A Study of Intergovernmental Fiscal Transfers in India and Pakistan

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LIST OF ACRONYMS

BE	Bachelor of Engineering
BPL	Below Poverty Line
CAA	Constitutional Amendment Act
CCI	Council of Common Interest
CDL	Cash Development Loans
CE	Central Excise
CSS	Centrally Sponsored Schemes
CST	Central Sales Tax
DC	District Council
DRGO	Distribution of Revenues and Grants-in-Aid Order
FANA	Federal Administrated Northern Area
FC	Finance Commission
FEI	Fiscal Equalization Index
FFC	Fourteenth Finance Commission
FRBM	Fiscal Responsibility and Budgetary Management
FRDL	Fiscal Responsibility and Debt Limitation
GDP	Gross Domestic Product
GDS	Gas Development Surcharge
GEI	Gender Equality Index
GP	Gram Panchayat
GPI	Gender Parity Index
GSDP	Gross State Domestic Product
GST	Goods and Services Tax
IBM	India Bureau of Mining
IGFT	Intergovernmental Fiscal Transfers
IMF	International Monetary Fund
IMR	Infant Mortality Rates
INR	Indian Rupee
KPK	Khyber Pakhtunkhwa
KWh	Kilowatt hour
LFPR	Labour Force Participation Rate
LG	Local Government
LGA	Local Government Act
LME	London Metal Exchange
MC	Municipal Committee
MGNREG	Mahatma Gandhi National Rural Employment Guarantee
MM	Mines and Minerals
MMR	Maternal Mortality Rates

NEC	National Economic Council
NER	Net Enrolment Rate
NFC	National Finance Commission
NITI	National Institute for Transforming India
NPCF	Provincial Consolidated Fund
NWFP	North West Frontier Province
OZT	Octroi and Zila Tax
PFC	Provincial Finance Commission
PRI	Panchayati Raj Institutions
RR	Revenue Receipt
SC	Scheduled Castes
SFC	State Finance Commission
SPDC	Social Policy and Development Centre
ST	Scheduled Tribes
TOR	Terms of Reference
ULB	Urban Local Bodies
UDAY	Ujjawal DISCOM Assurance Yojana
VAT	Value Added Tax
ZPs	Zila Panchayats

1 Introduction

In recent years, fiscal federalism has been on the forefront of policy debate in many developing countries. Particularly in the wake of the broader paradigm shift towards decentralization, whereby, the resource requirements of sub-national governments have grown along with increased responsibility of public service delivery. Federal systems differ enormously in the ways they allocate money, power, and authority across levels of government (Maite and Weingast, 2003)[1]. The design of fiscal institutions – that deal with allocation of taxes, spending and regulatory functions, along with revenue sharing arrangements among various tiers of government – has important implications for efficient and equitable provision of public services (Shah, 2005)[2].

Intergovernmental fiscal transfers, being an integral part of the federal system of governance, serve as an important tool for addressing both vertical and horizontal fiscal imbalances.[3] In the case of India and Pakistan, mechanisms for intergovernmental fiscal transfers have evolved from a common system, developed before independence in 1947. Since then, the modalities of these transfers – established through fiscal institutions – have undergone many changes in both the countries, in line with various constitutional developments. Even so, the purpose of the system of fiscal transfers in both countries is primarily to correct fiscal imbalances.

In both countries, finance commissions make recommendations on financial transfers from the Centre to the States (or Provinces), to correct fiscal and cost disabilities. However, differences in the institutional set up – including composition and mandate of the Commission – and processes have implications for fiscal autonomy at the sub-national level, fiscal and macroeconomic stability, and provision of public services. Since the responsibility of social service delivery in India and Pakistan lies primarily with the sub-national governments, strategies adopted for fiscal transfers may have implications for human development outcomes as well.

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[1] Maite, Careaga, and Barry R. Weingast. 2003. 'Fiscal federalism, good governance, and economic growth in Mexico', *In search of prosperity: analytical narratives on economic growth*: 399-435.

[2] Shah, Anwar. 2005. 'A framework for evaluating alternate institutional arrangements for fiscal equalization transfers'.

[3] Vertical fiscal imbalance arises due to asymmetric assignment of functions and finances between national and sub-national governments, while horizontal imbalances arises due to the differences in the fiscal capacity and fiscal needs across constituent units of the federation (the sub-national governments).

The overall objective of this study is to analyze systems of inter-governmental fiscal transfers in India and Pakistan and offer policy recommendations for government stakeholders, for a more equitable and efficient fiscal transfer system in each country. Specific objectives of the project are to: a) examine the individual and aggregate country level fiscal behaviour of federating units (provinces/states) in response to changes in design of intergovernmental fiscal transfers and the grants formula; b) analyze whether changes in design of intergovernmental fiscal transfers have a positive or negative impact on public investments by provincial/state governments for promoting social development; and c) explore the links between fiscal transfers to states/provinces and gender equality.

This research has been conducted by the Social Policy and Development Centre (SPDC) and the National Institute of Public Finance and Policy – in Pakistan and India respectively. This is a synthesis report prepared by the SPDC, based on major findings from both studies - detailed analyses on each of the countries is presented in the respective country reports.

THE COMMON LEGACY

The Cabinet Mission (1946) recommended that undivided India should be governed by a federal Constitution with the national government dealing with foreign affairs, defence and communications, whereas, the remaining functions were to be under the domain of sub-national government levels. The Mission also emphasized that to "hold together" a nation with cultural and linguistic diversity as India, a strong central government was necessary.

In India, forming an independent nation was relatively easier for the territories ruled directly by the British, to be integrated into the Union, as opposed to the integration of the "Princely States" (the treaties of accession signed by the individual rules).

The de-jure asymmetry in Indian federalism has been traced to the Constitution that was adopted in 1951, which classified the States into four categories; (i) provinces directly ruled by the British (Part A states), (ii) the princely States which had a relationship with the Government of India based on individual treaties (Part B States) which included the States of Hyderabad, Mysore, Jammu and Kashmir (iii) the remaining princely states acceding to the union were grouped (Part C States) and (iv) the territories ruled by other foreign powers gaining independence (French and Portuguese) and areas not covered in the above three categories were brought under the direct control of the union (Part D states or Union Territories).

The terms of accession differed depending on the bargaining strength of these States. It is also to be noted that the "Princely States" surrendered their "national sovereignty" in exchange of a "privy purse" (a guaranteed revenue stream). This asymmetric bargain of the

princely States to join Indian federation was for security and finance, in exchange for freedom and residual control rights.

Contrary to the process of administrative re-organization of India based on the principle of language, the North-Eastern part of India (Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura) is an exception due to its distinct differences in "ethnicity" from rest of India.

In Pakistan, according to 1935 Act, the Neimeyer Award was the basis for resource sharing between the federal government and the 'federating' units. After independence, Pakistan used the same principle for resource sharing, with some adjustments to the railway budget and for sharing income and sales tax till 1952 (Raisman award). All Provinces of West Pakistan (like in East Pakistan) were declared as one unit in 1955, thereby, two awards were declared in 1961 and 1964, and resources were distributed only among these two units. After the separation of East Pakistan in 1971, the new Constitution was adopted in 1973. Pakistan consists of four provinces, a federal capital territory, and special areas including FATA (Federally Administered Tribal Areas), Gilgit-Baltistan[4], and Azad Jammu and Kashmir.

From a historical perspective, federalism in Pakistan has experienced three distinct phases: the pre-1947 colonial legacy, pre-federalism (1947-1971) and the federalism since 1973. The phase 1947-1971 was dominated by centralization of the country and the elimination of federal structure within West Pakistan. However, since 1973, federalism re-strengthened as the National Finance Commission (NFC) Award became mandatory (at an interval extending not more than 5 years) through Article 160 of the Constitution of Islamic Republic of Pakistan, 1973.

THE MACROECONOMIC CONTEXT

Post economic reforms of 1991, the macroeconomic reforms in India have focused on fiscal consolidation at national and sub-national levels, through rule based fiscal controls. Fiscal autonomy to sub-national governments and fiscal cooperation between Union and States has also evolved during this period. Major changes in policy during this period that have had implications for Union-State fiscal relations are the following: (i) introduction of Fiscal Responsibility Legislation at the Union and State level during early 2000, (ii) introduction of nationwide Value Added Tax (VAT) in 2005, (iii) introduction of Goods and Services Tax (GST) in July 2017, (iv) award of the Fourteenth Finance Commission (FFC) which recommended sharing of 42 percent of the divisible pool of union taxes to the States, and

[4] Earlier, the region was called Federal Administrated Northern Area (FANA). In 2009, as part of legislative, executive and judicial reforms, self-governance to a certain extent was granted to the area of Gilgit-Baltistan through a Presidential Order.

(v) subsequent restructuring of non-finance commission transfers and abolition of the Planning Commission.

The FFC award is considered a "game changer" in reducing the discretionary elements in the intergovernmental fiscal transfers (IGFT) in India. The introduction of GST is an example of fiscal cooperation between the Union and the States and among the States. In India, the fiscal federal transfers system is also influenced by the federal debt-deficit dynamics. Based on the recommendations of the 12th Finance Commission, the Fiscal Responsibility Legislation was introduced at the sub-national level through performance linked transfers. The proportion of discretionary elements in IGFT system has also reduced in recent years.

In Pakistan, from a historical perspective, macroeconomic stability has been closely associated with containing high levels of debt and deficits, and the inflexibility of federal expenditure, in terms of debt servicing and sizable federal statutory transfers to the sub-national governments. In the case of Pakistan, the 18th Constitutional Amendment in April 2010 is a major charter of political rights as far as decentralisation and devolution of power to the provinces is concerned. It contains significant moves towards fiscal decentralization and stabilizing decentralized system of government. Though it did not make significant changes in tax assignment, but it clearly outlined federal and provincial expenditure responsibilities, with almost all social services transferred to the provinces. Almost concurrently, the 7th National Finance Commission (NFC) Award was concluded in December 2009, which made considerable changes in the design of intergovernmental fiscal transfers in favour of the provinces. Under this award, the share of provinces in federal taxes increased from 45 percent to 57.5 percent. Moreover, it successfully introduced multiple criteria for the horizontal distribution to distribute divisible pool transfers among provinces[5].

It is also to be noted that India and Pakistan are the only two federal systems where federal taxes are shared with sub-national governments as untied funds determined by a Finance Commission. In other federal systems, transfers are largely grants, both tied and untied. This has probably been inherited from the prevailing system during the pre-independence period. This system of sharing of federal taxes by an independent Finance Commission is also a major strength of the federal fiscal arrangement, in both the countries.

[5] Historically, population has only been kept as the criteria for horizontal distribution of NFC awards. In the 7th NFC award, however, multiple criteria for determining the NFC award- including population, poverty, socio-economic backwardness and inverse criterion of population density – were introduced.

STRUCTURE OF THE REPORT

This report is divided into eight chapters. Chapter 2 describes the institutional structures of fiscal federalism, while Chapter 3 details the composition of and trends in the inter-governmental fiscal transfers. Chapter 4 deals with the role of transfers in addressing horizontal fiscal inequalities. Debts and deficits, for both national and sub-national governments, are analysed in Chapter 5. The role of transfers in achieving development outcomes, with a particular focus on gender inequalities, is deliberated in Chapter 6, whereas, the transfers to local governments are discussed in Chapter 7. Conclusion and policy recommendations are furnished in Chapter 8.

2 Institutional Structure of Fiscal Federalism

The objective of the system of the intergovernmental fiscal transfers (IGFT) in India and Pakistan is to correct both vertical imbalances and horizontal disparities. A vertical imbalance arises due to asymmetric assignment of functional responsibilities and financial powers between different levels of government. While horizontal inequalities are the existing disparities in revenue capacity across constituent units of the federation, these mainly arise due to the differences in levels of fiscal capacity, as well as fiscal needs of each unit. These imbalances are different across federations and so is the design of transfers.

A large part of IGFTs are routed through the Finance Commission Awards in India and Pakistan, which are of great importance for both tiers of governments. In Pakistan, the finance commission is referred to as National Finance Commission (NFC), while in India it is the Finance Commission (FC). The mandate of finance commissions is to decide the level of vertical sharing of taxes and the method for the allocation, through a formula-based horizontal tax-sharing mechanism. In both the countries, finance commissions also provide grants to the provinces/states.

REVENUE ASSIGNMENT AS PER CONSTITUTION – INDIA

India, as per the Constitution, is a Union of States and not a federation. States do not have the right to secede from the Union. The Constitution gives power to the Union government to bi-furcate states, redefine state boundaries, and dismiss the elected States' government by imposing Presidential rule. Despite these centralizing features, important federal dimensions have been incorporated in the Indian Constitution.

The Seventh Schedule of the Constitution provides the assignment of revenue and expenditure between the Union and States. Part XI of the Constitution deals with the distribution of legislative, administrative and executive powers between the Union and States. Revenue assignment, as per the 7th Schedule of Constitution of India, is presented in Table 1.

Legislative powers are categorized under three lists namely: (a) Union List, (b) State List and (c) a Concurrent List, each representing the powers conferred upon the Union government, State Governments, and shared powers respectively. However, residuary powers remain with the Union, that is, legislative power rests with the Union government for subjects that are not mentioned in any of the three lists (or the residuary subjects).

Table 1: Revenue Assignment: Union and State Government – India

Union List	State List
1. Taxes on income other than agricultural income.	1. Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights, and alienation of revenues.
2. Duties of customs including export duties.	2. Taxes on agricultural income.
3. Duties of excise on the following goods manufactured or produced in India, namely: (a) petroleum crude; (b) high speed diesel; (c) motor spirit (i.e., petrol); (d) natural gas; (e) aviation turbine fuel; and (f) tobacco & tobacco products	3. Duties in respect of succession to agricultural land.
4. Corporation tax.	4. Estate duty in respect of agricultural land.
5. Taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; taxes on the capital of companies.	5. Taxes on lands and buildings.
6. Estate duty in respect of property other than agricultural land.	6. Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development.
7. Duties in respect of succession to property other than agricultural land.	7. Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India - (a) alcoholic liquors for human consumption (b) opium, Indian hemp and other narcotic drugs and narcotics but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
8. Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights.	8. Taxes on the consumption or sale of electricity.
9. Taxes other than stamp duties on transactions in stock exchanges and futures markets.	9. Taxes on the sale of petroleum crude, high speed diesel, motor spirit (commonly known as petrol), natural gas, aviation turbine fuel and alcoholic liquor for human consumption, but not including sale in the course of inter-State trade or commerce or sale in the course of international trade or commerce of such goods
10. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.	10. Taxes on goods and passengers carried by road or on inland waterways.
11. 11A. Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce. 11B. Taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.	11. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tram-cars subject to the provisions of Entry 35 of List III [Concurrent list].
	12. Taxes on animals and boats.
	13. Tolls.
	14. Taxes on professions, trades, callings and employments.
	15. Capitation taxes.
	16. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.
	17. Taxes on entertainments and amusements to the extent levied and collected by a Panchayat or a Municipality or a Regional Council or a District Council.
	18. Fees in respect of any of the matters in this list, but not including fees taken in any court.

The Goods and Services Tax (GST) was introduced on July 1, 2017, which is a dual GST, introduced in an overlapping tax base. The GST required a constitutional amendment (122nd Constitutional Amendment) to enable the Union government to tax consumption of goods and allow states to tax consumption of services. Post the constitutional amendment, both the central and the state tax bases have merged, and from this common base both the levels of government will collect taxes. The Constitutional amendment enabled the

creation of the GST council, the chairperson of which is the Union Finance Minister, and States have their ministerial nominees as members of the council. Since the creation of the Council in November 2016, it has designed the tax, rate structure and mechanisms for compensation to the states under GST, which is a commendable achievement. This also shows that the Indian federal system has transformed itself as a federation where both the Centre and States have learnt to trust each other and given up their exclusive taxation rights, with respect to a particular tax base for a better tax system. The creation of such a common tax base should result in the abolition of a fragmented tax regime, development of a common market, elimination of cascading of taxes, and should help increase the growth of GDP by promoting trade, business and investment.

The following Central and State taxes are to be subsumed under GST:

Central taxes	State taxes
• central excise duties • additional duties of excise • additional duties of customs • special additional duties of customs • service tax and central cess • surcharges so far as they relate to supply of goods and services	• state VAT • central sales tax • luxury tax • entry tax • entertainment tax • taxes on advertisement • purchase tax • taxes on lotteries • betting and gambling • state surcharges and cesses relating to supply of goods and services

This list shows that petroleum products, alcohol for human consumption, real estate sector and electricity duty are kept out of the purview of the GST. In other words, though most indirect taxes have come under GST, a large part of them also remain outside its purview. Incomplete coverage of goods and services indeed is an issue that the country needs to resolve as it moves further on the path of reform of indirect taxes, to get the full benefit of GST with comprehensive coverage. However, the agreed structure is a vast improvement from the present design.

