Research and Policy Brief

Fiscal Implications of the 7th NFC Award

Social Policy and Development Centre **December | 2017**

Since its commencement, the 7th NFC award received a positive response from provincial policymakers and academia. It was praised for resolving burning issues like revising computation of the Gas Development Surcharge (GDS), devising payment mechanisms for arrears of hydroelectricity profits, allowing provinces to collect sales tax on services, rationalizing collection charges of FBR taxes, and introducing multiple criteria for horizontal distribution. However, increasing provincial shares in the divisible pool have received a mixed response. While proponents of fiscal devolution praise it as a tool for promoting social development, it is criticized for reducing fiscal space of the federal government. With the passage of time, this view is getting stronger. The higher level of fiscal deficits of the federal government is often referred to in support of this view.

This policy brief aims to contribute to the above debate by analyzing the quantum of resource transfers from federal to provincial governments due to the 7th NFC award and highlights the fiscal efforts and level of fiscal balance of both tiers of governments during the post 7th NFC award period. An attempt is also made to delineate the causes of federal fiscal deficits.

Financial Implications of the 7th NFC Award

The financial implications of the 7th NFC Award for the federal and provincial governments are the following:

1) The collection charges of FBR taxes were decreased from 5 percent to 1 percent, thereby, enlarging the overall size of the divisible pool.
2) The federal government and all four provincial governments recognized the role of Khyber Pakhtunkhwa (KPK) as a frontline province against the war on terror. Therefore, one percent of net proceeds of the divisible pool are earmarked for KPK, for the entire award period.
3) The remaining proceeds of the provincial share of the divisible pool were increased from 46.25 percent to 56 percent in 2010-11 and then to 57.5 percent, for the rest of the award period.
4) The horizontal distribution of the divisible pool was based on four weighted factors: population (82 percent), poverty and backwardness (10.3 percent), revenue collection/generation (5 percent) and inverse population density (2.7 percent).
5) The award ensured that Balochistan received at least Rs83 billion under divisible pool transfers. In case the estimated share of Baluchistan was less than Rs83 billion, the balance funds would be contributed by the federal government.
6) The award revised the mechanism of calculation of GDS per MMBTU and raised the rate of excise duty on natural gas from 5.09 per MMBTU to Rs10 per MMBTU.
7) The federal government agreed to pay arrears of GDS to Balochistan on the basis of the new formula and long-held up hydel profits in four instalments of Rs25 billion each year to Khyber Pakhtunkhwa.

The financial implications[i] of these changes compared to the Distribution of Revenues and Grants-in-Aid Order (DRGO) 2006 can be summarized as follows: Aforementioned points one to five have a positive impact on divisible pool transfers to provinces, while a negative impact on federal share can be noticed; point six has a positive impact on straight transfers to provinces and is neutral for the federal government; and point seven has a negative impact on provincial grants and a positive impact on the federal government.

Table 1 presents financial implications of the 7th NFC Award on federal and provincial governments in comparison to the DRGO 2006. It indicates that as per the revised estimates from 2010-11 to 2016-17, in relative terms, Balochistan and Khyber Pakhtunkhwa are the major gainers from the 7th NFC award, with an average per year increase of more than 2.4 percent of the FBR taxes throughout the tenure of the NFC Award. In contrast, the 7th NFC award took away, on average, 8 percent of FBR taxes from the federal government. This percentage would be even lower if Rs25 billion are subtracted from the grants as they were previously agreed by the federal government and the 7th NFC award only outline the mechanism.

Table 1: The 7th NFC Award Comparative Financial Impact

	Federal Revenues	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan
Relative Impact [As a percentage of FBR Taxes] (%)					
2010-11*	-8.56	1.7	1.3	3.1	2.9
2011-12	-8.67	2.2	1.6	3.0	2.2
2012-13	-8.81	2.2	1.6	3.0	2.3
2013-14	-8.62	1.9	1.5	2.9	2.6
2014-15	-7.63	2.1	1.5	1.9	2.4
2015-16	-7.41	2.1	1.6	1.9	2.0
2016-17	-7.45	2.1	1.5	1.8	2.2

*Revised Estimates (RE)
Source: SPDC Estimates

Table 2: Level of Fiscal Effort by Federal and Provincial Governments

(Rs in Billions)

	DRGO 2006			7th NFC		
	2006-07	2009-10	ACGR	2010-11	2016-17	ACGR
Federal Government						
FBR Tax Revenues	847.2	1327.4	16.1	1550.2	3361.0	13.8
Other Tax Revenues	70.2	116.5	18.4	115.0	286.4	16.4
Total Federal Taxes	**917.4**	**1443.9**	**16.3**	**1665.1**	**3647.5**	**14.0**
Total Provincial Taxes	**36.8**	**54.8**	**14.2**	**64.6**	**321.8**	**30.7**

