to enter into a ‘bargain with the citizens’—taxation revenues in return for good governance and better service delivery. Unconditional transfers from the federal government to the subnational governments are like aid to a country from a foreign nation—this reduces the need to raise revenue from the citizens and thus saves the rulers from a more difficult task—providing good governance and better service delivery.[3] If the federal government conditions the transfers to the provinces with sufficient demonstration of own-source revenue generation effort, then the provinces would have no choice but to mobilise more own-source revenue.

3.2.9. *Revenue Generation Effort as Element of Distribution Criteria*

Though the inclusion of revenue generation as an element of the distribution criteria is a step in the right direction, there are some issues in its implementation. Revenue generation as an element of distribution criteria means the total tax revenue generated in a province i.e., the tax collected in a province against the tax bases assigned

[3]One reason why very meagre amount of agricultural income tax is collected in Pakistan is that the tax lies in the domain of the provinces which have little incentive to mobilise own revenues owing to their reliance on transfers from the federation.

to the federal government as well as to the provinces. As argued below, a better approach for this purpose would be to consider only the revenue generated against provincial tax bases (own-source revenue).

If the objective of the inclusion of 'revenue generation effort' in the distribution criteria is to encourage generation of own-source revenue by the provinces, then it is not clear how distribution on the basis of federal revenue generated in a province would encourage generation of own-source revenue. Moreover, collection of revenues by the provinces against tax bases assigned to the federal government would not yield (and has not so far yielded) the benefits of own-source revenue generation for two reasons. First, the machinery for tax collection is federal rather than provincial and secondly, the citizens do not expect the provincial governments to provide better services in return for federal taxes. Thus the improvement in governance at the provincial level would not result merely because more federal revenue is being generated by a province.

Another problem with the use of the revenue collected in a province against federal tax bases is that numerous firms do business and generate income in more than one province. Logically, the tax should be payable in the province where the income is generated. However, for administrative convenience the firms are required to pay tax on their consolidated national income in the province where the head office of the firm is located. Since the income tax is a federal tax, therefore the provinces, as well as the federal government, were till now indifferent to whether the tax payable from income generated in province X is actually deposited in province X or province Y. However now, that the revenue generation is an element of the distribution criteria, the administrative convenience referred to above gives an undue advantage to the province that might be host to head offices of a greater number of firms. For example the banking sector—the largest tax payer, generates income from all over the country, but pays income tax mostly in Sindh on its consolidated income in the country. The reason is that the head offices of most of the banks are located in Karachi—the capital city of Sindh. A more realistic approach therefore would be to include only the revenue generated against provincial tax bases for determining the tax effort of the province.

If at all it is essential to include the revenue generated against federal tax bases then the income generated by multi-provincial firms in each province should be estimated so that the tax liability against the province-wise income of the firm can be assessed for the purpose of the distribution criteria. Whereas estimating regional profits for a multi-provincial firm may be a difficult exercise, the practices adopted by different countries can be examined to estimate the regional earnings.

If the changes discussed above are incorporated in the distribution design, then the weight of 5 percent assigned to revenue generation should be increased significantly to encourage own-source revenue generation by the provinces. This would encourage the provinces to increase revenue generation from the provincial tax bases. It may be mentioned here that some important tax bases assigned to the provinces include property tax, tax on agricultural income and GST on services.

3.2.10. *Specification of the Divisible Pool: A Disincentive for Resource Mobilisation*

The process of distribution of revenues between the federal government and the provinces begins with the specification of the divisible pool—the revenue sources which the federal government can share with the provinces. Most but not all revenue sources are included in the divisible pool, for example personal and corporate taxes are a part of the divisible pool while Petroleum Development Levy (PDL) is not. Exclusion of some revenue sources from the divisible pool encourages the federal government to concentrate on increasing revenues from the excluded sources because the revenue from these does not have to be shared with the provinces. The specification of divisible pool creates a disincentive for the federal government to increase revenues from the sources which comprise the divisible pool. To illustrate, suppose that the federal government wants to raise its own revenue by Rs 100. To raise the required amount through tax on corporate profits the federal government would have to increase the corporate tax rate by such percentage that an additional amount of Rs 236 is mobilised. The federal government needs to mobilise more than the revenue that it requires because 57.5 percent of the additional revenue i.e. Rs 136 would go to the provinces, leaving the federal government with the required Rs 100. An alternative for the federal government is to increase the PDL by such percentage so as needed raise an additional Rs 100 only. The PDL requires lesser increase because it is not a part of the divisible pool i.e. the revenues from PDL are not to be shared with the provinces.

How can these disincentives be avoided? Table 5 provides the answer. At present 44 percent of the gross national revenue is being transferred to the provinces. Instead of specifying an elaborate list of revenue sources which would form the divisible pool, it can be simply stated that 44 percent of the gross federal revenue would constitute the pool of resources divisible among the provinces. This would take care of the federal disincentive to increase revenue from the sources that are divisible. This of course would have to be qualified with details like excluding royalties from oil and gas, which are to be transferred in full to the province concerned.