REVENUE ASSIGNMENT AS PER CONSTITUTION – PAKISTAN

Pakistan's tax system has undergone significant reforms over the last three decades, leading to the modernization of direct and indirect taxes. Some major reforms in direct taxes include the introduction of withholding taxes, rationalization of income and corporate tax rates, and introduction of self-assessment for filing income taxes. The developments in indirect taxation include rationalization of the customs tariff structure with a reduction of tariff bands and maximum rates, introduction of a tax on services, and efforts to introduce a value-added tax (VAT). However, federal and provincial tax

assignments have remained unchanged since 1973. Even the 18th Constitutional Amendment (2010) did not modify federal and provincial tax assignments and was limited to explicitly endorsing sales tax on services such as provincial tax - which was already a provincial tax since its inception in 2000, but was collected by the federal government on behalf of the provinces.

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

Federal taxes under the Fourth Schedule, Article 70(4), of the Constitution of Pakistan are given in Table 2. The federal government has a constitutional right to collect taxes on corporations, income other than agriculture income, and capital value of assets, excluding taxes on immovable property. Among indirect taxes, the federal government has a constitutional right to collect taxes on the sales and purchases of goods (imported, exported, produced, manufactured or consumed), but not on the sales of services. The other major federal indirect tax, includes taxes on international trade i.e. export and import duties and excise duties.

Table 2: Federal Revenue Assignment as per Constitutional Provision	
DIRECT TAXES	
• Taxes on income other than agricultural income	subject 47
• Taxes on corporations	subject 48
• Taxes on the capital value of the assets, not including taxes on immovable property	subject 50
INDIRECT TAXES	
• Duties of customs, including export duties	subject 43
• Duties of excise, including duties on salt, but not including duties on alcoholic liquors, opium and other narcotics	subject 44
• Taxes on the sales and purchases of goods imported, exported, produced, manufactured or consumed, except sales tax on services	subject 49
• Taxes on mineral oil, natural gas and minerals for use in generation of nuclear energy	subject 51
• Taxes and duties on the production capacity of any plant, machinery, undertaking, establishment or installation in lieu of the taxes and duties specified in entries 44, 47, 48 and 49 or in lieu of any one or more of them	subject 52
• Terminal taxes on goods, or passengers carried by railway, sea or air; taxes on their fares and freights	subject 53

The revenue assignment of provincial governments includes direct taxes on property, agriculture income, and professions. Among the indirect taxes, major provincial taxes

include sales tax on services, excise duty on alcohol/liquor/narcotics, motor vehicle tax and stamp duty.

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

Table 3: Provincial Revenue Assignment as per Constitutional Provision

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

THE CONSTITUTIONAL PROVISIONS FOR FC – INDIA

Under the Constitution, the Finance Commission is appointed by the President of India every five years, mainly to decide on the distribution of resources, viz., tax sharing and grants from the Union to the States. According to Article 280 of the Constitution:

(1) The President shall, within two years from the commencement of this Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission which shall consist of a Chairman and four other members to be appointed by the President.

(2) Parliament may by law determine the qualifications which shall be requisite for appointment as members of the Commission and the manner in which they shall be selected.

(3) It shall be the duty of the Commission to make recommendations to the President as to

(a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under this Chapter and the allocation between the States of the respective shares of such proceeds;

(b) the principles which should govern the grants in aid of the revenues of the States out of the Consolidated Fund of India;

(c) any other matter referred to the Commission by the President in the interests of sound finance

(4) The Commission shall determine their procedure and shall have such powers in the performance of their functions as Parliament may by law confer on them.

THE CONSTITUTIONAL PROVISIONS FOR NFC – PAKISTAN

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

(3A) The share of the Provinces in each Award of National Finance Commission shall not be less than the share given to the Provinces in the previous Award.

(3B) The Federal Finance Minister and Provincial Finance Ministers shall monitor the implementation of the Award biannually and lay their reports before both Houses of Majlis-e-Shoora (Parliament) and the Provincial Assemblies.

EVOLUTION OF IGFT – INDIA

India has a three-tier federal structure, with 29 State Governments and 7 centrally administered Union Territories and more than a quarter million local self-governments in States, in both rural and urban areas. The richest province is Goa, with a per-capita income of INR 270,150 and poorest per-capita income province is Bihar, with per capita income of INR 34,168, as per the Central Statistical Office data for the year 2015-16. In India, the

institutional mechanism of federal transfers from the Union to States revolves around three institutions, viz., Finance Commission, erstwhile Planning Commission and various ministries of the Union Government.[6]

Since independence, India has had 14 Finance Commissions and their recommendations have governed the sharing of taxes and Finance Commission's grants to the States. Recently the President of India has appointed the Fifteenth Finance Commission. Finance Commissions' awards continue to be the primary mode of resource transfer to the States.

The Finance Commission's recommendations, once accepted by the Parliament become mandatory, so that the transfer of funds affected in pursuance of these recommendations could be said to have a statutory sanction behind them.

However, given that the system of transfers has evolved over the years, a substantial part of the transfer of resources have at the same time fallen outside the ambit of the Finance Commission and it is the erstwhile Planning Commission through which a large share of resources are transferred to the States in the form of various grants. The Planning Commission transfers are in the form of plan grants, which have emerged as the single largest components of grants transferred to the states from the Union. In addition to these, there are non-statutory discretionary transfers made to the States by various ministries of the Union government in the form of centrally sponsored schemes (hereafter CSS). By nature, CSS grants are conditional, specific purpose grants. In recent years, among various grants, big ticket centrally sponsored schemes have become the principal drivers of conditional transfers to the States. As far as royalties from minerals are concerned in India, according to the Mines and Minerals (Regulation and Development) Act, the rates of royalty in case of major minerals are set by the Central Government once in three years through constituting a Royalty Study Group, while the State government sets the rates in case of minor minerals as per section 15 (3) of the MM (DR) Act 1957. The royalty rates and regimes differ from mineral to mineral. For instance, the royalty regime of non-ferrous minerals is ad valorem, where the rates are linked to London Metal Exchange (LME) rates.[7]

Also, Finance Commission transfers have increasingly become skewed towards States, by assigning higher shares in central taxes, which by nature is an entitlement to all the States. Since the primary mode of resource transfer is tax sharing by the Finance Commission, it

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[6]The Planning Commission was abolished in 2014. In place of Planning Commission, National Institute for Transforming India (NITI) Aayog has been constituted to foster cooperative federalism in the country. The role and mandate of NITI Aayog is discussed later. Unlike Planning Commission, NITI Aayog does not make any transfers to the States.

[7]The recent regime and rates per each mineral in India is given by the India Bureau of Mining (IBM). http://www.ibm.nic.in/index.php?c=pages&m=index&id=236)

has left little scope for fiscal equalization grants to play their role in equalizing fiscal capacities across States.

The Twelfth Finance Commission emphasized the need for a greater role of equalization grants in the scheme of transfers to correct for cost disabilities and redistributive consideration, as those were not adequately addressed through tax sharing. The Thirteenth Finance Commission also provided a large number of conditional specific purpose grants directed mainly towards improving fiscal imbalances and efficiency of government spending, with some implicit equalizing content.

A prominent feature of Indian IGFT has been the increasing tendency of the Union to intervene in Concurrent and State List subjects via Central schemes and programmes. If one examines Union Finance Accounts data from 2002-03 to 2016-17, the revenue expenditure on State List subjects increased from an average of 13.4 percent in 2000-03 to 21.2 percent in 2008-11 and was around 17.6 percent during the period 2010-15. On the other hand, revenue expenditure on Concurrent List subjects increased from an average of 10.8 percent in 2000-03 to 15.6 percent in 2008-11 and was around 15 percent during 2010-15. As a percentage of total Union expenditure, revenue expenditure on State List subjects increased on an average from 12.4 percent to 19.4 percent between 2000-03 and 2008-11 and was around 15.9 percent during 2010-15, and revenue expenditure on Concurrent List subjects increased from 10 percent to 13.2 percent 2000-03 and 2008-11 and further to 13.5 percent in 2010-15.

Thus, an increased intervention by the Union government in State Subjects is observable. This centralizing tendency has, however, been partially corrected through the recommendations of the Fourteenth Finance Commission (FFC). As per recommendations of the FFC, 42 percent of the divisible pool of Union taxes has been transferred to the States. This increase in unconditional transfers has resulted in a significant increase in untied fiscal space at the State level. The existing Federal fiscal relation in India is presented in the form of a flow chart (Chart 1).

The vertical sharing of taxes by the Union Government recommended by various finance commissions to address the vertical fiscal imbalance between the Union and States is presented in Table 4.

Chart 1: Flow Chart of Fiscal

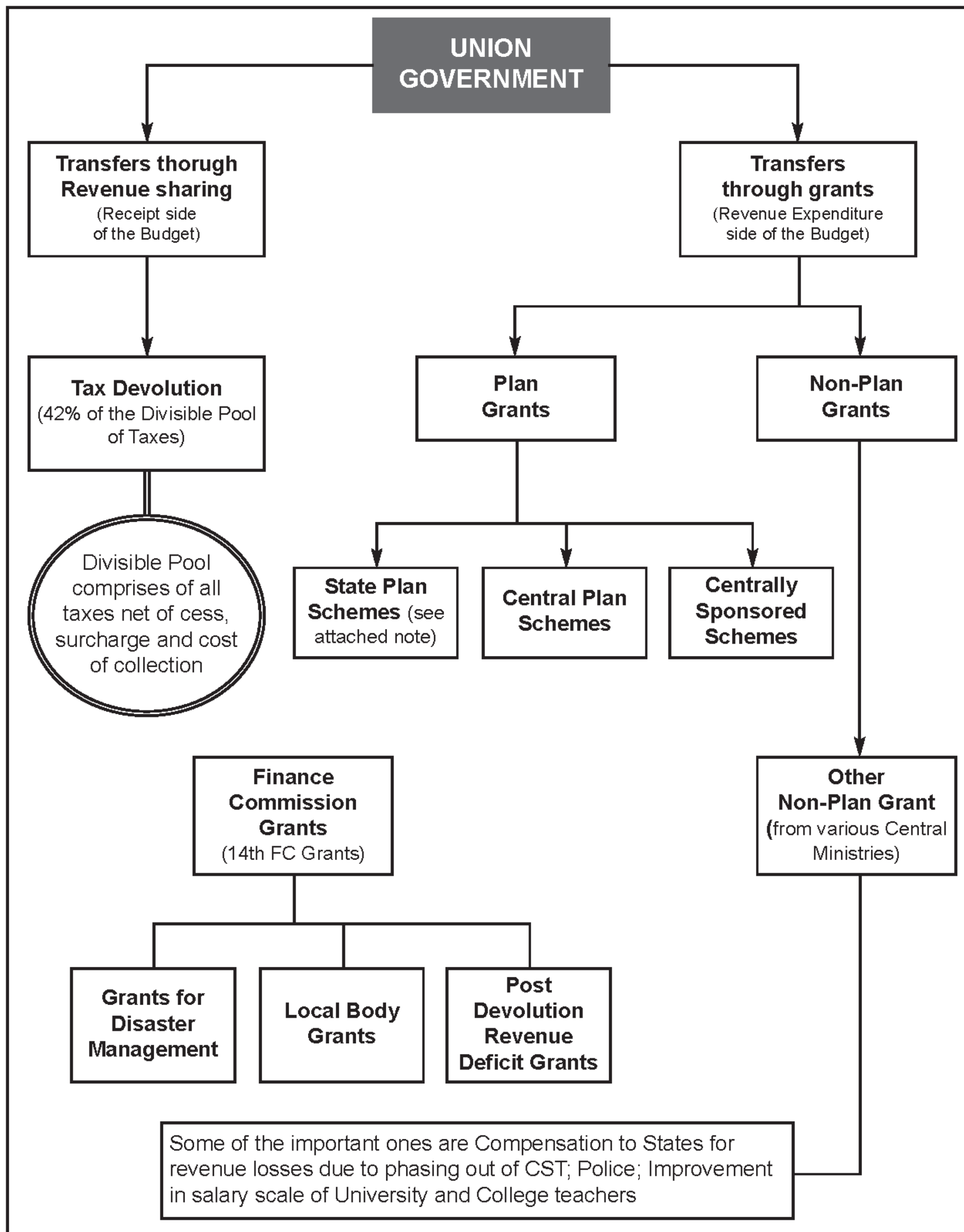

Table 4: Vertical Tax Sharing Recommended by Finance Commissions in India			
Finance Commissions	**Divisible Pool (%)**		
	Gross Tax Revenue (net of Cost of collection, cess and surcharges)	**Income Tax (net proceeds)**	**Union Excise Duties (net proceeds)**
First (1952-57)		55.0	40.0
Second (1957-62)		60.0	25.0
Third (1962-66)		66.7	20.0
Fourth (1966-69)		75.0	20.0
Fifth (1969-74)		75.0	20.0
Sixth (1974-79)		80.0	20.0
Seventh (1979-84)		85.0	40.0
Eighth (1984-89)		85.0	45.0
Ninth-1st report (1989-90)		85.0	45.0
Ninth-2nd report (1990-95)		85.0	45.0
Tenth (1995-2000)		77.5	47.5
Eleventh (2000-05)	29.5		
Twelfth (2005-10)	30.5		
Thirteenth (2010-15)	32.0		
Fourteenth (2015-20)	42.0		

Source: Reports of the respective Finance Commissions

To address the horizontal imbalance between the States, the FCs have used different criteria and weights for determining the inter se share of individual states in Union tax revenues. The first seven FCs used different distribution formulas for determining the devolution of income tax shares and union excise duties. This was the case because Article 270 of the constitution had provided for mandatory sharing of income tax, while Article 272 had provided for sharing of the union excise duties at the discretion of the central government. Population and collection and assessment of taxes were the only two criteria used by the first seven FCs for determining the inter se shares of the states in the case of income tax (Table 5). However, the criteria used for the devolution of union excise duties have evolved over time. Population continued to be the largest determining factor up to the Sixth FC, but its share declined from 100 to 75 percent. The Seventh FC drastically reduced the weight given to population to 25 percent (Table 6). Also, the changing nature of the criteria used indicates the greater emphasis on factors related to economic backwardness and fiscal weakness of the states. From the Eighth FC onwards there was a move towards unifying the formula for the inter se distribution of both income tax and union excise duties. The weight accorded to population was reduced considerably as evident from the tables below.

Table 5: Inter se Sharing of Income Tax – India					
Finance Commission	Weights (in percent)		Income Distance	Inverse per Capita Income	Backwardness
	Population	Collection/ Assessment			
First, Third, and Fourth	80.0	20.0			
Second, Fifth, Sixth, and Seventh	90.0	10.0			
Eighth	22.5	10.0	45.0	22.5	
Ninth	22.5	10.0	45.0	11.25	11.25

Source: Finance Commission Reports

Table 6: Inter se Sharing of Union Excise Duties – India							
Finance Commission	Relative Weights (Percent)						
	Population	Unspecified	Backwardness	Income Distance	Inverse per Capita Income	Poverty	Revenue Equalization
First	100						
Second	90	10					
Third		100					
Fourth	80		20				
Fifth	80		6.66	13.44			
Sixth	75			25			
Seventh	25				25	25	25
Eighth	25			50	25		

Source: Finance Commission Reports

Table 7: Inter-se Sharing of Taxes – India					
Criteria and Weights (%)	Finance Commissions				
	Tenth (Income Tax and Union Excise)	Eleventh	Twelfth	Thirteenth	Fourteenth
Population	20.0	10.0	25.0	25.0	17.5
Income Distance	60.0	62.5	50.0		50.0
Area Adjusted	5.0	7.5	10.0	10.0	10.0
Infrastructure Distance	5.0	7.5			
Fiscal Self Reliance/ Distance		7.5	7.5	17.5	
Tax Effort	10.0	5.0	7.5		
Fiscal Capacity Distance				47.5	
Demographic Change					10.0
Forest Cover					7.5

Source: Finance Commission Reports

The Tenth FC also recommended an "alternative scheme of devolution," whereby, after a constitutional amendment proceeds of all federal taxes were to be shared with the state governments. The alternative scheme was accepted by the central government and implemented through the 80th constitutional amendment.[8] The criteria and weights

[8]Based on the recommendations of the Tenth Finance Commission, an alternative scheme for sharing taxes between the Union and the States has been enacted by the Constitution (Eightieth Amendment) Act 2000. Under the new scheme of devolution of revenue between Union and the States, 26 per cent out of gross

adopted by the Finance Commissions to determine the inter-se shares between states are presented in table 7.

EVOLUTION OF IGFT: PAKISTAN

Pakistan is a parliamentary federation with three tiers of government: federal, provincial and local. The federal government collects a significant portion of revenues and re-distributes them using the vertical revenue sharing formula (among federal and provincial governments) and horizontal revenue sharing formula (among the four provinces) through the National Finance Commission.[9]

The NFC Award in Pakistan requires consensus of all members. In case consensus is not achieved, a Distribution of Revenues Order is issued by the President for continuation of the previous award.[10] The effect of consensus requirement is that there have been only four conclusive NFC Awards since 1974 as shown in Table 8. After the NFC Award 1974, two attempts have been made for the revision in the design of intergovernmental transfers but these have been unsuccessful. The much-awaited NFC Award through consensus was then materialized in 1991. This was followed by the NFC Award 1997 constituted for a period of five years (1997 to 2002), but remained in practice till 2006, when a distribution order from the president of Pakistan replaced the NFC Award 1997.

