NFC Award: Devising formula for horizontal distribution

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1. Rational and scope of study

This paper proposes an updated formula for resource distribution between provinces -- horizontal distribution -- under the upcoming National Finance Commission (NFC) Award. We maintain that the formula offered in the 7th NFC Award was predominantly needs-based and whatsoever equity indicators it has, by its very structure, fall short of capturing the full essence of equity. Further, we argue that existing indicators of efficiency – that is the size of provincial tax revenue, is not adjusted for the size of the provincial economy and, thus, fails to capture the efficiency part of tax collection -- that is, the effort made in this regard.

Accordingly, we suggest some solutions which include i) adjustment in the weights of respective indicators, ii) alternative composition of existing indicators, and iii) inclusion of new indicators. The underlying idea for the choice of new indicators is a gradual shift from a needs-based approach to an efficiency-based resource distribution. Based on existing literature on the issue and the regional consultations, we also identify major challenges that need to be overcome in order to end the deadlock on NFC negotiations at the official level.

It seems imperative to note here that some of these challenges pertain to the introduction of further efficiency in horizontal distribution of the federally pooled resources. The first contention we faced was that an NFC award is a political question and any changes in its formula may create political tensions. In any case, it will be difficult to achieve consensus on any new formula so we should not even think of discussing it at an intellectual level.

The second contention was that, after the 18th amendment in the Constitution, the federal government must not intervene in provincial matters. It is a province's own choices how much revenue it wants to collect and how it wants to spend the resources allocated to it. Third, given Pakistan's demographic structure and the weak state of local economy in several parts of the country, we cannot altogether ignore the needs-based distribution of financial resources so any discussion on changing the weight of indicators related to needs — population, for example — in the case of 7th NFC Award is not required.

For greater clarity, we would like to submit that we understand that the award is a political question but we also argue that this, in no way, rules out the possibility of debate on improving the resource distribution mechanisms. No NFC award, indeed, has been finalized without a debate at the technical level at least. We are also aware that the 9th NFC Award may not include the changes being suggested in this paper but this would, at least, start a debate the results of which may materialize in future negotiations. The debate on these issues gradually slows down the resistance and creates environment which is conducive for change. The critical shift from a 100% population-based

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resource distribution in last six NFC awards to a development-based distribution in the 7th NFC Award offers an example of just that.

We also submit that devising a formula for an NFC-guided productive provincial expenditure is not the same thing as an intervention in the internal affairs of the provinces. We need to differentiate between incentivizing and regulating the provincial expenditure. The NFC award – and also similar awards elsewhere in the world, often does the former through adding various indicators to its formulae. For example, many countries use forest cover to encourage/incentivize environment-related expenditures by regional/provincial government. This, by no means, equals to regulating the provincial expenditure.

Same holds true for the inclusion of indicators that promote tax efficiency in the provinces. This does not undermine the role of provinces in collecting taxes, as is commonly believed. Rather it contends that the size of the tax revenue must be adjusted to the economic and financial potential of a province to generate the tax revenue. This actually benefits the provinces with smaller economy.

We would also like to highlight that this paper, or the formula presented herein, does not undermine, under any circumstances, the importance of a needs-based distribution of the federally pooled resources. Even after this formula is applied, the distribution will still remain needs-based as the weight assigned to population of each province shall continue to dominate the resource distribution mechanism. We are only suggesting that policy makers need to start a discussion on how to gradually incorporate element of efficiency in the distribution of tax resources. In any case, any attempts at an adjustment in the weights of existing indicators or the inclusion of new indicators in the NFC formula are bound to reduce the population's weight since other indicators have much lower contribution in the distribution formula than population does.

In this context, this paper is an attempt to broaden the discussion on the NFC's objectives. We contend that the NFC has implications beyond the "supply of finances to provinces". Inter-governmental transfers within a country play a critical role in addressing the vertical and horizontal fiscal imbalances. The very purpose of the inception of NFC award in Pakistan was, in fact, to address these imbalances by financially supporting provincial governments through a fair distribution of resources so that the federating units -- the provinces -- could meet their liabilities and do not suffer financially as a result of horizontal fiscal imbalances.[2] Fiscal imbalances, in this case, refer to the varying ability of provincial governments to raise revenues. For example, Punjab is always likely to raise more revenues than Balochistan since Punjab has a bigger and more vibrant economy than Balochistan.

