**Making the NFC work**

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The recent demands from multilateral institutions such as the IMF and the World Bank to revisit the National Finance Commission (NFC) Award have ignited a fresh debate on resource distribution in the country.

Our political trajectory has been characterized by continuous wrangling between the centre and constituent units over the decentralization of political and fiscal powers. The Hamood-ur-Rehman Commission, established in the aftermath of the Bangladesh crisis, underscored the unequal and unjust distribution of financial resources as a fundamental factor contributing to the alienation of East Pakistan.

The 1973 constitution was an effort on the part of the political leadership to accommodate the concerns of the provinces. The last NFC Award and the 18th Amendment passed in 2010 were sequels to such endeavours to alleviate the concerns of the provinces and meet their demands for more political authority and fiscal space. However, despite these endeavours, controversies between the centre and the federating units persist, underscoring the need for a more harmonized and inclusive political framework.

The 7th NFC Award was overwhelmingly skewed in favour of the provinces. The main features of the award, which make it pro-provincial, included raising the share of the provinces in vertical distribution between the centre and the federating units. The federal share was reduced to 42.5 per cent, while the provincial share was increased to 57.5 per cent. In horizontal distribution, the award was designed to address the disparity among the provinces by adopting a more inclusive approach to resource allocation.

Instead of solely considering population size, the award incorporated various indices to ensure a fairer distribution of resources among the provinces. This adjustment aimed to address the longstanding grievances of smaller provinces and promote a more equitable sharing of resources. Given the largest population, in the previous awards Punjab would get the major chunk of the resources, leaving the smaller provinces discontented.

The 7th NFC Award addressed this demand of the provinces by including other factors for the distribution of resources. The indicators and weightage attached to them are reflected as follows: population (82 per cent); poverty/Backwardness (10.5 per cent); revenue collection/ generation (5.0 per cent); and inverse population density (2.7 per cent).

Another essential feature of the award, widely hailed by Khyber Pakhtunkhwa and Balochistan, was recognition of their specific considerations. In the case of KP, the award, while recognizing the role of KP as a frontline province in the 'war on terror', earmarked 1.0 per cent of the divisible pool for the province. Similarly, while recognizing the special development needs of Balochistan, the award enhanced the share of the province to 9.01 per cent and also protected the minimum share of Rs83 billion.

KP and Balochistan further benefited from the recognition of their demands for arrears of hydel electricity profits and arrears of the Gas Development Surcharge. Under these heads, KP was to receive Rs119 billion in five years, while Rs10 billion was to be transferred to Balochistan in the same period. Further, to maximize the size of the divisible pool, the award slashed the collection charges of the federal government from 5.0 per cent to 1.0 per cent; this amount was further added to the divisible pool.

The above-mentioned measures taken in the 7th NFC Award drastically reduced the size of the available finances of the federal government. As a result of this award, not only was the federal share in the divisible pool reduced, but some taxes that had been hitherto collected and used by the federal government were now made part of the divisible pool. Furthermore, the sales tax on services was also given to the provinces to collect and enhance their tax base. This has immensely shrunk the size of the national kitty, making it hard for the center to fulfill its commitment to service its debt and fund the defense and development expenditures.

There is a strong urge at the federal level to revisit the award. Critics of the award think that the distribution formula was finalized without taking into account the future financial needs of the centre, especially debt servicing, defence needs, and other exigency-based expenditures. Due to the limited fiscal space the 7th NFC Award has left to the centre, the federal government has no other option but to resort to internal and external loans to service the outstanding debts.

Similarly, the federal government finds itself in a tight corner when the need for unforeseen expenditures arises. Natural disasters like floods in 2022, locust attacks before that, and the Covid-19 pandemic posed challenges that required colossal funding. The federal government was financially too weak to cope with these crises without seeking foreign assistance.

Over the years, a host of proposals have been discussed to meet the expenditure requirements of the federal government. One such proposal is to shift the financial burden of subsidies on energy and the Benazir Income Support Program (Ehsas) to the provinces. For national security requirements, the federal government wants the provinces to forgo at least 7.0 per cent of their share in favour of the federal government. However, this is easier said than done.

First, any such changes in the resource distribution formula would require a constitutional amendment, which is not easy. The amended Article 160 (3A) now bars the successive National Finance Commission from reducing the allocated share of the provinces allowed by the preceding finance commission.

The 18th Amendment enhanced the fiscal powers of the provincial government by transferring certain taxes to the provinces -- sales tax on services and taxes on immovable property. Without an amendment to the constitution, these powers can not be withdrawn from the provinces. Any such move would inevitably be resisted by the smaller provinces and some large political parties like the PPP, which has been the strongest advocate of the 18th Amendment and the 7th NFC Award.

In such a scenario, one may wonder what options are left with the federal government to meet its pressing financial needs. Luckily, the constitution empowers the president to intervene and favour the federal government without resorting to any amendments in the constitution. Article 160 (6) of the constitution stipulates that: “the president may, by Order, make such amendments or modifications in the law relating to the distribution of revenues between the federal government and the provincial governments as he may deem necessary or expedient.”

There is a strong likelihood that the president may use his powers to add or delete any tax in the divisible pool, as empowered under Article 160(6), to compensate for the federal revenue losses. In a similar move, in 2018 the federal government invoked this provision and imposed a levy on petroleum products by declaring it a non-tax revenue.

Besides, the federal government may beef up its efforts to enhance its tax-to-GDP ratio. The whole edifice of the fiscal distribution mechanism of the 7th NFC Award was constructed on the premise that the federal government would achieve a tax-to-GDP ratio of 15 per cent. Unfortunately, instead of achieving 15 per cent tax-to-GDP ratio, the revenue from taxes has plummeted to 9.0 per cent.

The provincial governments have equally failed; their tax-to-GDP ratio has fallen from over 1.0 per cent of GDP to 0.8 per cent during FY2022-23. As such, there is a strong need for both federal and provincial tax-collecting agencies to optimize their tax-collection efforts. Once the size of the pie is increased, there will be enough resources for both the provincial and federal governments to satisfy their expenditure needs.

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