Table 8: Chronology of NFC Awards

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

On the distribution method, all the commissions up to the 4th NFC (1991) followed a 'gap-filling' approach by assessing the revenue receipts and expenditures based on the actual numbers, and recommending non-plan deficit grants to fill the financing gaps. This approach encouraged the provincial governments to: understate the predicted growth of their own tax revenues, increase their commitments on non-plan expenditure and run deficit budgets in the expectation that their financing gaps would be filled by grants from

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proceeds of Union taxes and duties is to be assigned to the States in lieu of their existing share in the income-tax, excise duties, special excise duties and grants in lieu of tax on railway passenger fares.

[9] Provinces also share their revenues with local governments through provincial finance commissions (PFCs).

[10] Sometimes, the distribution Order is issued with slight amendments in the previous award.

the Finance Commission. Apart from encouraging inefficiency, this approach also resulted in qualifying relatively better off provinces for such grants while disqualifying some of the poor provinces.

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

A major development in this regard was the 7th NFC Award of 2009 that significantly affected the resource distribution formula. Given the experience of several inconclusive NFC Awards, a consensus-based NFC Award after 12 years was in itself a big achievement. It was the first time that the distribution of resources among provinces was based not only on population, but also on other factors such as backwardness, inverse population density and revenue collection/generation. The 7thNFC Award has also helped in resolving other issues such as Gas Development Surcharge (GDS) and Hydroelectricity Profit. The 7th NFC Award completed its tenure in June 2015; therefore, it was a constitutional obligation to initiate deliberation on the 8thNFC Award. However, instead of constituting the 8th NFC[11] federal government constituted the 9th NFC and the President issued Distribution of Revenues and Grants-in-Aid (Amendment) Order in June 2015. In fact, the order did not amend anything except endorsing the continuation of protected revenue for the province of Balochistan. Deliberations on the 9th NFC are in progress, but at a slow pace.

Vertical Distribution of the Divisible Pool

Table 9 presents the formula for vertical distribution or the provincial share in the divisible pool of NFC awards. It indicates that until the NFC Award 1991, provincial governments received 80 percent of two major federal taxes "Sales Tax" and "Income and Corporation Tax", which were the most buoyant sources of revenues and were the focus of tax and tariff reforms initiated in the early 1990s. Also, the NFC Award 1991 increased transfers to the provinces by including federal excise duty on tobacco and sugar in the list of shared taxes.

In contrast, the NFC Award 1997 included all federal taxes in the divisible pool and decreased the provincial share from 80 percent to 37.5 percent. This change was based on optimistic revenue targets of certain macroeconomic projections, such as 17 percent

[11] 8th NFC was constituted without ToRs to fulfill constitutional requirement, but no deliberations were held.

growth in nominal GDP, 11 percent domestic and external inflation rate and higher expectations of revenue collection as a result of successful implementation of tax and tariff reforms. However, these expectations did not materialize due to many external and internal shocks that largely affected the federal tax collection.

The vertical distribution in DRGO 2006 was based on a similar divisible pool. However, for the first time, it introduced a variable share of provincial governments that annually increased by 1.25 percentage points ranging from 41.50 percent in 2006-07 to 46.25 percent in 2010-11. However, the award ended in 2010 with a provincial share of 45 percent.

Table 9: Provincial Share in Divisible Pool Taxes

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

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

**Excluding Central Excise Duty on Natural Gas

The vertical distribution in the 7th NFC award differed with other NFC Awards in three ways. First, the collection charges of the federal government were decreased from 5 percent to 1 percent, thereby, enlarging the overall size of the divisible pool. Second, the federal government and all the four provincial governments recognized the role of KPK as a frontline province against the war on terror by agreeing to allocate one percent of net proceeds of the divisible pool to KPK during the entire award period. 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. Third, this award ensured that Balochistan will get at least Rs83 billion under divisible pool transfers. In case the estimated share of Balochistan is less than Rs83 billion, the balance funds would be contributed by the federal government.

Horizontal Distribution of the Divisible Pool

Table 10 shows the formula for the horizontal distribution of the divisible pool in the NFC Awards. It points out that the entire distribution of the divisible pool among provinces in the first three conclusive NFC Awards and in DRGO was based only on population.

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

Table 10: Horizontal Distribution of Divisible Pool Taxes

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

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

NFC Awards and Straight Transfers

Straight transfers are not directly part of the NFC but are part of the separate Article 161 of the constitution, which outlines hydroelectricity profits, royalty on natural gas and crude oil, and excise duty on natural gas as straight transfers. Straight transfers were added in the NFC Award 1991 and since then have been a part of NFC negotiations and awards. The NFC Award 1991 added the Gas Development Surcharge (GDS) as a part of the straight transfers to be distributed on the basis of the province-wise share in gas production. After the introduction of sales tax on services in 2000, a part of this tax was added to the list of straight transfers by calling it a provincial sales tax. The remaining sales taxes on services were collected by the federal government under the Central Excise (CE) mode and treated like sales tax on goods.

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

Grants in Aid in NFC Awards

Grants and aid have been a permanent feature of almost all NFC Awards. Table 11 provides a snapshot of Grants in Aid under different NFC awards. NFC 1975 awarded grants-in-aid only to Khyber Pakhtunkhwa[12] and Balochistan, while NFC award 1991 did to all four

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

provinces. In both awards, the amounts were fixed and had a sunset clause. The NFC 1997 and the subsequent awards used a variable amount, either by assigning a percentage or linking with it divisible pool.

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

DRGO 2006 separately awarded grants-in-aid to all provinces based on an unknown criterion. The base year amount was set at Rs27,750 million and future growth was linked to the net divisible pool. The 7th NFC award abolished all grants, except that it allowed Gas Development Surcharge (GDS) arrears to be paid retrospectively to Balochistan on the basis of the new formula and for the payment of the held-up hydel profits to KPK. In order to address losses to Sindh due to the abolition of the separate divisible pool for OZT grants[13], 0.66 percent of the provincial divisible pool was awarded to Sindh.

Table 11: Horizontal Distribution of Divisible Pool Taxes

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

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

In summary, India and Pakistan inherited a common fiscal legacy. After independence, revenue assignment in both countries has evolved over time. While both countries have some similarities in revenue assignment, the major difference arises due to treatment of sales tax. In India, the sales tax on goods was a state tax, whilst the sales tax on services was a Union tax. This practice recently changed after the introduction of GST, which is a

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

combined goods and services tax designed on the VAT framework. In contrast, in Pakistan sales tax on goods is a federal tax, whilst sales tax on services is a provincial tax.

IGFTs are an integral part of both countries and constituted through finance commissions. A comparison of both the FC and NFC indicates a fundamental difference in their structure. In India, the FC is a technical body, headed by a senior or retired bureaucrat – it functions as an independent agency. While in Pakistan, the NFC is an intergovernmental forum comprised of representatives from federal and provincial governments, along with a non-statutory/technical member from each province. Consequently, the NFC award in Pakistan is a consensus based award.

Historically, the divisible pool in India consisted of income tax and union exercise duty till the Tenth FC. Different FC awards allocated different shares of income taxes and excise duties, ranging from 55 percent to 85 percent and 20 percent to 47.5 percent, respectively. The Eleventh FC, in 2000, adopted a different approach and broadened the divisible pool by adding gross tax revenue and excluding collection charges. In Pakistan, under the 1973 constitution, the divisible pool consisted of income tax, sales tax on goods and export duties on cotton till 4th NFC Award, which also added excise duty on tobacco and sugar. Eighty percent of these taxes were allocated to the provinces. However, the 5th NFC award in 1996 included all federal taxes in the divisible pool. Since then the divisible pool consists of all federal taxes collected by Federal Board of Revenue, excluding collection charges. Different NFC awards assigned different shares of divisible pools to the provinces – ranging from 37.5 percent to 57.5 percent.

A glaring difference in Indian FCs and Pakistan's NFCs is visible in the horizontal distribution of divisible pool. Horizontal distribution in Indian FCs is based on multiple criteria, while in Pakistan population had been the sole criteria used for horizontal distribution till 2009. The 7th NFC award added tax collection, backwardness, and inverse population density to the horizontal distribution.

3 Intergovernmental Fiscal Transfers: Structure and Trends

For any federation, the intergovernmental fiscal transfer mechanisms imply a design of transfer and sharing of resources between different tiers of governments in a particular federation. The objective of the system of intergovernmental fiscal transfers is to correct both vertical imbalances and horizontal inequalities in the distribution of federal resources. This chapter particularly focuses on vertical imbalances and analyzes the role of transfers in addressing the fiscal inequalities.

TAX-TO-GDP RATIO – A COMPARISON

The Tax-to-GDP ratio in both India and Pakistan remains on the lower side, compared to the respective sizes of both economies. India's tax-to-GDP ratio is currently approximated at 16 percent, which is well below that of other emerging economies. Similarly, the tax-to-GDP ratio in Pakistan is currently 12.5 percent, which does not compare well to other economies either. For instance, Pakistan's economy is the 42nd largest in terms of nominal GDP, but it ranks 157 out of 179 countries in terms of the tax-to-GDP, ratio, which is much lower compared to its economic ranking.

Chart 2: Tax-to-GDP Ratio

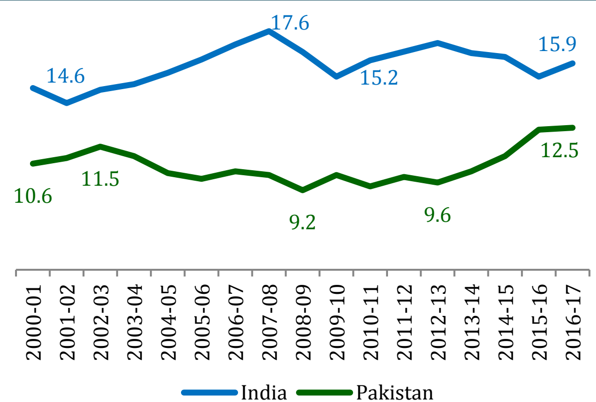


Chart 2 presents a comparative analysis of Pakistan and India's fiscal efforts since 2000-01. The Tax-to-GDP ratio in India has remained greater than that of Pakistan, although the difference between the two has kept fluctuating. In India, it has continuously increased since 2001-02 and peaked at 17.6 percent in 2007-08, however, after this period a declining trend has been observed. An almost reverse trend is apparent in the case of Pakistan; the tax-to-GDP ratio declined from 11.5 percent in 2002-03 to 9.2 percent in 2008-09, fluctuated between 2009-10 and 2012-13, and increased subsequently.

The major source of difference in the tax-to-GDP ratio between the two countries is the fiscal effort of sub-national governments,[14] largely due to difference in their taxation powers. In India, the level of tax revenue collected by the States is much higher than that collected by the provinces in Pakistan. For example, in India, the States' own tax revenue in

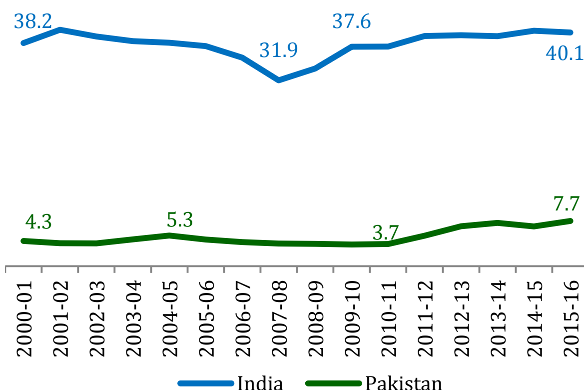
[14] Sub-national governments refer to State governments in India and Provincial governments in Pakistan.

2015-16 was 5.3 percent of GDP whereas major chunks came from sales tax on goods. In Pakistan, the provinces' own tax revenue was only 1 percent of the GDP.

TAX REVENUES OF SUB-NATIONAL GOVERNMENTS

The contribution of sub-national governments' own tax revenue in the total tax revenue is presented in Chart 3. In India, the share of the States' own tax revenues as a proportion of total tax revenues was 40 percent in 2015-16. On the other hand, provincial governments in Pakistan contributed only 7.7 percent of the tax revenue, suggesting that provincial governments have a very narrow base of taxes and are over-reliant on federal transfers. The buoyant sources of revenues such as sales tax on goods and income and corporate taxes are under the domain of the federal government. From the perspective of sustainable public service provision, the provincial governments require enough 'own' revenues, as opposed to being heavily reliant on federal transfers and grants.

Chart 3: Sub-national governments – Own tax revenue as % of total tax revenue



As far as the trend during the last 15 years is concerned, the States' shares in India have declined from 40.5 percent in 2001-02 to 31.9 percent in 2007-08, after which an increase has been observed. This declining trend in the States' share coincides with the period during which the Union government's tax revenue was on a rising path, during which the tax-to-GDP ratio of central taxes increased from 7.9 to 11.9.

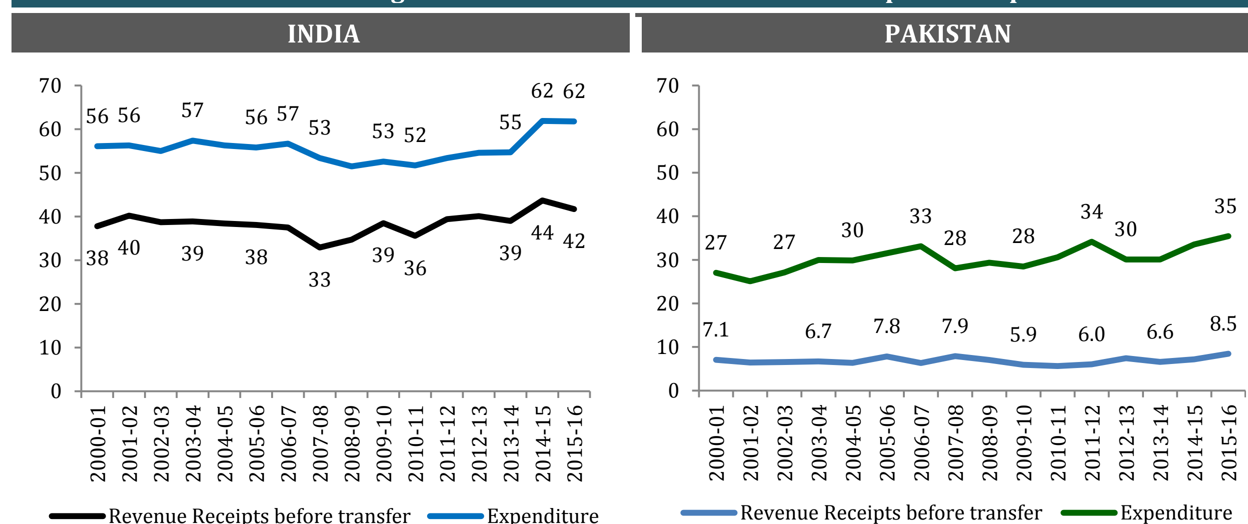
In the case of Pakistan, the share of provincial own tax revenue in the total tax revenue remained around 4 percent on an average during 2000-01 and 2010-11. Subsequently, a clear upward trend was observed after which the provincial share increased from 3.7 percent (2010-11) to 7.7 percent. The gradual increase in the provincial share of taxes is an outcome of the devolution of sales tax on services, which was introduced in the 7th NFC Award.

EXPENDITURES OF SUB-NATIONAL GOVERNMENTS

In both countries, the adequate provision of social services is largely a function of sub-national governments, which is also reflected by the level of expenditures of these governments. The share of sub-national government's expenditures as part of total expenditures (union/federal and states/provincial combined) is presented in Chart 4. In India, the share of States in the combined expenditure exceeds that of the Union, which hovered around 55 percent from 2000-01 to 2013-14 and increased to 62 percent in 2015-16.

In the case of Pakistan, the share of the provinces in the total expenditure, on an average, remained 29 percent during 2001-02 and 2009-10. An increasing trend, however, is observed after the 7th NFC Award, where this share increased from 31 percent in 2010-11 to 35 percent in 2015-16. This increased level of provincial expenditure corresponds to the enhanced degree of functional responsibilities of the provinces after the 18th Constitutional Amendment.

Chart 4: Share of sub-national governments in combined revenue receipts and expenditures



VERTICAL FISCAL IMBALANCE

The existence of a vertical fiscal imbalance is evident in both countries due to asymmetric revenues between central governments[15], relative to their spending responsibilities. On the other hand, sub-national governments have insufficient revenues from their own sources to be able to fulfil their spending responsibilities. As shown in Chart 4, the share of expenditures by sub-national governments exceeds the share of their revenue receipts before fiscal transfers. This gap, however, is considerably larger in Pakistan as compared to India, with a current magnitude of 27 percent and 20 percent respectively.