We draw on the review of existing literature on the NFC awards in Pakistan, best global practices and several consultations across all the four provinces to offer arguments presented in the paper. The consultations were held with policy makers from each province and civil society organizations to document the perceptions and concerns of the provinces regarding the existing NFC award and the expectations from the upcoming one. Also, the proposed changes in the resource distribution formula were presented to various stakeholders during our meetings with them to solicit their feedback which, then, was used to update our proposals.

[2] See also, Jaffery & Sadaqat, 2006.

Overall our approach entails i) a documentation of the NFC award's evolution in Pakistan, ii) a comparative analysis of the resource distribution criteria over time, iii) an assessment of the 7th NFC Award, iv) a study of the resource distribution criteria of peer countries and a documenting of the feedback from the participants of provincial consultation workshops. All these elements are then combined to formulate proposals for the upcoming NFC discussions.

2. Composition of the National Finance Commission (NFC)

A quick refresher on the purpose and the structure of NFC in Pakistan will be helpful here. Constituted under Article 160 (1) of 1973 constitution, NFC has evolved over time. The very purpose of its establishment was an *optimal and judicious distribution of resources… in line with the developmental goals of the federation and federating units*. The NFC, constitutionally mandated to be convened after every five years, consists of the Federal Finance Minister (Chairman), provincial finance ministers and other members to be appointed by the President of Pakistan in consultation with the governors of the provinces. The prime charter of the NFC is to deliberate on the following:

1. Allocation of taxes and duties between the federation and the federating units
2. Extending grants to the provincial governments
3. Exercise of borrowing powers by two level of governments
4. Any other financial agenda referred to the Commission.

2.1. A historical overview of NFCs in Pakistan

So far Pakistan has had eight NFC awards. The 7th NFC Award was initiated in 2006-07 and extended without any changes in 2010 under the 8th NFC Award. Prior to independence, the Government of India Act, 1939 governed financial coordination between the center and the provincial governments. The Act specifically chalked out the constitutional responsibilities of both the entities concerning the distribution of revenue resources which were used in Neimeyer Award for resource sharing between the federation and the federating units.

The same resource sharing principle was initially used post-independence through certain adjustments for sales tax and income sharing were made in 1952 under what is known as Raisman Award. In 1955, "One Unit" declaration occurred under which all the provinces of West Pakistan became a single political unit. East Pakistan became the other unit of the federation. In the two subsequent awards -- announced in 1961 and 1964 -- the distribution of resources took place only amongst these two units.

When the current constitution was adopted in 1973, it provided that a federal pool of financial resources constituting of the net proceeds of specific taxes will be distributed among the federation and the federating units in addition to any indigenous revenue sources the provinces may already have (SPDC 2018). The Constitution made it obligatory for the center to form and convene an NFC at regular intervals of five years. In Table-1, we provide a comparative analysis of the NFC awards from 1974 to 2007 in the form of *NFC Distribution Matrix* encompassing all features of the awards.

Table 1: The NFC Distribution Matrix
Vertical & Horizontal Distribution across Federal & Provincial Governments

	Divisible Pool	Revenue Sharing Criteria	Vertical Distribution	Horizontal Distribution			
				Punjab	Sindh	NWFP	Baluchistan
1st NFC AWARD 1974 (CONCLUSIVE)	**Fewer taxes included which include** - Income tax - Sales tax - Export duty	Population (100%)	20% federal 80% provincial	60.25%	22.50%	13.39%	3.86%
2nd NFC AWARD 1979 (INCONCLUSIVE[3])	Followed 1974 NFC formula[4]. However, following the new census of 1981, population proportions changed and resources shares were changed accordingly	Population (100%)	20% federal 80% provincial	57.97	23.34	13.39	5.30
3rd NFC AWARD 1985 (INCONCLUSIVE)	Followed 1979 NFC formula, But remained inconclusive	Population (100%)	20% federal 80% provincial	57.97%	23.34%	13.39%	5.30%
4th NFC AWARD 1985 (CONCLUSIVE)	Included: -Income tax -Sales Tax -Export duties - Expansion in divisible pool & provincial shares by adding excise duties on sugar & tobacco -Custom duty remained with federal government	Population (100%)	20% federal 80% provincial	57.88%	23.28%	13.5%	5.30%
5th NFC AWARD 1996 (CONCLUSIVE)	All taxes and duties were included in divisible pool comprising of: -Income Tax -Wealth Tax -Capital Value Tax -Sales Tax -Export duties - Custom duties - Any other tax collected by federal government --Royalties on crude oil & surcharge gas	Population (100%)	62.5% federal 37.5% provincial	57.88%	23.28%	13.5%	5.30%
6th NFC AWARD 2000 (INCONCLUSIVE)	Followed 5th NFC formula[5] Inconclusive due to lack of consensus among members	Population (100%)	62.5% federal 37.5% provincial	57.88%	23.28%	13.5%	5.30%
7th NFC AWARD 2006	All taxes and duties were included in divisible pool comprising of: - Income Tax -Wealth Tax	Population 82%, Backwardness & poverty 10.3%,	55% federal for first year and 1% decrease per annum for	57.36 %	23.71 %	13.82 %	5.11%