Table 5

Revenue Transferred to Provinces

NFC	Financial Year	Revenue Transferred to Provinces as Percentage of Gross Total Revenue of Federal Government (%)
NFC 1991	1991-92	26.0
	1992-93	26.1
	1993-94	27.9
	1994-95	30.1
	1995-96	31.8
NFC 1996	1996-97	33.8
	1997-98	26.3
	1998-99	24.2
	1999-00	27.4
	2000-01	30.4
	2001-02	27.7
	2002-03	27.5
	2003-04	27.8
	2004-05	28.0
	2005-06	29.5
NFC 2006	2006-07	
	2007-08	
	2008-09	31.4
	2009-10	31.9
NFC 2009	2010-11	44.6
	2011-12*	44.0

3.2.11. ***Evaluation of Distribution Design Against Best Practice***

The broad principles of resource distribution design derived from the review of relevant literature are given in Box 1.

Box 1

Autonomy: The transfers should allow the subnational governments to determine their own expenditure priorities.

Predictability: The amount transfers should be known well in advance so that the provinces may budget their expenditures with a modicum of certainty.

Simplicity: The transfer criteria should be objective and be fairly easy to understand.

Equity: The transfers should take care of the fiscal needs of each subnational government.

Revenue Adequacy: Transfers should take care of the imbalance in resource availability between the federation and the provinces as well as amongst the provinces.

Incentives: transfers should encourage constituent units to raise revenues and control expenditures.

Accountability: The grantor must be accountable for the design and operation of the programme. The recipients must be accountable to the grantor and the citizens for financial integrity and better utilisation.

Source: Primarily Adapted from Pulling Back from the Abyss: Third Annual Report, Institute of Public Policy, Beaconhouse National University. (The last point 'Accountability' is an addition to the criteria included in the report.)

The revenue distribution design in Pakistan fares well on the yardsticks of autonomy and simplicity. Predictability is not complete but not bad either. However, it scores poorly on the scales of 'incentives' and 'accountability' whereas it is too early to assess it in terms of 'revenue adequacy' and 'equity'. The performance of the distribution design is discussed below in some detail.

The subnationals enjoy complete autonomy as to the use of the funds available, the criteria is simple enough—the weights assigned to the elements of the criteria are known in advance and one has to know only, for example, the population of a province to figure out the grant entitlement of the province against the population share. The absolute amounts of transfers that a province is to receive are partially predictable. The criterion describes the transfers in terms of percentage share of the divisible pool. The absolute size of the divisible pool in a financial year depends upon the revenue that the federal government is able to generate against the sources included in the divisible pool. The transfers are predictable in the sense that the federal government sets the target for collection against each tax source, thus the targeted amount of the divisible pool and the targeted provincial shares are known at the beginning of the financial year. However, the transfers are unpredictable in the sense that in recent years the federal government has been missing the revenue target by a significant margin. This introduces an element of uncertainty regarding the size of the divisible pool and hence the provincial share of transfers. More time is required to grade the new distribution design on the criteria of 'revenue adequacy' and 'equity'. On the one hand, a large number of new functions have been transferred to the provinces under the 18th amendment, while greater funds are being transferred under the 7th NFC Award. With more functions to perform, and greater financial resources at the disposal of the provinces, only time will tell whether the resources are enough to meet the financial needs of the provinces and if these are equitably distributed across provinces.

The revenue distribution design fares poorly in terms of 'incentives' to raise own-source revenue and 'accountability' for the appropriate use of the transfers. As discussed in section 3.2.8, the 7th Award in fact had a dampening effect on own-source revenue generation. The reason of course is greater transfers from the federal government. Lesser transfers from the federal government coupled with perhaps partial allocation of some attractive tax bases, like income tax, to the provinces will encourage the provinces to increase revenue generation from their own tax sources. This is also likely to make the provinces more accountable to their own electorate as successful taxation is essentially a bargain between the citizens and the government.

To conclude, the distribution design is simple, allows autonomy to the provinces as to the use of funds and the amount of transfers is predictable, though with a degree of uncertainty. However, the distribution design offers no encouragement to the provinces to raise own-source revenue. The two principles, namely 'autonomy' and 'incentives to raise own-source revenue' may at times conflict—the distribution design that offers greater incentive for own-source revenue generation may not always allow complete autonomy to the constituents as to the use of transfers. For example, the use of matching grants in some developed countries restricts the use of transfers for certain specific purposes but at the same time encourages own-source revenue generation because the subnationals have to spend a part of the amount from own sources. It is society in general and the policy makers in particular who choose between greater provincial autonomy in the use of transfers and more incentives to generate own-source revenue. The latter has more benefits from the perspective of economic development and good governance.

4. CONCLUSION

The 7th NFC Award in December 2009 ended a prolonged deadlock over the design of the distribution of revenue resources. Yet the present institutional structure of the NFC remains prone to potential deadlocks in the future. The two-tier institutional structure proposed in this study can be helpful in smooth functioning of the NFC with better distribution mechanisms. Though the new distribution design is an improvement over the previous one but still it does not come close to the international best practices. For example, the population share—which is not a part of the distribution design in developed countries and carries a small weight in some developing countries—has a large weight of 82 percent in Pakistan. A good design should encourage own-source revenue generation by the provinces as against the potential dampening effect of the 7th NFC Award in this respect. The distribution design, on its own, can only partially encourage own-source revenue generation e.g., by including the revenue effort and matching grants in the distribution design. While the weight of the revenue effort is not large enough, the matching grants do not figure at all in the prevailing distribution design. To further encourage own-source revenue generation, the federal government needs to share broad base tax bases, like the income and corporate taxes, with the provinces rather than transferring the revenue from these through the distribution design.

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