Vertical imbalances are corrected by fiscal transfers from central to sub-national governments, as per the recommendations of Finance Commissions. The following sub-section illustrates the trends in these transfers in India and Pakistan.

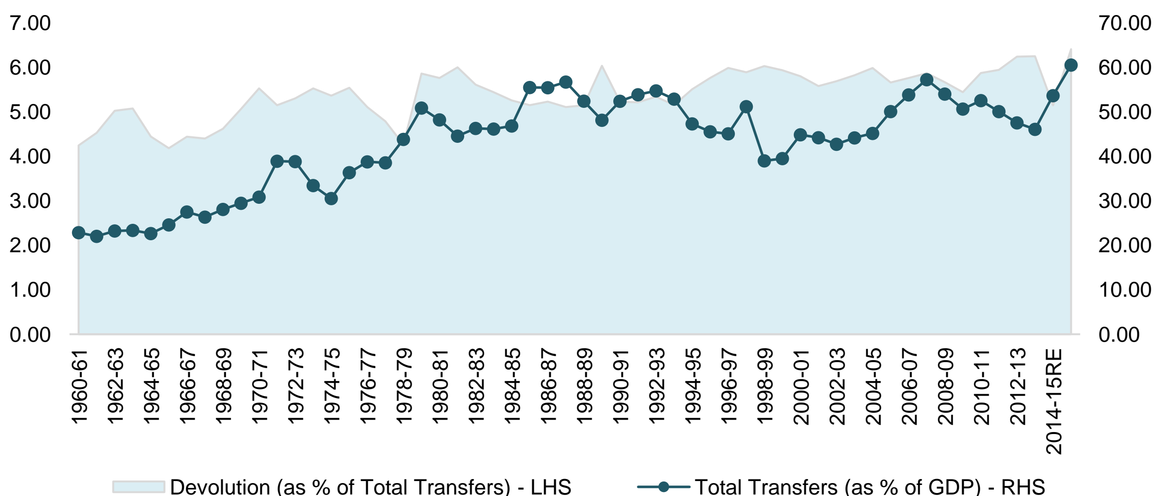
Trends in Fiscal Transfers – India

The level of total transfers from the Union to the States has significantly increased over time. As shown in Chart 5, aggregate transfers as a percentage of the GDP have increased

[15] The Central government refers to the Union government in India and Federal government in Pakistan.

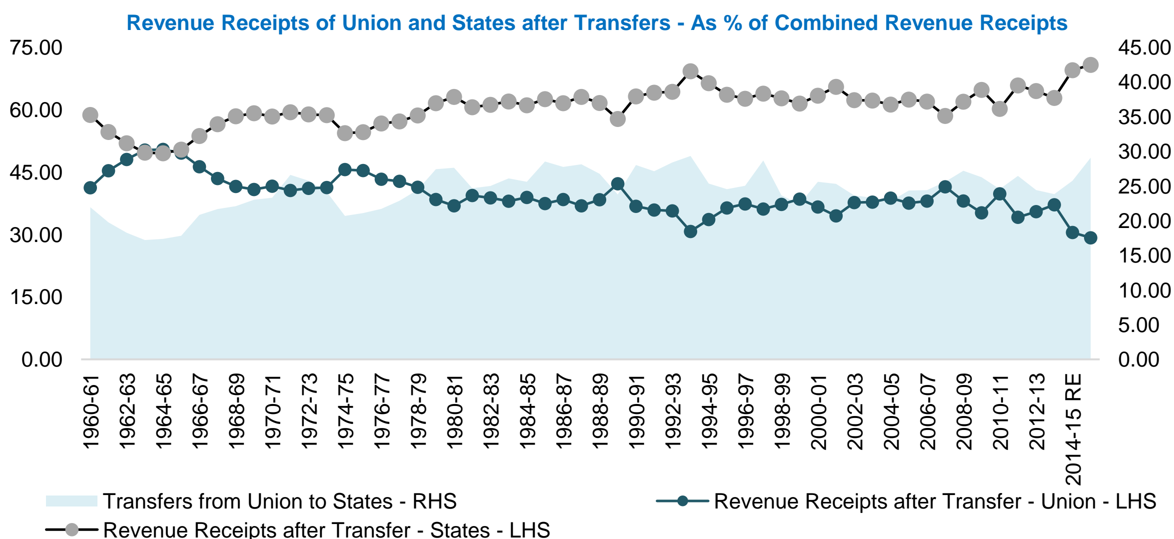
from 2.3 percent in 1960-61 to 6.0 percent in 2015-16. Currently, the fiscal transfers consist of a sizeable share of central taxes – 64 percent of total transfers, while the remaining 36 percent are grants. The level of transfers, as a percentage of combined revenue receipts has risen from 21.9 to 29.1 percent during the same period (Chart 6).

Chart 5: Aggregate Transfers including Grants as % of GDP –India



Source: (Basic data), Indian Public Finance Statistics (various years)

Chart 6: Share of Union and States Revenue in Combined Revenue Receipts after Transfers – India



Source: (Basic data), Indian Public Finance Statistics (various years)

A disaggregated picture of total transfers offers interesting insights; The share of central taxes in the combined resource pool being transferred from the Centre to the States, has increased from 42 percent in 1960-61 to approximately 60 percent in recent years, whereas, the share of grants from the Centre has decreased from 57.6 percent to 36

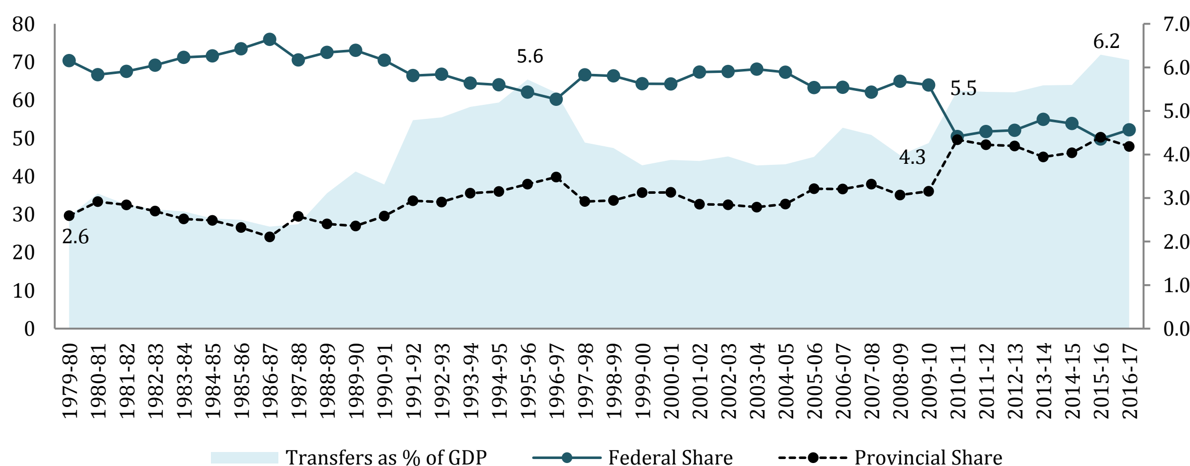
percent during the same period. It must also be noted that the share of statutory grants has reduced from 33.2 percent in 1960-61 to 25.9 percent in 2013-14 and is budgeted even lower at 21.5 percent for 2015-16. However, total transfers have risen not only in absolute terms and as a percentage of revenue receipts, but also as proportions of the GDP. It is to be noted that this increased share of total transfers in the nation's GDP has occurred in periods of high growth, thus reflecting the progressivity of transfers from a Centre that has devolved a higher quantum of its resource pool to the States over the years.

The resource position of the States after transfers is presented in Chart 5. The share of resources transferred to the States amounted to roughly one-fifth of the combined revenue receipts of the Centre and the States. After fiscal transfers (share in taxes and grants), the resource position of the States has improved over the years; the budgeted transfers for 2015-16 constituted 29.1 percent of the combined revenue receipts. As a result, the share of the States' revenue in combined revenue receipts has increased from 58.7 percent in 1960-61 to 62.8 percent in 2013-14 and is budgeted at 70.8 percent for 2015-16. Finance Commission's transfers have thus played a crucial role in addressing the vertical imbalance between the Union and State governments.

Trend in Fiscal Transfers – Pakistan

The level of total transfers from federal to provincial governments has shown an overall increasing trend during the past two and a half decades. As shown in Chart 7, the level of transfers, as a percentage of the GDP has risen from 2.6 percent in 1979-80 to 6.2 percent in 2016-17. However, there has been some fluctuation; an increasing trend can be observed during the period between the 4th and 5th NFC Award (1991-1996). After the 5th NFC Award, the level of transfers declined from 5.6 percent in 1995-96 to 4.0 percent in 2008-09. A considerable increase is evident after the 7th NFC Award. As mentioned earlier, the 7th

Chart 7: Aggregate Transfers including Grants as a % of GDP and Share of Provinces in Combined Revenue Receipts after Transfers – Pakistan



Source: (Basic data), Indian Public Finance Statistics (various years)

NFC Award increased the provincial share in the divisible pool from 46.25 percent to 57.5. This has resulted in a significant enhancement in the aggregate transfers to the provinces.

Chart 6 also illustrates the respective shares of federal and provincial governments in combined revenue receipts, after transfers. The share of the federal government remains in the range of 60 to 76 percent till 2009-10. On average, the gap between the shares of the two tiers remained at 42 percent during the1980s. Subsequently, it narrowed to an average of 30 percent until 2009-10, aside from some fluctuations. A convergence between the two shares is obvious after the 7th NFC Award, where the level of receipts of provincial governments is almost equal to that of the federal government. It, therefore, appears that the transfers through the Finance Commission have been instrumental in correcting the vertical fiscal imbalance between the federal and provincial governments, particularly since 2010-11.

In conclusion, differences in the taxation powers of sub-national governments in both countries, has led to parallel differences in revenue collection performances. In India, since partition, the sales tax on goods is a state tax and similarly, octroi is a local government tax. While in Pakistan, sales tax on goods is a federal tax and octroi (being a local government tax) was abolished in 1999. These differences have resulted in different tax-to-GDP ratios. In India, the tax-to GDP ratio is higher than that of Pakistan. In India, two-fifth of the tax revenues are collected at the state level, whereas, less than one-tenth of the tax revenues are collected by provinces in Pakistan.

Similar to tax revenue collection, there are differences in the expenditure patterns of both countries as well. On average after the 14th FC, Indian sub-national governments have a share of more than 60 percent in total government expenditure. In contrast, the same share of sub-national governments' in Pakistan, even after the 7th NFC award, is on average less than 35 percent. Despite the low share in total public spending compared to Indian states, provincial governments in Pakistan face relatively higher vertical imbalance that requires a sizeable share of federally collected taxation revenues to bridge the gap.

Intergovernmental fiscal transfers in both countries have been instrumental in addressing the vertical fiscal imbalance. In India and Pakistan after the 14th FC and the 7th NFC respectively, total transfers touched 6 percent of the GDP. This high magnitude of transfer resulted in a substantial change in share of revenues of both tiers of the governments. In India after the transfers combined share of states in revenues reached to 70 percent while in Pakistan, both tiers of the government have an equal share in revenues (50:50).

4 Addressing Horizontal Inequalities: The Role of Transfers

Horizontal disparities in the federal system of government arise due to differences in fiscal capacities and fiscal needs of federating units. Levels of horizontal fiscal inequalities differ across the different federations and so does the subsequent treatment of inequalities. Federating units, in both India and Pakistan, are facing large degrees of fiscal disparities. This section highlights the extent of the fiscal capacities of India and Pakistan, followed by the role of transfers in fiscal equalization.

HORIZONTAL FISCAL IMBALANCES ACROSS STATES IN INDIA

Per capita income is a widely used proxy for judging the fiscal capacity of a region. The richest province in India is Goa, with a per capita income of INR 270,150 and poorest is Bihar, with a per capita income of INR 34, 168, as per the Central Statistical Office's data for the year 2015-16.

In order to analyse the role of performance and incentives in federal transfers, different criteria of Finance Commissions have been clubbed under five broad heads namely - Need (population, area-adjusted, demographic change), Equity (backwardness, income distance, inverse per capita income, poverty, revenue equalization, infrastructure distance, fiscal capacity distance), Efficiency/Performance (contribution, tax effort, fiscal self-reliance), Fiscal Disability (forest cover), and Non-Plan Revenue Deficit. Examining these criteria and their weightage for successive Finance Commissions reveals the progressivity of transfers, in terms of a shift from predominantly, need-based transfers to transfers based on equity and efficiency parameters.

Chart 8 shows that while the First FC transferred Union Excise to States solely based on need (population), from the Fourth FC onwards there was a shift towards equity (backwardness, income distance, etc.), and the weight for equity parameters was also increased gradually. For the first time, the Tenth FC introduced the efficiency criterion (tax effort) to reward fiscal discipline.

For the sharing of Income Tax proceeds, need (population and area-adjusted) continued to be an important criterion until the Seventh FC, having a weight of 80 percent and 90 percent over the seven FCs (Chart 9). The remaining weight was given to the efficiency criterion, the parameter being contribution (from First to the Ninth FC); the Tenth FC introduced tax effort as the efficiency criterion. As weightage of the need criterion reduced from the Eighth FC onwards, the equity criterion was introduced to address concerns of poverty and backwardness across the various States.

Chart 8: Criteria for Distribution of Union Excise to States (%)

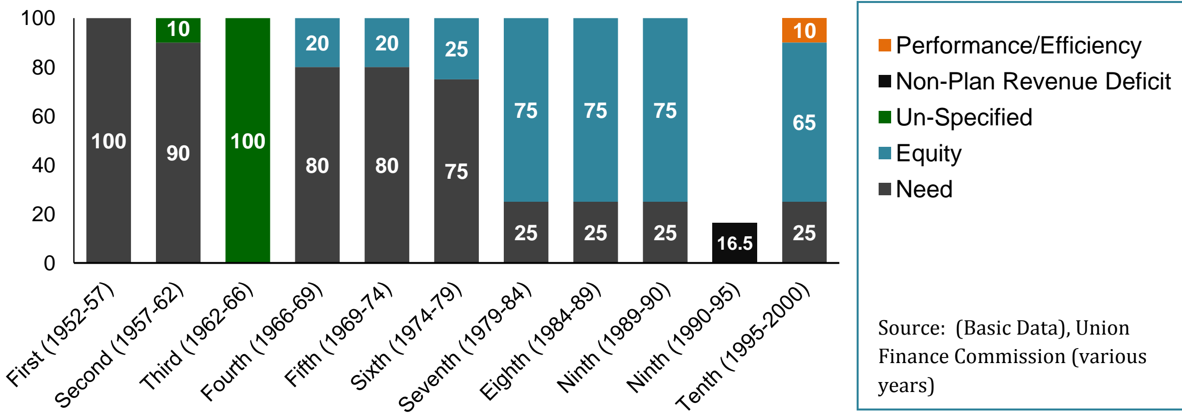


Chart 9: Criteria for Distribution of Income Tax Proceeds to States – First to Tenth FC (%)

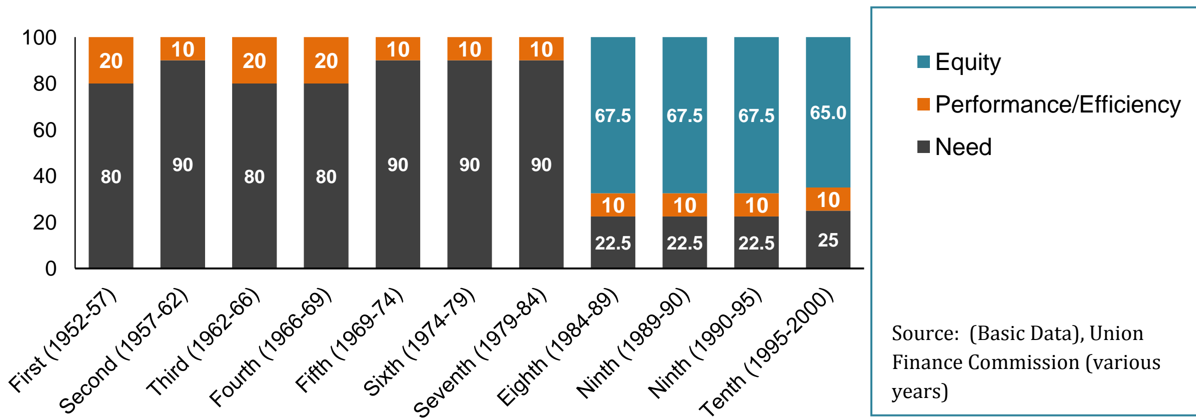
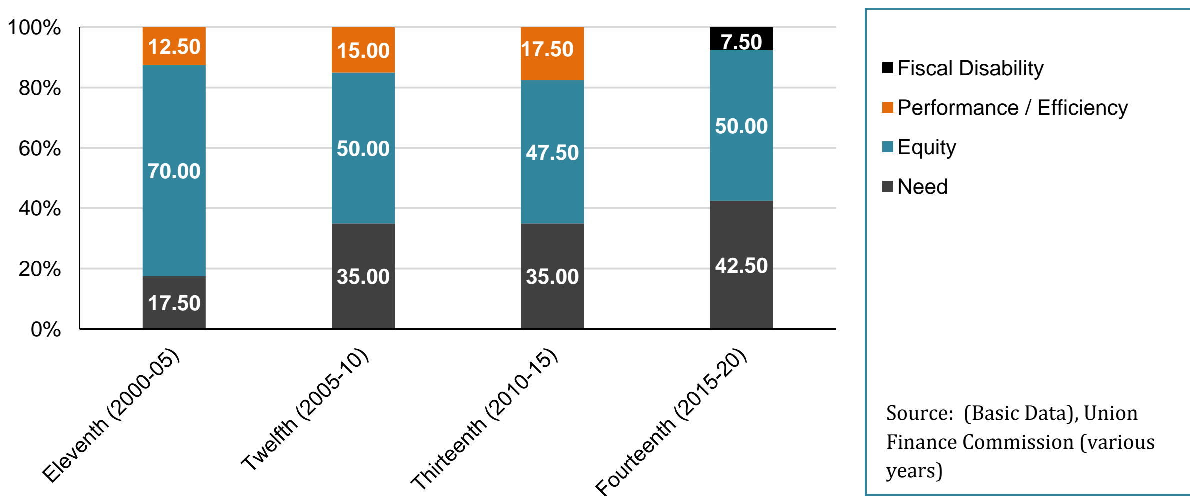