[3] An inconclusive NFC award means that particular NFC could not be implemented and the arrangement of previous conclusive NFC award continued to be implemented. The NFC Award in Pakistan requires consensus of all members. In case consensus is not achieved, the Award stands "Inconclusive" & previous NFC award continues in practice and a Distribution of Revenues Order is issued by the President for continuation of the previous award.

[4] "Followed previous NFC Formula" denotes that the new NFC award adopted the arrangements of previous NFC award. For example, followed 1974 NFC formula" here refer to that 2nd NFC award adopted all the arrangements agreed upon under 1st NFC award.

[5] "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" (SPDC 2018).

(CONCLUSIVE)	-Capital Val Tax - Sales Tax -Export duties - Custom duties - Any other tax collected by federal government --Royalties on crude oil & Surcharge gas	Revenue generation & collection 5%, Inverse pop. density[6] 2.7%	subsequent years for duration of award; 45% provincial for first year and 1% increase per annum for subsequent years for duration of Award.	

Source: Ahmad, I., Mustafa, U., & Khalid, M. (2007)[7] and SPDC (2018)[8]

Table-1 provides information on major characteristics of NFC awards with a focus on horizontal distribution. One can clearly note some key characteristics of these awards. One, over a 33 year period between 1974 and 2007, the NFC award remained mainly limited to adjustment in the divisible pool through inclusion and exclusion of various taxes. Two, though the 5th NFC Award did not make any structural change -- its broader structure remaining almost similar to the past awards, it did include all the federal taxes in the divisible pool and, accordingly, reversed the federal and provincial shares. It also introduced the concept of matching grants to complement the resources that the provinces could generate on their own. The 6th NFC award, too, adopted the same formula.

Third, and the most important point given the scope of this paper, first six NFC awards were exclusively needs-based. The resources were distributed purely on provincial needs as manifested by the size of their population. The larger the population of a province the higher its share. Punjab, with its population being the biggest, continued to enjoy a resource share ranging between 57.88% and 60.27% during 1974-2006. On the other side, Balochistan, the most deprived province, received the smallest share of resources at a minimum of 3.8% and a maximum of 5.30%.

2.2. How different was the 7th NFC Award?

The resource distribution apparently seems to have witnessed a fundamental shift in the form of the 7th NFC Award[9]. It shifted the criteria of resource distribution significantly and introduced elements which were seen as making the distribution equitable and progressive. A new resource sharing formula was, subsequently, agreed upon which provided that the resource distribution was based, for the first, not on population alone but also on multiple other factors such as inverse population density, backwardness and local tax revenue generation and collection.

[6] Inverse population density shows the dispersion of population (Inverse pop density = 1/pop density where pop density = Population/Area (in sq. km) Balochistan must have higher inverse population density as it has lower population per square kilometer area compared to Punjab and other provinces. Refer to Report of the National Finance Commission (2009) for details. It is available at http://www.finance.gov.pk/nfc/reportofthenfc_2009.pdf

[7] National Finance Commission awards in Pakistan: A historical perspective

[8] A Study of Intergovernmental Fiscal Transfers in India and Pakistan, Social Policy and Development Centre, January 2018