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

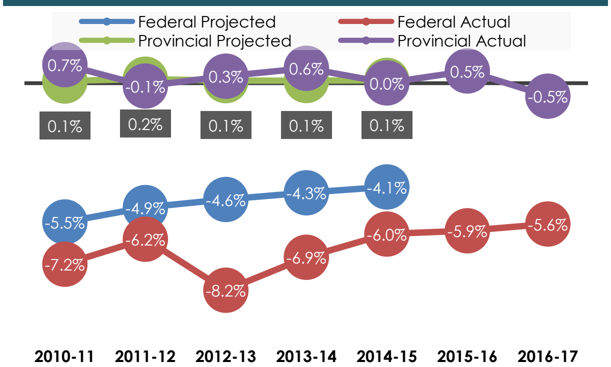
Level of Fiscal Effort

It was generally perceived that a higher share of provincial governments in FBR taxes will put pressure on the federal government for resource mobilisation to meet its expenditure. Consequently, the tax-to-GDP will increase due to these efforts. However, a look at the growth rate of FBR tax collection reveals that growth in FBR taxes declined after the 7th NFC Award. During 2006-07 to 2009-10, growth in FBR taxes was more than 16 percent, which declined to 13.8 percent during 2010-11 to 2016-17. A similar trend is evident from other tax revenues - growth has declined after the 7th NFC Award (Table 2). In contrast, tax revenues of provincial governments have had an impressive growth of more than 30 percent after the 7th NFC award as compared to only 14 percent during 2006-07 and 2009-10. The devolution of sales tax on services is the main reason for this phenomenal growth.

Level of Budget Deficit

The 7th NFC award projected the key budgetary magnitudes of both federal and four provincial governments for 2010-11 to 2014-15. Based on these projections Chart 1 presents the actual and projected budget deficits of both federal and provincial governments as a percentage of the GDP. It indicates that during the post-7th NFC period, actual federal budget deficit surpassed the projected budget deficit with wild margins. For example, for 2012-13 the projected federal budget deficit was only 4.6 percent of the GDP, while the actual budget deficit was more than 8 percent of GDP. In contrast, the provincial budget balance shows a mixed trend. For instance, for 2012-13 NFC projected a combined provincial budget surplus of 0.1 percent of the GDP, while the actual budget surplus was 0.3 percent of the GDP. However, for 2011-12 for the similar projection, provincial governments altogether had a budget deficit 0.1 percent of the GDP, instead of a surplus.

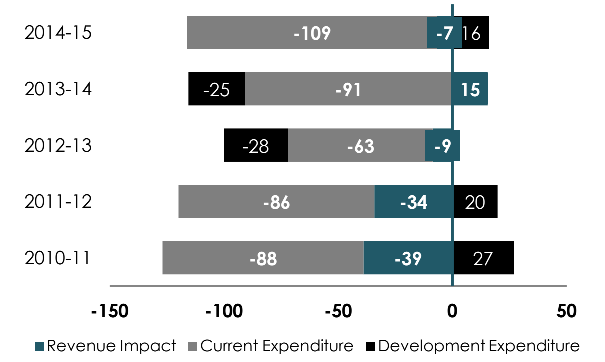
Chart 1: Trend in Federal and Provincial Budget Deficits *(as percentage of GDP)* (%)



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

It is generally argued that the higher share of provinces in the 7th NFC Award is the biggest cause of financial problems for the federal government, including massive growth in federal budget deficit. Chart 2 shows a deconstruction of the federal budget deficit into three components i.e. revenue, current and development expenditures impacts. Each component shows the net contribution of deviations in actual and projected amounts in an increase in the federal budget deficit, in percentage terms.

Chart 2: Causes of higher than the anticipated federal budget deficit (%)



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

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

A look into the causes of high deviations in current expenditures compared to the 7th NFC projections reveals several factors. For instance, in 2012-13, to address the issue of circular debt – that partly caused a shortfall in energy production – the federal government instated a huge power sector subsidy, which pushed the current expenditure to a higher level. Apart from this one-time shock, the federal government has been unable to capitalize the envisaged impact of the 18th Amendment on current expenditures. During the first year of the 7th NFC award, the federal government has increased the salary of employees by 50 percent. Moreover, instead of reducing the number of ministries due to transfers of functions to provinces, the federal government has increased the number of ministries/divisions.

Conclusion

The above analysis clearly spells out that the 7th NFC award is not the biggest cause of a higher federal budget deficit. While the 7th NFC award transferred less than one percent of the GDP to provinces compared DRGO 2006, deviation in the federal budget deficit is more than one percent of the GDP. The main cause of a higher budget deficit is the tremendous growth in current expenditures. FBR revenue shortfall caused a slight deviation in the budget deficit that effects provinces more than the federal government. Given that the 7th NFC award transferred more resources to relatively backward provinces, it is important to continue this level of resources for much needed socio-economic development and achieving SDGs. One possible strategy for dealing with higher than anticipated budget deficits is controlling the level of current expenditures and mobilizing resources.

[i] Apart from above changes the 7th NFC award allows provinces to collect sales tax on services, which also have financial implications on both tiers of the governments. However, as per the Constitution sales tax on services is a provincial tax. Therefore, it is the provincial government who bore financial losses due to pre-7th NFC de-facto practices. Consequently, the above analysis does not incorporate the financial impact of the sales tax on services.

Research and Policy Brief prepared by Muhammad Sabir

SOCIAL POLICY AND DEVELOPMENT CENTRE

Head Office: C-99, KDA Scheme 1, off Karsaz Road, Karachi | Tel: (92-21) 111-113-113 | Email: spdc@spdc.org.pk | www.spdc.org.pk

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