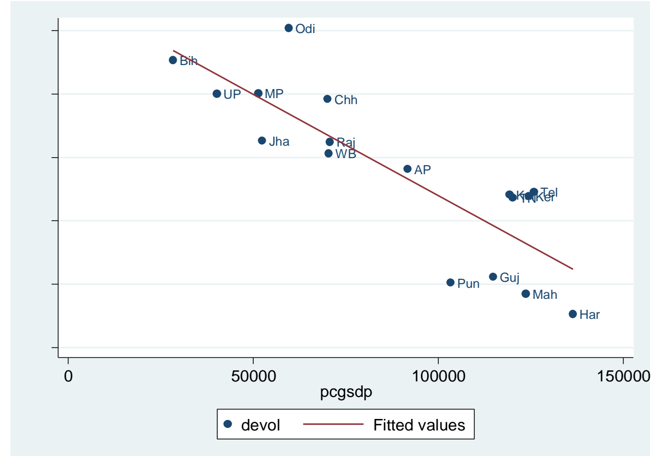
Chart 10: Criteria for Devolution of Funds to States – Eleventh to Fourteenth FC



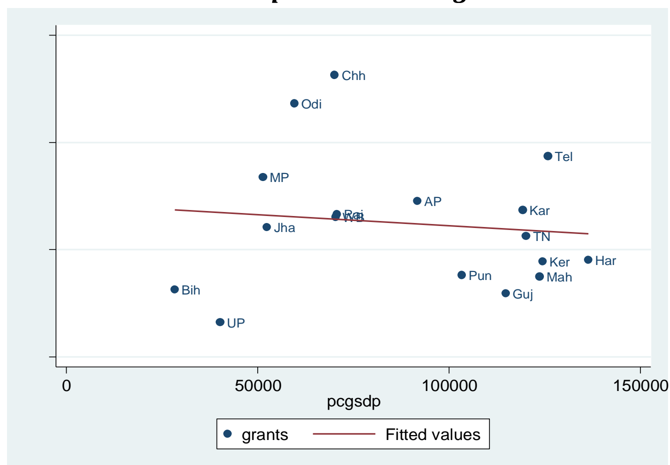
From the Eleventh FC onwards, when all Union taxes formed the divisible pool of resources, fiscal discipline/ fiscal self-reliance was allotted a sizeable weight (7.5 percent in Eleventh and Twelfth FC, and 17.5 percent in Thirteenth FC). However, a paradigm shift in India's transfer system came with the Fourteenth Finance Commission that gave 10 percent weight to demographic change and 7.5 percent weight to forest cover. While the former was to account for demographic changes that have happened in the country post-1971 (the benchmark year for deciding transfers), the latter was to compensate States where a large forest cover was a cost-disability factor.

The imbalance in the assignment of revenues and expenditures between different levels of government in any federation is resolved through inter-governmental fiscal transfers. It is important to examine to what extent these imbalances, especially horizontal, have been addressed by IGFT in India. The following scatter-plots of per capita tax sharing by the Finance Commissions and per capita GSDP (Gross State Domestic Product) of states shows that per capita tax share (in INR) is lower for high per capita income states and vice versa. In other words, tax sharing by the finance commission is very progressive. Considering the scatter-plot per capita grants (all grants) with per capita GSDP it appears that the progressivity is

Chart 11: Scatter-plots of tax sharing, grants and total transfers with per capita GSDP



Per capita Tax sharing



Per capita Grants

Per Capita Total Transfers

Note: per capita tax sharing, grants and total transfers are average over three years 2012-13, 2013-14, and 2014-15.
Source: Finance Accounts of respective States

relatively lower as the fitted line is relatively flat. However, the total transfers (tax sharing and grants) are progressive, as is evident from the scatter-plot of per capita transfers and per capita GSDP of states.

Some descriptive statistics capturing horizontal fiscal inequalities also indicate that fiscal transfers have played an important role in reducing such inequalities. For instance, as shown in Table 12, the maximum-to-minimum ratio of States' own revenue receipts is 6.18 in 2014-15, while after transfers the maximum-to-minimum ratio of States' total revenue receipts increases to 2.39. As far as the trend is concerned, the situation has improved over the years, whereby, inter-state inequalities (measured in terms of maximum-to-minimum ratio) in revenue receipts and expenditures have reduced since 2001-02.

Table 12: Descriptive Statistics Capturing Horizontal Fiscal Inequalities

	Max/Min Ratio	Standard Deviation	Mean	Coefficient of Variation
Own Revenue Receipts				
2001-02	10.33	871.96	1692.31	51.52
2014-15	6.18	3169.22	8221.16	38.55
Total Revenue Receipts				
2001-02	3.14	742.04	2445.57	30.34
2014-15	2.39	2768.47	12961.17	21.36
Total Expenditure				
2001-02	3.98	1091.5	3392.33	32.18
2014-15	2.71	3696.34	15693.6	23.55

Source: Calculated from Finance Accounts of States

HORIZONTAL FISCAL IMBALANCES ACROSS PROVINCES IN PAKISTAN

As mentioned above, per capita income is widely used as a proxy for judging fiscal capacity. However, in the case of Pakistan, official estimates of provincial GDP are not available. In the absence of per capita income, we used provincial own revenues as a crude proxy for fiscal capacity[16] and population, and area as a proxy for fiscal needs. In terms of per capita own revenues Sindh is ahead of all provinces, while Balochistan has the lowest per capita own revenues. Both Punjab and Khyber Pakhtunkhwa are in the middle and have marginal differences in per capita own revenues. In terms of population, Punjab has the highest share of more than 54 percent, while Balochistan has the lowest share of slightly above 6 percent. In terms of the share of population, Sindh and Khyber

Table 13: Horizontal Inequalities in Pakistan

	Rs. Per Capita Own Revenues**	Population Share (%)*	Area Share (%)
Punjab	1,705.8	54.8	26.7
Sindh	3,196.3	23.9	18.3
Khyber Pakhtunkhwa	1,627.2	15.2	9.7
Balochistan	881.7	6.1	45.2

* Population Census 2017

**Own revenues in 2016-17 divided by 2017 population

[16] Own revenues is a poor proxy of fiscal capacity as actual revenue collection do not account for fiscal efforts and may be misleading as relatively poor province may collect more revenue by capitalizing fiscal capacities. However, it provides a baseline for fiscal equalization.

Pakhtunkhwa are in middle with a share of almost 24 percent and more than 15 percent, respectively. In contrast, Balochistan has the highest share in the area, followed by Punjab, Sindh and Khyber Pakhtunkhwa.

Horizontal distribution of divisible pool taxes in Pakistan has been on the basis of only population, until 2009. The process of fiscal equalization was promoted by moving from a population-based horizontal sharing formula to multiple criteria in the 7th NFC Award. Currently, the distribution is based on four criteria: population (82 percent); poverty/backwardness (10.3 percent); revenue collection/generation (5 percent) and inverse population density (2.7 percent).

As shown in Table 14, the 7th NFC Award has achieved, compared to previous awards, the greatest degree of fiscal equalization. Consequently, in relation to population share, the share of revenues has increased most for the two relatively backward provinces, Balochistan and Khyber-Pakhtunkhwa.

Table 14: Ratio between Share in Transfers and Share of Population

Province	1990-91	1996-97	2005-06	2009-10	2010-11
Punjab	0.953	0.884	0.821	0.822	0.815
Sindh	1.030	1.069	1.270	1.235	1.127
K-PK	0.948	1.186	1.043	1.099	1.234
Balochistan	1.453	1.491	1.647	1.565	1.857
Pakistan	1.000	1.000	1.000	1.000	1.000

Source: SPDC [2016]

The extent of fiscal equalization is measured by constructing the Fiscal Equalization Index (FEI), the methodology for which is provided in Box 1. The trend in FEI in different types of transfers during previous Awards is given in Table 15. It is evident that the largest improvement in FEI has taken place after the 7th NFC Award.

Table 15: Fiscal Equalization Index (FEI) Before and Afterwards

	1990-91	1991-92	1996-97	1997-98	2005-06	2007-08	2009-10	2010-11
Divisible Pool Transfers	0.000	0.000	0.000	0.000	0.000	0.018	0.020	-0.068
Straight Transfers	-0.252	-0.347	-0.220	-0.206	0.208	0.173	0.162	0.007
Special Grants	-	0.123	0.123	-0.632	-0.864	-0.420	-0.443	0.763
Total	-0.012	-0.084	-0.026	-0.067	0.017	0.011	0.014	-0.061
Change due to Award	-0.012	-0.084	-0.026	-0.067	0.017	0.011	0.014	-0.061

Source: SPDC [2016]

The fiscal equalization index, FEI, is estimated among the Provinces for expenditure on each social sector. The resulting magnitude leads to two conclusions, there has been significantly greater equalization following the 7th NFC Award in social sector expenditure compared to total expenditure, especially in the case of education and water supply and sanitation.

Table 16: Fiscal Equalization Index of Social Services Expenditure		
	2009-10	2014-15
Total Social Sector Expenditures	-0.027	-0.087
Expenditures on:		
Education	-0.038	-0.096
Health	0.014	-0.033
Water Supply & Sanitation	-0.049	-0.212

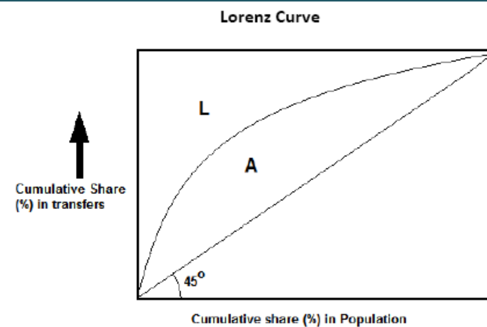
Source: SPDC [2016]

In summary, India and Pakistan have vast horizontal disparities in terms of fiscal capacity and needs. In India, per capita income varies substantially across states, while in Pakistan per capita own revenues differ substantially across provinces. Different finance commissions in India and Pakistan adopted different approaches in dealing with horizontal inequalities. In India, FCs adopted a complex approach containing four sets of indicators for horizontal distribution, including fiscal need, equity, performance and fiscal disabilities. In Pakistan, the NFCs adopted a simple approach for horizontal distribution that heavily relied on fiscal need. Both, the FC and NFC augmented divisible pool transfers with grants, which were often earmarked for less developed state/provinces.

To conclude, it can be inferred from the analysis that overall, inter-governmental fiscal transfers and grants have played an important role in reducing horizontal fiscal inequalities in both the countries, whereby, less developed states/provinces have benefited more than the developed ones.

Box 1: Fiscal Equalization Index

The Gini coefficient based on the Lorenz curve has traditionally been used to quantify the extent of income inequality. We use a similar technique to determine the extent of fiscal equalization achieved by transfers. This requires a comparison of the cumulative shares in transfers of provinces in ascending order of development, with the corresponding cumulative share in the population. This is diagrammatically shown in the figure.



If curve L, lies for the most part above the 45° line then this indicates that fiscal equalization is taking place. This requires computation of the area A below the curve L,

SB, SB, Sp, Ss, the share of Balochistan, KPK, Punjab and Sindh respectively in transfers PB, PB, Pp Ps share of Balochistan, KPK, Punjab and Sindh respectively in population

It is assumed that in the ascending order of level of development we have Balochistan, K-PK, Punjab and Sindh. Area A is derived as follows:

$$A = \left\{S_B\left[\frac{1}{2}P_B + P_N + P_p + \frac{1}{2}P_s\right] + S_N\left[\frac{1}{2}P_N + P_P + \frac{1}{2}P_s\right] + S_P\left[\frac{1}{2}P_P + \frac{1}{2}P_s\right] + \frac{1}{2}P_s\right\}.100 \qquad (1)$$

The Fiscal Equalization Index (FEI) is then derived as: FEI= B-A/B or FEI= 1- A/B (2)

Where B = ½ (100) (100) = 5000

In the event of perfect fiscal equalization where all the transfer accrues to the least developed province, we have that: A= (100) (100) = 1000

And FEI = -1: With some fiscal equalization, A > B; And -1 < FEI < 0; Alternatively, if there is perfect disequalization and the most developed province receives all the transfers then A = 0

And FEI = 1

Therefore, there is fiscal equalization when 0 < FEI < 1

Source: SPDC (2016)

5 Fiscal Federalism and Debt Management

Debt management in a federal structure of the governance is a complex issue. In many countries, subnational governments have limited borrowing powers due to concerns regarding possible impacts on macroeconomic stability and debt sustainability. In both India and Pakistan the Constitution, in addition to providing revenue raising and expenditure powers, assigns borrowing powers to national and subnational governments. Aside from these defined borrowing powers, both countries also have fiscal responsibility acts.

This chapter discusses issues related to debt management in India and Pakistan. It lays out the constitutional provisions with respect to the borrowing powers in each country, followed by a discussion on the fiscal responsibility acts for public debt management in both countries. It also presents the implications of the 7th NFC awards' recommendations and the 14th FC's impact on the deficits and debt levels.

BORROWING POWERS OF THE NATIONAL AND SUB-NATIONAL GOVERNMENTS

The Constitution of Pakistan has provisions for borrowing powers of federal and provincial governments. Similarly, the Indian Constitution outlines borrowing powers of the union, state and local governments.

Borrowing Powers –India

Article 292 and Article 293 of the Constitution regulates the borrowing powers of the Union and State Governments, respectively. Article 292 allows the Union government to borrow on the security of the Consolidated Fund of India - within and outside the country (subject to the limits, if any, specified by the Parliament). Whereas, Article 293 restricts borrowing powers of the State governments on the scrutiny of the Consolidated Fund of India, within the territory of India with the consent of the Union government. The Article further dictates that States may borrow freely without debt ceiling limits, unless they hold outstanding loans from (or guaranteed by) the Union government; and that the Union government may also give loans to the State governments, subject to such conditions, as laid down in a law of Parliament. Due to these provisions, the Union Government incurs external and internal debt both, while the State governments incur internal debt. Public debt in India is, thus, the sum of external and internal debt incurred by the Union and State governments.

Since State governments cannot borrow externally, almost all external aid received as grants from various multilateral and bilateral agencies are channelled through the Central Government to the States (and other institutions) implementing the projects. Loans from both multilateral and bilateral agencies, thus, have to be made to the Union through the State Government and its institutions that may be implementing the project.

Borrowing Powers – Pakistan

Article 166 and Article 167 of the Constitution of Pakistan outlines the borrowing powers of both federal and provincial governments. The 18th Constitutional Amendment, although did not change the borrowing powers of the federal government, it enhanced those of the provincial governments.

Article 166: Borrowing by Federal Government.

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

Article 167: Borrowing by Provincial Government.

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

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

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

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

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

FISCAL RESPONSIBILITY AND DEBT MANAGEMENT

In tandem with the Constitutional provisions for borrowing powers, both countries also have fiscal responsibility Acts. These acts have similarities and subsequent challenges for proper implementation.

Norms of Fiscal Responsibility – India

An institutional reform in debt management was a result of the Fiscal Responsibility and Budgetary Management (FRBM) Act, 2004. A more recent institutional reform is the new FRBMA Review Committee that was constituted by the Finance Ministry in 2016, to suggest a roadmap for fiscal consolidation. It was felt that the existing FRBMA had proved ineffective. While there were transparency issues, the major concern with the old FRMA was that it was suspended with impunity in 2009, for several years, during which the fiscal deficit went out of control. Need was also felt to have a fiscal deficit range as a target instead of a fixed target, to provide necessary fiscal policy space to the governments in the wake of dynamic developments in the economy such as the award of the FC-XIV, the implementation of the 7th Pay Commission Award, the issue of UDAY power bonds by most State governments, and etc.