[9] Literature reports conflicting start timeline for 7th NFC. It is evident that "Through Ordinance No. 1 of 2006, made amendment in the "Distribution of Revenues and Grants-in-Aid Order, 1997". Consequently, the new NFC was announced to take effect from 1st July 2006 [Pakistan (2006 a)]." Further Iftikhar, Mustafa & Khalid (2009) reports 7th NFC to be effective from 2006. SPDC Report (2018) however reports that "a major development in this regard was the 7th NFC Award of 2009 that significantly affected the resource distribution formula",

Table 2: Horizontal Distribution of Resources (1975 to 2009)

Factors	NFC 1975	NFC 1991	NFC 1997	NFC 2006	NFC 2009
Population	100%	100%	100%	100%	82.0%
Poverty/Backwardness[10]	-	-	-	-	10.3%
Revenue Collection/ Generation[11]	-	-	-	-	5.0%
Inverse Population Density	-	-	-	-	2.7%
***Note:** the distribution is made from pool excluding 1/6th of sales tax collected and distributed in lieu of Octroi/Zila Tax					

As shown in Table-2, the new NFC formula, formally applied in the 7th NFC Award, gave population a weightage of 82% weight while the rest of the 18 percentage points were distributed among backwardness captured through poverty incidence (10%), inverse population density (2.7%) and tax revenue/generation (5%). The 7th NFC Award also addressed other outstanding issues such as the distribution of hydro-electricity profits and Gas Development Surcharge (GDS).

The 7th NFC Award meant that Punjab's share dropped the most while the share of Balochistan increased considerably. Punjab also remained dissatisfied with the federal government's share remaining high (44%). Since 2014, however, the federal government has sought an additional 6-7% rise in its share for expenditure on security, law and order as well as for development in Azad Kashmir and Gilgit Baltistan regions (Shah, 2019).

The 7th NFC Award proved to be effective in certain areas. It facilitated fiscal decentralization and provincial autonomy and there was a considerable expansion of the divisible pool with the inclusion of all federal taxes in it. There are, however, some gaps in the 7th NFC Award model which impede the desired outcomes as far as increasing the capacity of the provincial governments to generate their own tax revenues and to introduce efficiency in their expenditure are concerned. We highlight some of these gaps in this section.

Without any doubt, the 7th NFC Award was a departure from the previous awards and represented a critical shift in resource distribution. But, contrary to the popular belief, the 7th NFC Award did not offer a progressive, equitable and efficiency-based formula. First, it fundamentally remained needs-based as population still carried 82% weight in it. If we add the inverse population density to this, 87% weight was allocated to needs-based indicators. Two, the inclusion of the absolute size of provincial tax revenues as an efficiency indicator did not produce the required result because of problems in the structure of the indicator at one hand and lower weight (5%) assigned to it on the other hand.

The absolute size of tax revenues, for example, does not capture the differences in "the size of economy" across provinces. The absolute share of a province with a larger economy, say Punjab, will always be high in the divisible pool because, under current circumstances, it is highly likely to

[10] Denoting state of backwardness, poverty here refers to incidence of poverty in respective provinces. This is a head count index which shows share of population living below poverty line. Refer to Report of the National Finance Commission (2009) for details. It is available at http://www.finance.gov.pk/nfc/reportofthenfc_2009.pdf

[11] "Sindh advocated the use of revenue collection as an indicator whereas the other three provinces demanded the use of revenue generation as an indicator", the 7th NFC commission decided to use both revenue collection and generation with 50% for each. As "Federal Board of Revenue showed inability to provide data on generation basis" withholding tax paid on electricity consumption, reported in FBR Year Book 2007-08, was used as proxy for revenue generation. Refer to Report of the National Finance Commission (2009) for details. It is available at http://www.finance.gov.pk/nfc/reportofthenfc_2009.pdf

collect higher taxes than others. Most importantly, this larger collection =of tax revenues does not reflect "tax efficiency". =It rather denotes a "larger economic activity". Similarly, a comparatively lower weight assigned to revenue collection discourages provinces from investing in revenue mobilization as the costs of doing so may override the potential gains from the NFC award. This has overtime increased their dependency on the federal government.[12]

Pakistan's tax system has undergone considerable reforms over the past decades but tax assignments of the federal government and provinces have remained unchanged since 1973. No modifications occurred for the federal and provincial tax portfolios even when the 18th amendment to the constitution was passed in 2010. The federal government has the constitutional right to collect taxes on all income except the one earned from agriculture, immoveable property and the capital value of assets minus taxes on immovable property. The federal government also collects sales tax on the purchases and sales of goods (exported, imported, manufactured, produced or consumed) excluding the tax on the sale of services. The other major segment of the federal indirect tax comprises of tax on international trade (excise duties, import/export duties).

The provincial government tax assignments include taxes on agriculture income, professional income and immovable property. As far as indirect taxes are concerned, the provinces collect sales tax on services, excise duty on liquor/narcotics/alcohol, stamp duty and motor vehicle tax. It is also worth mentioning that majority of the provincial tax assignments are subject to a rule known as "through a bar" in the federal tax list This means that a particular part and portion of the tax base comes under the federal domain while the residual tax base comes under the provincial jurisdiction. For example, income tax comes under the federal domain but agriculture income tax is a provincial collection. Similar is the case with capital gains tax.

In such a tax framework, even the incentives for performance based-matching grants for the provincial governments, as provided under the 1997 NFC award[13], failed due to a deficiency in revenue generation through their own efforts. For a long time, the provisional tax collections also remained subdued due to a lack of capacity, non-availability of data at the provincial level on incomes and wealth, as well as a lack of accountability within the revenue generation framework.[14]

The 7th NFC Award is also applauded for increasing the provincial share from 45% to 50% (tax revenue + grants) in the five years after its announcement. There is, however, a down side to this increase: it has resulted in an increase in the non-development expense of the provincial governments which, certainly, is not a desirable outcome.

The NFC's focus on population as the main determinant of resource distribution also frustrates its original objective of addressing fiscal imbalances among the federating units. Despite a rising disparity in the economic and demographic landscapes of various provinces, there has been no serious change in the distribution of federal resources which continue to flow in disproportionally large numbers to the federating units that have larger populations (Ahmed, Mustafa and Khalid, 2007).

[12] See Ahmed and Naqvi (2016); Jamali & Ahmed (2016); Nazir et al. (2018).
[13] If revenue growth of 14.2% was posted.
[14] See Ahmed (2017). See also Kardar, 2006 and Ahmed, Mustafa and Khalid, 2007.

We, therefore, argue that a constitutionally acceptable debate should be initiated for establishing new benchmarks to determine the federal-provincial shares as well as the share of each province. We also contend that this debate should also redefine the objectives of the NFC itself.

3. What needs to be done?

It is this context that necessitated that the future NFC awards include a gradual shift from a needs-based distribution of resources to an efficiency-seeking sharing of resources. The award must go beyond the need for a consensus and start acting as a tool to promote efficient provincial expenditure and incentivize progressive taxation by i) adjusting the weights of existing indicators, ii) changing the composition of existing indicators, and iii) including new indicators. Before we offer the alternatives, a look into the Indian experience of resource distribution may establish how the finance commissions can reflect the evolving economic and financial needs of the federating units in changing times.

The Finance Commission of India (henceforth IFC) has experimented with different criteria over time. To address horizontal imbalances across the states, it has used tax collection and population for determining the *inter se shares* of the states under first six financial awards even though the weightage given to population decreased from 100% to 75% in the 6th IFC Award The 7th IFC Award made a a fundamental paradigm shift and decreased the population weight to 25%. The change triggered the use of other indicators related to fiscal weaknesses and economic backwardness (SPDC 2018). The following tables -- 3, 4 and 5 == exhibit how weights assigned to population have decreased significantly in India and how the base for resource distribution has expanded to four sets of determinants.

It is important to note here that we use IFC to show that how it kept modifying the resource distribution mechanism in the face of arising developmental and other challenges. In this regard, our focus is on the composition of IFC and the balance it has to achieve while changing the distribution mechanisms. We are also mindful of the fact that, unlike Pakistan's NFC which is a political forum, IFC is a technical body and its decisions are not necessarily consensus-based. As some experts and academics have already argued, the mechanisms exclusively based on consensus always suffer from inertia.

NFC in Pakistan, in contrast with its counterpart in India, has also suffered many delays even when the Constitution provides that its award is announced every five years. Its ad-hoc nature has hampered it from coming up with optimal resources distribution formula. This situation is likely to continue in the 9th NFC Award.