The Committee recommended reducing the Union's debt to GDP ratio from 49.4 percent in 2016-17 to 40 percent by 2022-23, the States' debt ratio targeted to remain at around 20 percent, and the combined debt of the Union and the States targeted to reduce from 68 percent in 2016-17 to 60 percent by 2022-23. It also recommended a fiscal deficit trajectory – fiscal deficit coming down from 3.5 percent in 2016-17 to 3 percent in 2017-18 and remaining at that level for the next two years, and then declining steadily to 2.5 percent by 2022-23, yielding a debt ratio of 38.7 percent. The element of flexibility has been ensured by providing an "escape clause" which would enable departure from the fiscal deficit target in specific circumstances, on the recommendation of Fiscal Council. The independent Fiscal Council, upon its constitution in the near future, shall be an important institution of public debt management in the country.

Norms of Fiscal Responsibility – Pakistan

The federal government of Pakistan is operating under the Fiscal Responsibility and Debt Limitation (FRDL) Act since 2005. The Act has on time to time been amended to add new roles over targets. It was last amended on 1st July 2017. The amended Act sets the following limits: (a) reducing the federal fiscal deficit net of foreign grants to 4 percent of the GDP during the three years beginning from 2017-18, afterward maintained at three and half

percent of the GDP; (b) ensuring that by June 30, 2019, the total public debt-to- GDP ratio does not exceed 60 percent; (c) ensuring that within a period of five financial years beginning from the financial year 2018-19, total public debt shall be reduced by 0.5 percent every year and from 2023-24 going up to financial year 2032-33, a reduction of 0.75 percent every year to reduce the total public debt to fifty percent of the· estimated gross domestic product, and thereafter maintaining it to fifty percent or less of the estimated gross domestic product; and (d) not issuing new guarantees (including renewal) beyond two percent of the GDP in any year.

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

DEBT-DEFICIT DYNAMICS UNDER THE LATEST FINANCE COMMISSION

The 14th Finance Commission of India has explicit provisions to limit state deficit and borrowing by adopting a rule-based approach to manage debt-deficit dynamics. While the 7th NFC Award in Pakistan does not have direct provisions for defining borrowing limits, in the aftermath of the 7th award, provincial governments were under pressure to generate budget surpluses to reduce the overall national budget deficit. Provinces were also offered an interest rate for maintaining surpluses for a minimum of three-months.

Debt-Deficit Dynamics Post 14th Finance Commission Award – India

Post-Fourteenth Finance Commission (FFC), the debt-deficit dynamics of states have changed substantially. The FFC has recommended that sub-national governments in India maintain zero revenue deficits or revenue surplus, and a fiscal deficit threshold of 3 percent of GSDP. The FFC envisaged that the quality of deficits is equally significant as the levels. FFC prescribed the following conditions for enhanced borrowing limits of States:

i. Fiscal deficit of all States will be anchored to an annual limit of 3 percent of the GSDP. The States will be eligible for flexibility of 0.25 percent over and above this, for any given year for which the borrowing limits are to be fixed if their debt-GSDP ratio is less than or equal to 25 percent in the preceding year.

ii. States will be further eligible for an additional borrowing limit of 0.25 percent of the GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10 percent of the revenue receipts in the preceding year.

iii. The two options under these flexibility provisions can be availed by a State either separately, if any of the above criteria is fulfilled, or simultaneously if both the

above-stated criteria are fulfilled. Thus, a State can have a maximum fiscal deficit-GSDP limit of 3.5 percent in any given year.

iv. The flexibility in availing the additional limit under either of the two options or both, will be available to a State only if there is no revenue deficit in the year in which borrowing limits are to be fixed and the preceding year.

The underlying rationale of the new framework of borrowing is to provide fiscally prudent states with additional borrowing for higher capital expenditure. As per the FFC's assessment, state-level capital outlay during its award period is expected to increase from 3.83 percent of GDP in 2015-16 to 4.61 percent of GDP in 2019-20. The success of this enhanced borrowing would be judged both by the increase in the number of states qualifying for this facility and by the increase in capital expenditure at the state level.

The analysis of outstanding debt and deficits of all States ex-post to FC-XIV period in the first year of assessment (2015-16) revealed that only five States – Jharkhand, Karnataka, Madhya Pradesh, Odisha and Sikkim - have successfully managed to maintain the FRA thresholds of deficits and the criteria of outstanding-debt-to-GSDP ratio below 25 percent, and interest payment-to-revenue receipts ratio below 10 percent. Therefore, they are eligible for enhanced borrowing of 0.5 percent as suggested by the FFC. Gujarat, Meghalaya and Uttarakhand were eligible for partially enhanced borrowing procedure since at least one of the IR/RR or Debt/GSDP was maintained within the stipulated limits. However, as this recommendation was implemented from fiscal year 2016-17, these States did not benefit from this enhanced borrowing facility. As per the information obtained from Ministry of Finance, Government of India, in 2016-17 six States have become eligible for enhanced borrowing.

Debt-Deficit Dynamics Post 7th NFC Award – Pakistan

Historically, provincial governments have engaged in very limited direct borrowing, not only because of a degree of fiscal prudence, but also due to limited access to the banking system and the capital market. During the 70s and 80s, provincial governments had floated some long-term market loans as part of the permanent debt. This practice has largely been discontinued. The federal government has also been making cash development loans (CDLs) to the provincial governments. The latter have argued that interest rates charged by the former were high in relation to the cost of borrowing. Currently, most of the loans to the provinces are in the form of foreign assistance.

The 7th NFC made no recommendations on borrowing, except for emphasising that both governments would develop and enforce mechanisms for maintaining fiscal discipline through legislative and administrative measures.[17] The budgetary magnitudes show a

[17] 7th NFC Award, Paragraph (3) of the Miscellaneous Section.

mixed trend in fiscal balance after the 7th NFC award. Accordingly, the federal government has relatively high budget deficits as a percentage of the GDP, which reached to 8.4 percent of the GDP in 2012-13 (Table 17).

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

Table 17: Post 7th NFC Award Federal and Provincial Fiscal Balance *(Rs in Billions)*

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

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

In contrast, to reducing the overall national budget deficit, the federal government has put pressure on provincial governments to generate surpluses. One such example of this pressure is an incentive grant mechanism under the advice of IMF. The Government of Pakistan signed a Memorandum on Economic and Financial Policies for 2013/14 –2015/16 with the IMF on August 19, 2013, which contained a list of "Prior Actions and Structural Benchmarks under Extended Fund Facility". One of the prior actions mentioned in the list is "Impose a balanced budget requirement on provinces and agree with provinces to save additional revenues generated by the program." In compliance with this action, the

memorandum contained an assurance from the federal government which states that "… an agreement has been reached at the level of the Council of Common Interest to assure that it is used for deficit reduction or saved. In addition, the government has tightened the balanced-budget requirement on provinces, and provided incentives for them to maintain surpluses (prior action)."

An analysis of the Council of Common Interest's (CCI) decision in this regard revealed that the federal government in consultation with the provinces had decided that provinces would be allowed the rate of return on their minimum surpluses at the latest T-bills rate, maintained for a minimum of three months. As per this decision, the federal government distributed more than Rs3.8 billion during 2013-14 as an incentive grant on maintaining provincial surplus. This explains the budget surpluses at provincial levels during 2013-14 to 2015-16 (Table 18).

Table 18: Incentive Grant on Maintaining Provincial Surpluses *(Rs. In Million)*

	2013-14	2014-15	2015-16
Punjab	557	3,593	1,685
Sindh	2.3	481	837
Khyber Pakhtunkhwa	1,504	4,279	1,198
Balochistan	1,802	2,980	2,001
Total	**3,865**	**11,333**	**5,721**

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

The provincial governments used these surpluses for early retirement of expensive debt from the federal government. As of June 30, 2011, the combined outstanding debt of the four provinces is estimated at less than five percent of the national GDP, with the share of external debt at approximately 70 percent. Interest payments constitute less than four percent of the revenue receipts. As of June 30, 2015, the combined outstanding debt of the four provinces is estimated at less than three percent of the national GDP, with the share of external debt having increased to more than 80 percent. In other words, due to improved debt management at the provincial level, provinces have a low level of overall debt with a high proportion of external debts. These external debts are routed through the federal government and are in the form of development assistance from multilateral and bilateral donors.

In summary, the states of India managed a higher level of development expenditure approximately 2.5 percent of the GDP, with almost 40 percent going to investments in power and irrigation. However, many states are running large revenue deficits and the combined state debt-to-GDP ratio has approached 30 percent. The FRBM Acts and the Finance Commission awards set rule-based fiscal controls at the state level and created a mechanism for providing performance incentive–based transfers for better fiscal management. The FFC set a new framework of borrowing that provides fiscally prudent States, with additional borrowing for higher capital expenditure. The success of this

enhanced borrowing can be judged both by the increase in the number of States qualifying for this facility, as well as by the increase in capital expenditure at the State level.

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

6 The Role of Transfers in Achieving Development Outcomes

Since the responsibility of social service delivery in India and Pakistan lies mainly with the sub-national governments, fiscal transfers play an instrumental role in achieving development outcomes and reducing gender inequalities, through provision of required fiscal space. This section provides an overview of development indicators in both countries, with a particular focus on gender differential outcomes.

HUMAN DEVELOPMENT OUTCOMES – INDIA

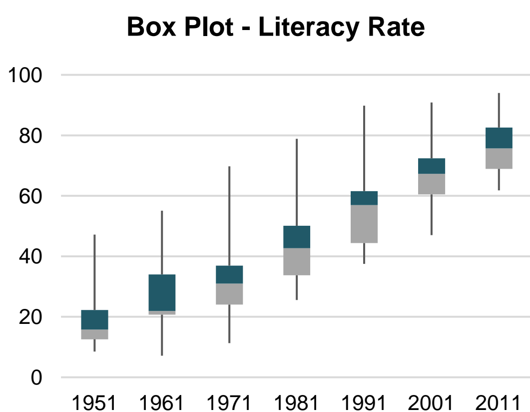
The adult literacy rate in India has improved significantly from 18 percent in 1951 to 74 in 2011. Among the States, Kerala has had the highest literacy rate throughout the time period - 94 percent in 2011. Bihar on the other hand, has had the lowest literacy rate -61.8 percent in 2011 - but the gap between the best performing and the worst performing States has gradually declined over the years. The box plot depicts (Chart 12) how the distribution across States has become relatively more normal over the years.

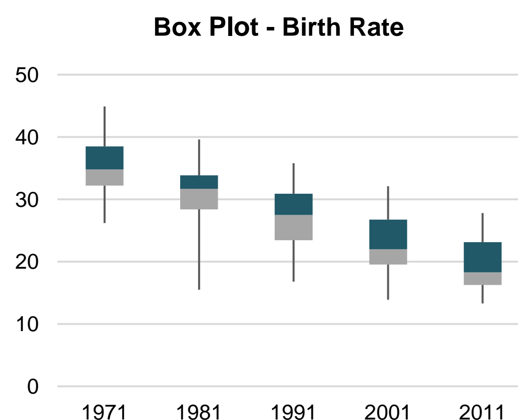
The average birth rate in India has reduced from 36.9 to 21.8 between 1971 and 2011; however, regional variations have increased. The maximum-to-minimum (Max-Min) ratio among the States has increased from 1.71 to 2.09 over the same period. It has also been noted that Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Rajasthan and Uttar Pradesh continue to have high birth rates which skews the distribution with these States lying in the third quartile. The death rate has reduced by more than half, from 14.9 in 1971 to 7.1 in 2011 - Nagaland having the lowest reported death rate of 3.3. Regional variations have come down marginally as evident from the box plot (Chart 12).

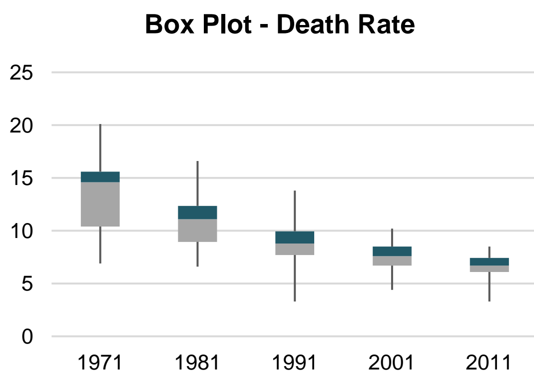
There has been a massive reduction in infant mortality rates (IMR) – from 129 in 1971 to 44 in 2011, and in maternal mortality rates (MMR) – from 407 during 1998-00 to 167 during 2011-13. Yet again, sharp regional variations are observed – Madhya Pradesh's IMR of 59 in 2011 was over five times higher than that of Manipur's, which was 11 during the same period. Assam had an MMR of 300 during 2011-13 – five times higher than the MMR of Kerala. For IMR, while the inter-quartile distribution has become evenly spread over time, the Max-Min ratio has increased from 2.88 in 1971 to 5.36 in 2011. With respect to MMR, while the Max-Min ratio has reduced drastically from 25.25 during 1998-00 to 4.92 during 2011-13, the inter-quartile distribution suggests that a lot of States have an MMR that is higher than the median value.

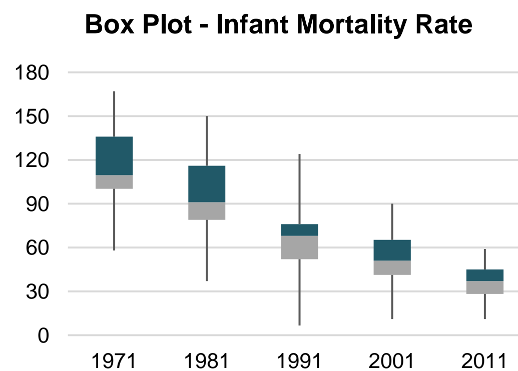
The overall poverty rate of India has decreased from 54.9 percent in 1973-74 to 21.9 percent in 2011-12; however, the gap between the best and worst performing States has widened, and consequently, so has the inter-quartile distribution which reflects increasing regional inequalities. In 1973-74, Orissa's poverty rate (66.2 percent) was two and a half times higher than that of Himachal Pradesh (26.4 percent). In 2011-12, the highest poverty rate of roughly 40 percent in Chhattisgarh was five times the poverty rate of the State with the lowest poverty rate of 5 percent, Goa.

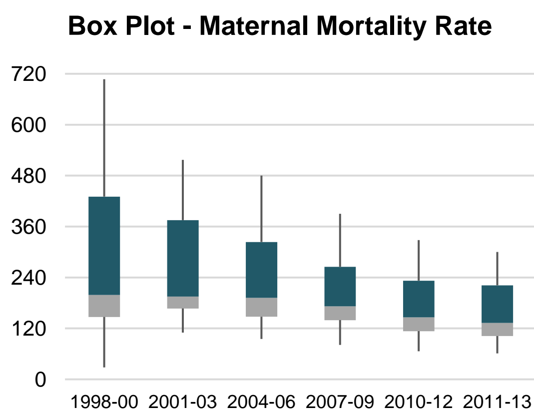
Chart 12: State-wise performance on select social parameters

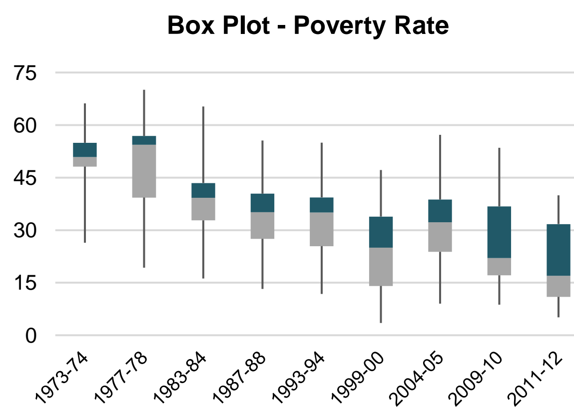






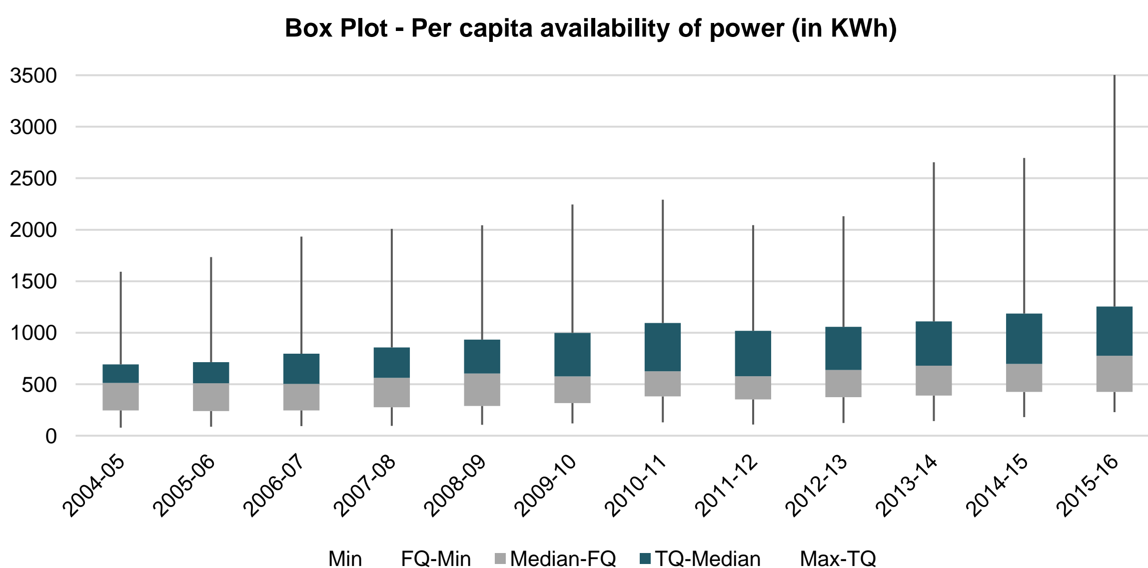






On the other hand, the per capita availability of power in the country has improved a lot in a decade's time period - from 532.9 KWh in 2004-05 to 901.3 KWh in 2015-16 (Chat 13). The median per capita availability of power has also increased from 512.7 KWh to 775.65 KWh during the same period. The average, however, is higher each year because of the outlier, Goa – the State had a per capita availability of power of 3511.6 KWh in 2011, hence the box plot has upward shooting whiskers.