Table 3: Inter-se sharing[15] of Income Tax in India

Finance Commission	Weights (in percent)		Income Distance[16]	Inverse Per Capita Income[17]	Backwardness[18]
	Population	Collection of taxes			
	80.0	20			
Second, Fifth, Sixth & Seventh (1957-1984)	90.0	10			
Eighth (1984-89)	22.5	10	45.0	22.5	
Ninth (1989-95)	22.5	10	45.0	11.25	11.25
Source: Finance Commission Reports					

Table 4: Inter-se sharing of Union Excise Duty in India

Finance Commission	Weights (in percent)		Income Distance	Inverse Per Capita Income	Backwardness
	Population	Collection of taxes			
	80.00	20			
Second, Fifth, Sixth & Seventh (1957-1984)	90.00	10			
Eighth (1984-89)	22.5	10	45.0	22.5	
Ninth (1989-95)	22.5	10	45.0	11.25	11.25
Source: Finance Commission Reports					

Table 5: Inter-se sharing of tax-India

Finance Commission	Finance Commissions				
	Tenth (income Tax and union excise)	Eleventh	Twelfth	Thirteenth	Fourteenth
Population[19]	20.0	10.0	25.0	25.0	17.0
Income Distance[20]	60.0	62.0	50.0		50.0
Area Adjusted[21]	5.0	7.5	10.0	10.0	10.0
Infrastructure Distance [22]	5.0	7.5			
Fiscal Self Resilience[23]/ Distance		7.5	7.5	17.5	

[15] ***Inter se*** is a Legal Latin phrase that means "among or between themselves". The phrase is "used to distinguish rights or duties between two or more parties from their rights or duties to others"

[16] It is the distance of actual per capita income of a state from the state with the highest per capita

[17] Inverse Per Capita Income implies inverse relationship between population growth and per capita income

[18] *BACKWArdness* measured through poverty, geographical remoteness, per capita income,

[19] The **population** criterion reflects the assumption that a state's expenditure needs generally grow proportionally with the number of its inhabitants. The criterion does not take in account the differences of states in their fiscal capacities, but provides equal per capita transfers to all states.

[20] **Income distance** criterion primarily aims to remove the poverty and the backwardness of the poorer States and takes into account the per capita income of the States. It is the distance of actual per capita income of a state from the state with the highest per capita and it is the only measure of fiscal capacity.

[21] The indicator is intended to reflect cost disadvantages to state governments for providing basic services to its citizens. Less densely populated areas typically require higher levels of government services and these create higher costs

[22] Infrastructure Distance can be interpreted as a criterion that reflects cost deficiencies of a state. The assumption involved is that the greater the infrastructure deficiencies of a state are, the greater will be its costs of providing public services.

Tax Effort[24]	10.0	5.0	7.5		
Fiscal Capacity Distance				47.5	
Demographic Change					10.0
Forest Cover[25]					7.5
Source: Finance Commission Reports					

The IFC has adopted different mechanisms to address horizontal inequalities and clubbed multiple criteria under five broad categories namely i) needs-based, ii) equity-based, iii) efficiency-based, iv) fiscal disability[26] and v) non-plan revenue expenditure[27]. These criteria, a clear deviation from a needs-based formula to the one based on equity and efficiency, resulted in progressivity of transfers when implemented through successive FC awards.

As we can see in the tables above, the weight of needs-based criteria decreased from the 8th IFC Award onwards and equity-based criteria were introduced to tackle backwardness and poverty across the states. Table 5 clearly exhibits how dynamic IFC has been over time. Not only has it changed the weights of indicators, it has also introduced new indicators as and when required. On the contrary, Pakistan exclusively followed a needs-based (population-driven) criterion for the horizontal distribution of its federal divisible pool-in the first six NFC awards.

3.1 Proposals for the future NFC awards

We emphasize that, for a formula to be judicious, the choice of parameters should not be narrowly and sub-optimally focused on a single factor such as population which is based on a national census which, in turn is conducted after decades and has always has problems involving internal migration and the political and parliamentary dividend of demography. Due weightage, therefore, must be given to some other important indicators which are already being adopted by the rest of the world.

We also acknowledge that the shift to an efficiency-based distribution formula is not possible overnight. So, at this point, we want to initiate a debate at least on the need for moving towards an efficiency-led resource distribution through i) reducing the weight of population and ii) including efficiency-based indicators such as provincial tax effort captured through difference between tax collected and estimates of tax potential.[28]

We also need to change the parameters for the existing indicator of backwardness from absolute poverty to relative poverty. To guide provincial expenditures towards development, essentially without regulating these expenditures, we also need to think about some transitory indicators that may include i) changes in the provincial forest cover to tackle environmental challenges, and ii) social expenditures to promote development efforts in the provinces. To meet these goals, we propose the following for the future NFC negotiations.

[23] For Fiscal Self Resilience index, the commission adopted the improvement in the ratio of own revenue receipts of a State to its total revenue expenditure related to a similar ratio for all States as a criterion for measurement. The ratio so computed is used to measure the improvement in the index of fiscal discipline in a reference period in comparison to a base period.

[24] Tax Effort is measured by weighted tax-GDP ratio, i.e. the ratio of per capita own tax revenue of a State to its per capita income weighted by the inverse of per capita income. The intention of the measure is to reward poorer States, which exploited its tax base as much as a richer State.

[25] The commission assigned 7.5 per cent weight to **forest cover** as the new criteria to balance the benefit of the huge ecological benefits and the opportunity cost in terms of area not available for other economic activities that becomes indicator of fiscal disability.

[26] This indicator was used to compensate the forgone revenues by converting lands into forest. The states which mainly shared the forest cover were not able to put the lander under forest to any other use creating a fiscal disability.

[27] Non-plan revenue expenditure includes interest payments, statutory transfers to provinces, pensions etc.

[28] See also Ahmed and O' Donoghue (2009). Hussain and Rana (2010) also calculate fiscal effort for provinces of Pakistan.

i. Cut the population's weightage down by at least 10% in the next two NFC awards; slash its share by another 15% in the subsequent two awards to ultimately reduce its weightage to 50%
   a. Replace the existing indicator of absolute tax revenue with tax collection efforts -- i.e. the difference between the revenue collected and the estimates of revenue potential. Also increase the weight for this indicator to 10% in the next two awards iii. Keeping its current weight, replace absolute poverty with relative poverty. Until the gross (provincial) product data is available, we propose poverty-distance as an indicator. Poverty-distance is the difference between the provincial poverty incidence and a) poverty target set under the provincial Sustainable Development Goals (SDGs) framework; and b) province with lowest poverty incidence.

iv. Incorporate expenditure efficiency indicators that may include, for example, expenditure on forest cover.

Table 6: Proposed indicators for the future formula

Existing formula in 7th NFC		**Proposed Formula for next two NFC awards**		**Comment**
Indicator	**Weight (%)**	**Indicator**	**Weight (%)**	
Population	82.00	Population	72-67%	-Cut the weight by 15% in the next two NFC awards. -Deviation from need based approach to efficiency
Poverty	10.30	Poverty Distance	10.30	-Indicator composition changed –- Indicator of progressivity
Inverse Population Density	2.7	Inverse Population Density	2.70	No change
Tax Revenue	5.00	Tax Effort (tax revenue-tax potential[29])	10.00	-Weight doubled -Indicator composition changed -Captures efficiency -Addresses the size of provincial economy problem
-----	------	Forest cover	7.00	-New indicator added -Improves spending efficiency -Can be changed as circumstances demand in future.

3.2 Challenges in moving towards the new formula

The NFC by and large has remained an unsuccessful forum to evolve and address the issue of fiscal decentralization in an optimal manner. Most of the time, it has developed precious little consensus, paving the way for interim awards that only benefited the larger provinces. Overtime this has led to an increased resentment among the economically smaller provinces. Drawing on feedback from the

[29] World Bank can be approached to measure the tax gap. It has already been working on the issue. The study entitled "Public Financial Management and Governance" mentions that "recent studies of the World Bank estimate a tax gap of about 75 percent between the current receipts and potential of taxes collection" https://peri.punjab.gov.pk/system/files/Chapter%2010%20Public%20Financial%20Management%20and%20Governance_0.pdf

participants of workshops held in all the four provinces, we highlight some of the key concerns of the different federating units. We maintain that failing to overcome these challenges may allow the status-quo to prevail at the expense of harmonious relations among the provinces as well as between the provinces and the federation.