Chart 13: State-wise performance on per capita availability of power



The above analyses reveal that stances towards developmental fiscal policy have played a key role in improving development outcomes at the state level. This has become possible due to the States' own revenue efforts and improvement in resource positions due to higher transfers. However, regional imbalances persist. These regional imbalances have caused inter-state migration – from the relatively poorer states (Uttar Pradesh, Bihar, and, Rajasthan) to the relatively richer states of the country (Maharashtra, Haryana, and Punjab). The analysis also implies that a relatively more progressive transfer system and a developmental fiscal policy stance can significantly reduce migration from poorer to richer states of the country.

HUMAN DEVELOPMENT OUTCOMES – PAKISTAN

The overall adult literacy rate in Pakistan has improved from 45 percent in 2001-02 to 60 percent in 2014-15 – most of this increase (from 45 percent to 55 percent) was observed during 2001-02 to 2006-07. This 10 percentage point growth occurred at the time when provincial shares in the divisible pool were relatively low and fixed. Although public spending on education has comparatively increased, this has not translated proportionally

in to the anticipated increase in the literacy rate. Even after the 7th NFC award, literacy rates increased marginally from 58 percent to 60 percent. Similar growth patterns are seen in the provinces.

Trends in net enrolment rates (NER) at the primary level highlight anomalous patterns which are relatively inconsistent with the patterns of public spending in the primary education sector. For instance, in 2001-02 the overall NER in Pakistan was 51 percent, which subsequently, increased to 65 percent in 2006-07 (Table 19). Although during this period, provincial shares in the divisible pool were fixed, two additional resources were transferred to the provinces i.e. one-sixth of the GST on goods and GST on services. It must be noted that the share in GST services was not high in magnitude, compared to the resources transferred through the 7th NFC award. Despite the hefty increase in provincial resources after the 7th NFC award, the overall NER remained stagnant. Province-wise trends portray an even bleaker picture. For example in Punjab, after a massive increase of 16 percentage points between 2001-02 and 2006-07, the NER remained stagnant afterwards, hovering around 70 percent. In Sindh and Balochistan after an initial increase of 10 and 9 percentage points respectively, the NER fell and subsequently, depicted trends of negative growth. So far, Khyber Pakhtunkhwa is the only province with a positive trend in NER; however, the pace of growth is relatively slow compared to that in the initial period.

Table 19: Trend in selected Human Development Indicators

	Pakistan	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan
Literacy Rate – 10 years and above					
2001-02	45	47	46	38	36
2006-07	55	58	55	47	42
2010-11	58	60	59	50	41
2014-15	60	63	60	53	44
Net Enrolment Rate- Primary: 6-10 years(%)					
2001-02	51	54	47	51	40
2006-07	65	70	58	61	50
2010-11	66	70	62	64	56
2014-15	67	70	61	71	56
Full Immunization (%)					
2001-02	53	57	45	57	24
2006-07	76	83	65	76	54
2010-11	81	86	75	77	53
2014-15	82	90	73	78	51
Gender Parity in Primary Education (%)					
2001-02	79	86	72	63	59
2006-07	84	92	77	72	63
2010-11	86	93	81	79	59
2014-15	86	92	81	80	63

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

The Gender Parity Index (GPI) – ratio of the Net Enrolment Rate (NER) of girls divided by the NER of boys – for primary education is an indicator used to track gender equality in primary education, through household surveys. GPI in primary education indicated an improvement in Pakistan's case; over the period 2001-02 to 2010-11, it increased from almost 79 percent to 86 percent, but remained unchanged afterwards. Provincial comparisons indicate worsening of gender equality in two populous provinces, Punjab and

Sindh. The decline in 2014-15 is counter intuitive to the increase in public spending on primary education, after the 7th NFC award. Balochistan shows a mixed trend in GPI which hovers between 59 percent and 63 percent. After the 7th NFC award, the GPI of Balochistan showed an improvement of 3 percentage points. However, it is critical for the province to maintain this pace. Khyber Pakhtunkhwa is the only province showing a gradual improvement in gender parity.

Immunization coverage is one of the indicators used to assess the success of health policies being practiced in a country. Trends in child immunization rates for major diseases in Pakistan and provinces reveal gradual improvement. In 2001-02, slightly more than half of children aged12 to 23 months had immunization coverage, this increased to 82 percent in 2014-15. Much like the education sector, growth is observed to be high particularly during elected local government period (2001-2007). Province-wise comparisons highlight that Punjab leads the score with 90 percent children from the relevant age bracket with full immunization in 2014-15. In Khyber Pakhtunkhwa, the share of immunized children is gradually improving – 78 percent children were immunized during same period. Sindh, after showing progress till 2010-11, showed a decline of 2 percentage points in the post - 7th NFC period. Similar trends are visible in Balochistan, whereby, after initial growth child immunization coverage declines. It is alarming to note that almost half of the children did not receive full immunization in Balochistan during 2014-15.

Table 20 indicates that the share of tap connections in Pakistan, as sources of drinking water, increased from 25 percent in 2001-02 to 36 percent in 2006-07, indicating an increase of 11 percentage points. However, during 2006-07 to 2010-11, a decline of 4 percentage points is visible. The province-wise trend depicts a more or less similar picture of access to drinking water. After the 7th NFC award, while public spending on water and sanitation increased, this did not translate into an increase in access to tap water. Thereby further corroborating the insight that the elected local governments, with financial transparency, can play a greater role in provision of water services.

Table 20: Access to tap water

	Pakistan	Punjab	Sindh	Khyber Pakhtunkhwa	Balochistan
			(%)		
2001-02	25	39	30	20	25
2006-07	37	44	47	29	36
2010-11	35	45	43	24	32
2014-15	33	35	41	18	27

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

GENDER DIFFERENTIAL OUTCOMES

The fiscal transfer systems addressing gender inequalities in India and Pakistan vary in approach and methodology. In India, fiscal transfers aimed to address gender inequalities, are mostly through “tied” transfers from federal government to sub-national governments.

In this regard, the Mahatma Gandhi National Rural Employment Guarantee (MGNREG) scheme is one of the largest centrally sponsored schemes of the Government of India. It is in the form of direct fiscal transfers to rural local governments – routed through the State governments – for creation of public employment. In the absence of conditional/tied transfers, as in the case of Pakistan, indirect effect of fiscal transfers on gender inequality through expenditures on relevant sectors can provide some insight. Therefore, Gender Equality Index (GEI) by province has been constructed. In order to link the index with the NFC transfers, the elasticity of growth in GEI, with respect to growth in real per capita social expenditure has been estimated. The following sub-sections summarize the analyses regarding gender differential outcomes in both countries.

Gender Differential Outcome: India

MGNREG is based on the principle of self-selection and is a step towards the legal enforcement of the right to work, as an aspect of the fundamental right to live with dignity (see Box 2).[18] This programme aims to redress seasonal, cyclical and structural unemployment in the country by providing the low-skilled, poor population a work entitlement, ensuring that when all else fails the government acts as an 'employer of last resort'. Using the NSS 68th round data on Employment and Unemployment, we estimated the impact of participation in the employment guarantee programme on gender equality, proxied by the women labour force participation. In the empirical investigation, the following questions were asked:

1. What are the determinants of female labor force participation in rural India?
2. Is female labor force participation higher across Indian States with MGNREG, the direct fiscal transfer?
3. Do care economy variables matter for female labour force participation?

Econometrically, the determinants of labour force participation rate (LFPR) were examined using the probit model. These estimates are confined to rural unit record data of national sample survey, since the MGNREGA is only relevant to rural employment.

The basic Probit model is as follows:

$$Pr\{L = 1\} = \alpha + \beta_1 MGNREG + \beta_2 X_i + v_i + e_i$$

The expanded Probit model incorporates control variables including religion, social group, marital status, level of education and the MGNREGA job card. The findings suggest that the impact of MGNREGA on LFPR is positive. LFPR is likely to be lower for those who are not registered in any MGNREGA job, for both females and males. It can be therefore

[18] http://ftp.iza.org/dp6548.pdf

deciphered that though MGNREGA provides employment opportunities for both men and women, it is the women who gain the most from the job guarantee scheme. The results, thus, support the hypothesis that MGNREG engenders higher labour force participation.

Further, a negative association is observed between the level of education and LFPR for females. LFPR is found to be lower for educated women, compared to those who are illiterate. There could be two possible explanations for lower LFPR among educated women. Most of the work in the rural areas is concentrated in either agriculture or MGNREGA, and since work under both these categories is unskilled in nature, educated women do not prefer to opt for such work due to its nature. Therefore, the level of education has a negative impact on LFPR in the rural areas for females.

Box 2: Direct Fiscal Transfers and Gender Equality

The National Rural Employment Guarantee Act (NREGA) of India was enacted by the Indian Parliament on September 5, 2005. This Act guaranteed 100 days of employment per year for individual households willing to do unskilled manual work at the statutory minimum wage. It was later renamed as Mahatma Gandhi National Rural Employment Guarantee (MGNREG) scheme on 2nd February, 2006. This is one of the largest centrally sponsored schemes (CSSs) of the Government of India in the form of direct fiscal transfers to rural local governments – routed through the State governments – for creation of public employment. The total allocation under MGNREG in 2017-18 (BE) is Rs 480 billion. Regardless of the budget allocation, as per the MGNREG legislation, the Government needs to provide supplementary budgetary allocation if needed.

Integrating gender in MGNREGA Policy formulation

At the policy formulation stage itself, the Act was gender focused.[19] First, the Act mandates that one-third of the job guarantee programme's beneficiaries should be women. Two, it envisages a distance criteria that the work has to be done within the stipulated 5 km from the residence of the job seeker, with preference to women and the aged. Three, it prescribes equal wages for men and women in public works programmes. Four, it envisages a 'labour entitlement' of 100 days to the members of the household (not one person in the 'household'). This gives further space for women to participate in the programme. Five, a gender-aware financial inclusion practice was emphasized in its operational guidelines, which recommended the local government to facilitate opening of individual bank accounts for men and women instead of joint bank accounts for the wage payments. Six, it prescribed provisioning of care economy infrastructure at the worksites such as child care to enhance the work force participation of women.

Gender Differential Outcome: Pakistan

To analyse the gender differential outcomes in Pakistan, we constructed a Gender Equality Index (GEI). Three indicators were used to derive the GEI covering education and employment. These are as follows:

G1 = Female to Male Literacy Ratio

G2 = Female to Male Net Enrolment Rate in Primary and Secondary Education, and

G3 = Female to Male Employment to Population Ratio.

The Gender Equality Index is an average of G1, G2 and G3 and mathematically given by

$$GEI = 1/3(G1 + G2 + G3)$$

A higher magnitude of GEI indicates a greater extent of gender equality.

[19] https://blogs.commons.georgetown.edu/economicsofpoverty/files/2015/12/Right-to-work.pdf

The trend in GEI for each Province is given in Table 21. It appears that the rate of improvement in gender equality is generally very slow. The highest level of gender equality is observed in Punjab, followed by Sindh. The two relatively backward provinces, Khyber-Pakhtunkhwa and Balochistan, have significantly lower levels of gender equality. Also, there is no clear evidence of a catching up by these two Provinces.

Table 21: Trend in Gender Equality Index

	2004-05	2007-08	2014-15
Punjab	0.65	0.64 (-0.5)*	0.70 (1.3)
Sindh	0.53	0.54 (0.6)	0.56 (0.5)
Khyber-Pakhtunkhwa	0.43	0.47 (3.0)	0.48 (0.3)
Balochistan	0.40	0.39 (-0.8)	0.42 (1.0)

Growth rates are given in parenthesis.

Table 22: Elasticity of Gender Equality Index with Social Sector Expenditure

	Elasticity
Punjab	0.087
Sindh	0.067
Khyber- Pakhtunkhwa	0.092
Balochistan	-0.007

Finally, we quantify the elasticity of growth in GEI with respect to growth in real per capita social expenditure. The objective is to test the hypothesis that an increase in social service spending has a positive impact on gender equality. Elasticity estimates are given in Table 22. The estimated elasticities are very small. The unfortunate conclusion is that in Pakistan increases in social sector expenditure, have not had much of an impact on the level of gender equality. What is perhaps required is a fundamental change in values and attitude towards women.

In a nutshell, the 14th FC in India and the 7th NFC award in Pakistan provided relatively higher fiscal space to the state/provincial governments. It was expected that this fiscal space would lead to betterment of the needy population, particularly, those belonging to backward states/provinces, and be a source of an increase in expenditures in the social sector, which will ultimately help in generate momentum for gender equitable social development.

In India, long-term trends in development indicators show overall improvement. Although not explicitly linked to the FCs, it is an outcome of both factors i.e. States' own revenue efforts and improvement in resource positions due to higher transfers. A far as MGNREGS is concerned there is a clear gender focus of the scheme in its formulation itself, which provided impetus to enhanced labour-force participation of women. This is corroborated by empirical evidence which reveals that the MGNREGS has been instrumental in reducing gender parity in labour force participation.

In Pakistan, the available fiscal indicators represent an improved situation, since public spending on three social services namely education, health and water supply and

sanitation has increased as a percentage of GDP. However, up till 2014-15, these higher degrees of resources have failed to generate the much needed momentum for social development in the country. Regarding gender inequality, the estimates of elasticity of growth in GEI with respect to growth in real per capita social expenditure are positive in most cases; however, the magnitude is small indicating a positive but weak linkage between social spending and gender inequality.

7 Fiscal Federalism And Local Governments: An Uneven Development

India and Pakistan have inherited a common local governance system from the British colonial era, which was directly controlled by provincial governments with the help of district officers. However with the passage of time, both countries have transformed their systems of local governance through a variety of constitutional amendments. Such legal developments allow for an active role of elected representatives of local government and provide a basis for state/province level finance commissions. In both countries, local government financing is heavily dependent on transfers and grants from the upper two tiers. The State finance commission (SFC) in India and provincial finance commission (PFC) in Pakistan are the constitutional bodies responsible for designing a formula-based transfer mechanism for resource sharing between the states/provinces and local governments.

LOCAL GOVERNMENT SYSTEM IN INDIA

With constitutional recognition of urban and rural local bodies after the 73rd and 74th Constitutional Amendment (1992), the structure of inter-governmental fiscal relations underwent several changes. One of which, involved a statutory constitution of State Finance Commissions (SFCs) in all the States (barring Mizoram, Nagaland and Meghalaya). Transfer of resources from the state to local bodies has been the main task of SFCs.

As far as the financing is concerned, local governments in India have heterogeneous and narrowly based taxation powers. Octroi is a leading source of taxes in Octroi-levying States which include Maharashtra, Orissa, Gujrat, and the like. Property tax is also an important local government tax in India. Other important local government taxes comprise of the profession tax, entertainment tax, advertisement tax, surcharge on stamp duty, and motor vehicles tax. However, these taxes including user charges only finance less than 10 percent of the local government's expenditures. Remaining local government financing is dependent on grants from states and the union. SFCs provide a basis for sharing resources between states and the local government. Moreover, the 14th Finance Commission also linked the union grants to local governments with SFCs.

State Finance Commission

The Constitution of a State Finance Commission (SFC) is mandated in Article 243-I (1) and 243-Y (1) of the 73rd and 74th Constitutional Amendment Act (CAA), 1992. SFCs are required to review the financial position of local bodies (i.e., Panchayats and Municipalities) and to make recommendations regarding:

a) the principles which should govern:
   (i) the distribution between the State and the local bodies of the net proceeds of the taxes, duties, tolls and fees leviable by the State, which may be divided between them under this part and the allocation between the local bodies at all levels of their respective shares of such proceeds;
   (ii) the determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by, the local level governments;
   (iii) the grants-in-aid to the local bodies from the Consolidated Fund of the State;
b) the measures needed to improve the financial position of local bodies; and
c) any other matter referred to the Finance Commission by the Governor in the interests of sound finance of the local level governments.