The first and the foremost concern expressed by the provinces is that the existing mechanisms of resource distribution are not implemented in letter and spirit. The non-implementation of AGN Qazi formula[30] is referred to as a case in point. A trust gap, they argue, has developed between the federal government and the provinces. The participants from all the four provinces, therefore, feel that it is useless to talk about the new formula when existing formula is not being implemented fully. Bridging this trust gap shall be critical for initiating any meaningful debate on resource distribution.

The provincial participants further flagged the fact that various constitutional provisions regarding the fiscal and administrative devolution are not being fully met. In this context, they highlighted how the present narrative of the federal government on the possibility of rolling back some of the provisions of the 18th amendment worries all the provincial administrations. Members of the federal cabinet often also proclaim that the current NFC award formula weakens the federation – a view not shared by the provincial administrations.[31]

Another challenge has been a non-systematic approach to devolve, capacitate and empower the provincial governments to create their own revenue collection mechanisms. The provinces should have been facilitated in a timely manner so that their dependence on the center had decreased. Despite expansion in the overall resource pie since the 1st NFC Award due to greater collection of indirect taxes, the federal government has maintained the status-quo in the collection and distribution of resources instead of coming up with a rules-based mechanism (for resource distribution) and expanding the resource flow to the provincial and local administrations.

Finally, the stakeholders saw the very composition of NFC as one of the major challenges. It is an intergovernmental platform and has no mandate or discretion to take decisions and implement them on its own. The legal framework governing it needs an overhaul. It must be given the status of a technical body with some discretion and power to take decisions on its own. It is, however, important to note here that the introduction of discretion may not be read as undermining the importance of the consensus-based decision making.

Conclusion

Despite many challenges, we maintain that the current scenario is favorable for a debate on a new criterion for resource distribution. The latest electoral process has led to a situation where the ruling party (PTI) holds majority of seats in the National Assembly, has formed government in Punjab, is enjoying a second term in Khyber Pakhtunkhwa and has become a part of a coalition government in

[30] The Aftab Ghulam Nabi (AGN) Kazi committee was formed in July 1985 to frame a formula for the calculation of the Net Hydel Profits (NHP) to the provinces under the article 161(2) of the constitution and was headed by Planning Commission deputy chairman AGN Kazi. Article 161 (2) of the Constitution states, "the net profits earned by the federal government or any undertaking established or administrated by the federal government from the bulk generation of power at hydro-electric station shall be paid to the province in which the hydro-electric station is located". The committee finalized its report two years later, in July 1987 to be exact, which was approved by the CCI in Jan 1991 and since then, KP and center have been trying to reach a settlement on the issue.

[31] See Hussain 2019, and Ismail 2019.

Balochistan. This is a milieu where public consensus, approval and implementation are comparatively easier to achieve.

Since the 7th NFC Award two other aspects have also changed: data availability and the evidence of the success or the failure of previous awards. Given this, it is, easier to identify a distribution rule that provides effective solution to the financial disparities. Furthermore, the localization of SDGs with the support of provincial and local governments is altering the socio-economic thinking.

With the SDG construct in the backdrop, the resource distribution criteria discussed above is not only logically appealing but also the need of the hour. The countries which realize the importance of fiscal federalism never compromise on it and never leave it on an inconclusive note. Like in India, NFC should be a technical body and it should function as an independent agency.

Going beyond mere resource distribution, the future awards need to ponder over some bigger questions as well. Particularly, two questions need an immediate deliberation. First, are the provinces ready to deepen the elements of equity and efficiency in the distribution formula? What will be the key tradeoffs of moving to a more refined efficiency-based formula? And who are the winners and losers? Second, how effective is NFC as a legal mechanism? Do we need to introduce some elements of discretion in its decision-making? We are well aware that these are difficult questions and that changing the status-quo will take time. However, addressing these questions is essential if we envisage a stronger federation in the future.[32]

From our consultations, we note that the awareness about NFC is low. A public debate led by the federal government can bring forward progressive ideas. The federal government needs to highlight that NFC is a tool to create economic efficiency and to seed development priorities across the country.[33] In this regard, the government may set up a permanent NFC caucus in the provincial assemblies. A continued and broad-based dialogue on NFC must be ensured by involving the news media, civil society, academia and policy think tanks. The development partners of Pakistan, having experience from other countries, may also help in offering technical advice on this subject.

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[32] See also Ahmed and Qadir (2018), Khan et al. (2016), and Ishfaq et al. (2017).
[33] For example, see Manzoor et al. (2016).

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