The Constitution provides for the setting up of SFCs within one year of the commencement of the Constitution (73rd Amendment) Act 1992, and, thereafter, at the expiry of every fifth year. Therefore, as per Constitutional provisions, setting up of a fifth SFC became due in the year 2014-15 for all States. Available information shows that only six States have constituted their fifth SFC. Although eleven states have constituted their fourth SFC, there are many which are yet to constitute their fourth as can be seen from Table 23. A number of states are still in their 3rd and 2nd SFCs. As a result, the latest SFC constituted across States (barring one state) ranged from the second SFC to the fifth. Thus there is considerable divergence between Constitutional provisions and workings of the SFC on ground.

Table 23: Status of Constitution of State Finance Commissions

States	State Finance Commission				
	5th	4th	3rd	2nd	1st
Assam, Bihar, Himachal Pradesh, Kerala, Rajasthan and Tamil Nadu (6)	√				
Andhra Pradesh, Haryana, Madhya Pradesh, Maharashtra, Odisha, Punjab, Sikkim, Tripura, Uttar Pradesh, Uttarakhand, and West Bengal (11)		√			
Chhattisgarh, Gujarat, and Karnataka (3)			√		
Arunachal Pradesh, Goa, Jharkhand, Manipur, and Nagaland (5)				√	
Jammu & Kashmir (1)					√

Source: Various State Finance Commission Reports
Note: Figures in parenthesis refer to the number of States

While reviewing the performance of SFCs in its report, the Thirteenth Finance Commission recommended measures to strengthen their functioning. More recently, a task force was constituted by the Ministry of Panchayati Raj, Government of India, to suggest measures to strengthen SFCs to enable them to perform their functions as envisaged in the 73rd and

74th Constitutional Amendment Act (CAA). The Fourteenth Finance Commission recommended that the basic grant component of local body grants for gram panchayats should be distributed among them, using the formula prescribed by the respective SFCs for the distribution of resources. Similarly, the basic grant for urban local bodies will be divided into tier-wise shares and distributed across each tier, namely the municipal corporations, municipalities (the tier II urban local bodies), and the nagar panchayats (the tier III local bodies) using the formula given by the respective SFCs. The Commission further recommended that the State Governments should apply the distribution formula of the most recent SFC, whose recommendations have been accepted.[20] This approach in a way puts pressure on the State governments to ensure periodic appointment of SFCs.

Vertical Distribution: Despite the core ToR of all SFCs remaining more or less the same (i.e., the principles which should govern the distribution, between the State and the local bodies, of the net proceeds of the taxes, duties, tolls and fees leviable by the State, which may be divided between them under this part, and the allocation between the local bodies at all levels of their respective shares of such proceeds), the State Finance Commissions have not been uniform in their approach towards the definition of divisible or the shareable pool of resources. The divisible pool differs across States and Commissions, even when the TORs are unambiguous as to what is shareable. In determining vertical devolution, some SFCs have recommended devolution of a percentage of own tax revenues of the state, while others have recommended a share of own revenues (i.e., own tax and own non-tax revenues). There are some that recommended devolution of total revenues of the state, inclusive of the state's share in central transfers, and in case of Kerala, the SFC recommended sharing a part of plan resources with local governments, in addition to a share of state's own tax revenues. Thus, the composition of divisible pools have varied across SFCs, thereby, making comparison of SFC awards across local bodies difficult.

Not only is the composition of the divisible pool different across SFCs, the quantum of transfers recommended also varies widely. Panchayats and municipalities are in the Directive Principles of State Policy and are under State's Jurisdiction. The 73rd and 74th Constitutional Amendments do not supersede that position. Since centrality of State governments in deciding the process of decentralisation continues even after the 73rd and 74th Constitutional Amendment, our approach remained sensitive to this aspect. This does not imply an argument for a "one size fits all" policy for the local governments. However, as own source revenues of local bodies are very small and most of the central funds are tied in

[20] The Commission prescribed that in case the SFC formula is not available, then the share of each gram panchayat should be distributed across the entities using 2011 population with a weight of 90 percent and area with a weight of 10 percent; and in the case of urban local bodies, the share of each of the three tiers will be determined on the basis of population of 2011 with a weight of 90 per cent and area with a weight of 10 per cent, and then distributed among the entities in each tier in proportion to the population of 2011 and area in the ratio of 90:10.

nature, the argument is raised to highlight the importance of vertical sharing of resources from the SFC, which are important sources of untied funds to them.

Horizontal Distribution: The horizontal sharing of funds recommended by the SFCs between PRIs and ULBs in most States is on the basis of rural and urban population or on a composite index comprising of various indicators, viz., population, SC/ST population, density of population, area, percentage of illiterates, percentage of people below poverty line, and population per hospital bed. Two important observations can be made from the analysis of the criteria for horizontal distribution: (i) The share of PRIs is dominant in most States except Uttar Pradesh and Maharashtra; (ii) the share of PRIs is more than 65 percent in most States except Gujarat, Maharashtra, Uttar Pradesh, Tamil Nadu.

For horizontal distribution of resources within each tier (namely, GP, PS , ZPs), the SFCs have used a number of indicators like population, area, SC/ST population, illiterates/literacy gap/literacy rate, number of BPL families, proportion of Yellow Card holders. For ULBs (i.e., municipal corporations, municipalities, nagar panchayats), the criteria used include population, area, SC/ST population, illiterates/literacy gap/literacy rate, slum population, revenue effort, gender ratio, number of BPL families, backwardness index, population density, etc.

LOCAL GOVERNMENT SYSTEM IN PAKISTAN

In Pakistan, local governments have been a somewhat neglected tier of government, with the exception of the Devolution Plan 2001. The history of decentralized governance in the country had a unique feature until 2010 since all the local government reforms were initiated by non-representative military regimes. The first local government (LG) system was introduced under the Basic Democracy Ordinance (1959) by the military government. While this ordinance assigned some functions, ranging from basic health, social welfare to infrastructure to the LG, a few could be performed due to lack of fiscal capacity. The system was rolled back after the change of government[21].

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

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

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

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

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

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

Local Government Financing

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

The Octroi and Zila tax (OZT) was abandoned in 1999. To offset the loss of revenues of the local councils it was decided to levy 2.5 percent additional sales tax (over and above the existing GST of 12.5 percent at that time) for payment to provincial governments. From 1999, the federal government provided a grant to local governments through provincial governments, till 2006. The OZT grants were transferred separately to provincial governments based on their base year amount, which was much lower than the actual collection under one-sixth of GST goods. On the demand of the provinces, these grants were enhanced to one-sixth of the sales tax and were added in the divisible pool of transfers under DRGO 2006. From 2006-07 to 2009-10, the NFC transfers to provinces clearly mentioned the OZT grants in the divisible pool as one-sixth of the GST. However, the equivalent amount was deducted from the provincial share in the divisible pool instead of grants from federal government, and was directly transferred to local governments.

During the deliberations for the 7th NFC Award, it was decided that there was no need to create two divisible pools; one for OZT grants and other for horizontal distribution of

revenues. Therefore, OZT grants were merged in the provincial divisible pool and their share was appropriately adjusted. Since then, the ear-marking of OZT grants to local governments has been discontinued by the provinces, except for Khyber Pakhtunkhwa, which is against the spirit of 7th NFC Award.

Provincial Finance Commissions

A review of PFC awards during 2003 to 2010 indicates large variations in vertical and horizontal distributions of resources. These variations range from the formation of divisible pool, retained and allocable shares, and the criteria for horizontal distribution.

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

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

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

Interestingly, the provinces included several elements in their PFC criteria in line with the position they took on the NFC. For instance, in order to strengthen its case of including tax collection as a criterion in NFC, Sindh was the only province that introduced tax collection for horizontal distribution. Balochistan used area as an indicator for horizontal distribution

to make a strong case for adding area as a criterion in NFC award. In contrast, Khyber Pakhtunkhwa and Punjab followed the lag infrastructure and development need, respectively.

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

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

Table 24 presents the horizontal distribution under the Interim Punjab Finance Commission Award, 2017. It shows that almost 70 percent of the local government share is allocated to the District Education Authority[22], while another 16 percent is to the District Health Authority. Only 12.8 percent is allocated to the elected local governments such as Metropolitan Corporations, Municipal Corporations, Municipal Committees, and District Councils.

Table 24: Horizontal Distribution under Interim PFC Award Punjab, 2017 (%)

District Education Authority	66.9
District Health Authority	16.0
MC/MUC/DC	12.8
Union Councils	4.3

The Award named divisible pool transfers as general-purpose grants. These grants aim to achieve fiscal equalization through equitable horizontal distribution for reducing the gap in the provision of comparable level of public services. The criterion for distribution of the grants is based on a mix of population, per capita expenditures in base year, and various need indicators.[23] Poverty and inverse population density are common indicators while rest differ across different authorities. For instance, education related indicators are used to distribute resources for the District Education Authority. Apart from general purpose

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

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

grants, the Award specifies three other grants namely the transition grant, development grant, and grants for union councils, which will receive 4.3 percent of the divisible pool.

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

In conclusion, a review of fiscal decentralization at local government level indicates a strong message in both countries - fiscal empowerment of local government is heavily dependent on the discretion of state/provincial governments. These state/provincial governments have a greater tendency of centrality of power for the provision of public goods and services, and control of resources. In that context, a one size fits all decentralization approach is also not desirable. but our analysis shows that differences in approaches of various SFCs/PFCs are not really based on the rationale and objective of fiscal decentralization.

As far as operational aspects are concerned, it is observed that despite the statutory provisions, there is delay in the timely constitution of the SFCs/PFCs in provinces in Pakistan and many States in India. Another important aspect of the findings is the difference in the treatment of the divisible pool by the individual PFC/SFC across Provinces/States. Despite clear legislations, different SFCs/PFCs have defined divisible pools according to their own judgment, making comparison of awards across SFCs/PFCs extremely difficult.

8 Conclusion and Policy Recommendations

Fiscal federalism has been on the forefront of policy debate in many developing countries and Pakistan and India are not exceptions to this trend. Both countries inherited the legacy of fiscal federalism, rooted in the combined Indian Act 1935 and the Cabinet Mission Plan 1946. However, after the independence despite having similarities, each country created its own diverse path. An analysis of more than 70 years of this journey offers many useful insights for future policy choices, based on learning from experiences across the border. This synthesis report has provided a summary of these experiences and policy choices. This particular chapter provides an overview of the key messages that emerged from the analyses and subsequently, offers some policy choices.

As per the Constitution, India is a 'Union of States' and not a federation, in a strict sense. While as per the 1973 constitution, Pakistan is a federation. Both countries have a three-tier government structure. Local level decentralization is sub-national responsibility. The experience of sub-state decentralisation varies across States/provinces. The constitutions in both countries clearly outline revenue and expenditure assignments for the top two tiers of government. Revenue assignment in India and Pakistan have various similarities, however, the biggest difference is the treatment of sales tax. In India, since partition, sales tax on goods was a state tax, while the relatively new sales tax on services was a federal tax, until the introduction of GST in VAT mode. In contrast, as per the Constitution of Pakistan 1973, sales tax on goods is a federal tax and the relatively new sales tax on services is a provincial one.

Given that the sales tax on goods is a buoyant tax, difference in tax assignment has resulted in parallel difference in tax collection. In India, States' own revenues are 6 percent of the GDP, while in Pakistan provincial revenues are hardly one percent of the GDP. This variation is also reflected in overall tax-to-GDP ratio. In India on average, the overall tax-to-GDP ratio is 16 percent while in Pakistan it has recently reached to 12.5 percent of the GDP. Moreover, provincial governments in Pakistan are more dependent on the federal government compared to States in India in relation to the Union government. Much like the revenues, States in India also have higher spending powers compared to provinces in Pakistan. However, both Indian states and Pakistan's provinces require intergovernmental fiscal transfers to finance their spending.

The Finance Commission (FC) in India and National Finance Commission (NFC) in Pakistan are the constitutional bodies that recommend the design of intergovernmental transfers and grants. In India, the FC is a technical body largely comprised of experts and headed by a

senior or retired government official – it functions as an independent agency. In Pakistan, the NFC is an intergovernmental forum represented by federal and provincial governments along with a non-statutory/technical member from each province – the award requires consensus from all members.

Both FCs in India and NFCs in Pakistan have evolved over time, having fewer divisible pool taxes earlier and moving on to having almost all federal/ Union taxes in the divisible pool. The 14th FC in India assigned 42 percent of the divisible pool taxes to states, while the 7th NFC award assigned 57.5 percent of the divisible pool taxes to provinces. After receiving the transfers and grants, share of States in total revenue have reached 70 percent in India, while in Pakistan federal and provincial governments have almost equal shares in total revenues.

Both countries have horizontal fiscal inequalities. However, the FCs and NFCs have used different mechanisms to address these inequalities. Indian FCs adopted a complex mechanism consisting of four sets of indicators namely fiscal needs, performance, fiscal disability and equity to address these inequalities while the NFC in Pakistan adopted the simplest approach based on population – a proxy of fiscal need. Often divisible pool transfers have been augmented with grants for relatively backward States/provinces. The trend in various equalization measures in India and fiscal equalization index in Pakistan, highlight the positive role of intergovernmental transfers and grants in addressing fiscal inequalities.

An alarming message emerges from the analysis is the vulnerable position of local governments in both countries that largely depends on the discretions of States/provinces. In both countries, provincial or States' governments have leaned towards centralization. This is reflected by the fact that despite the statutory provisions, there have been delays in the timely constitution of the SFCs/PFCs in provinces in Pakistan and many States in India. Moreover, despite clear legislations, different SFCs/PFCs have designed the pool of shareable resources according to their own preferences.

Finally, intergovernmental transfers have played an important role in the socioeconomic development of the country. In India, long-term trends show improvements in key education and health indicators, as well as, improvement in the availability of electricity. In Pakistan, improvement in selected education and health indicators is visible since 2000 but the pace of development slowed down after 2008 when local government were made almost dysfunctional.

Regarding gender differential outcomes, MGNREGS in India has a clear gender focus and empirical estimates indicate that the scheme has contributed to enhance labour-force

participation of women. In the case of Pakistan, the link between public spending on social services and gender equality in education and employment was explored through a composite index. The results display a positive elasticity but with small magnitude, implying that more efforts are needed to achieve gender parity.

POLICY RECOMMENDATIONS

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

- The vertical fiscal imbalance and intergovernmental fiscal transfer are the integral part of the federal system of governance. Both India and Pakistan largely used unconditional transfers to address vertical fiscal imbalances. The analyses show a positive impact of these unconditional transfers on socioeconomic development. Therefore, it is recommended that FCs and NFCs should continue untied and transparent intergovernmental transfers to address vertical imbalances.

- FCs in India and the 7th NFC in Pakistan used multiple criteria to address horizontal fiscal inequalities, which played a pivotal role in addressing horizontal disparities. Therefore, it is recommended that multiple criteria for horizontal distribution of resources be continued in future.

- Integrating gender-sensitive criteria in the design and mechanism of fiscal transfers is important in achieving development outcomes. Therefore, an explicit gender-sensitive criterion needs to be introduced for horizontal distribution of resources.

- Comparative analysis of both countries highlights data challenges and data gaps. For instance, while India has official estimates of State level GDP, it is lacking in Pakistan. Timely availability of socioeconomic data is also a challenge. Therefore, ensuring availability of relevant macroeconomic and social sector data at the provincial/State level would be beneficial for evidence based and effective policy choices.

- While both countries have appropriate legislations for intergovernmental fiscal transfers from State/province to local government. However, in practice, SFCs/PFCs are irregular, delayed and sometimes non-existent. Strengthening and timely constitution of the SFCs/NFCs is crucial for better social service delivery.

- Local level data in both countries is sketchy; therefore, creation of credible data based on local finances is essential for any meaningful analysis of their financial and operational performance. Non-availability of reliable and audited data relating to local governments majorly limits functioning of the SFCs/PFCs.

- The comparative analysis shows differences in tax assignments of sub-national governments resulted in large vertical imbalances. The vertical imbalance in Pakistan is more striking than India. Literature on fiscal federalism documents growing evidence that large vertical fiscal imbalances are a threat to fiscal stabilization and efficiency. Therefore, the overall level of own-taxes of both State/provinces and local governments should be increased. Particularly, strengthening fiscal autonomy of local governments in both countries by appropriate tax assignment is needed.

- Progress on the SDGs in a federal country is a shared responsibility of all tiers of government. Since a large number of SDG goals, as per expenditure assignment in these two countries, come under the domain of sub-national governments, strengthening their resource position of critical importance. Considering the existence of large vertical fiscal imbalances in both countries, strengthening federal fiscal system would help improve the resource position at the sub-national level to achieve SDGs. This requires evidence-based policy research at the sub-national level, linking SDGs to sub-national finances and fiscal transfers.

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