IMPLICATIONS OF THE NEW NATIONAL FINANCE COMMISSION

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July 1995

SOCIAL POLICY AND DEVELOPMENT CENTRE

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The President of Pakistan has recently constituted the National Finance Commission (NFC) under Article 160 of the 1973 constitution. The present NFC Award of 1990 is due to expire on the 30th of June 1996, after being in operation for five years. The government has by this action demonstrated its commitment to preserving the continuity in inter-governmental fiscal relations in the country. Therefore, the constitution of the NFC is a timely and welcome stop.

According to the press release notifying the constitution of the NFC the federal minister of finance (the portfolio held by the Prime Minister) will be the chairperson of the Commission while the members are the finance ministers of the four provinces, the advisor to the Prime Minister for Finance and Economic Affairs and four non-official members. The federal finance secretary is expected to act as the official expert.

The terms of reference (TOR) given to the Commission by the President are as follows:

a) The distribution between the Federation and the provinces of the net proceeds of the taxes given below.

   i) Taxes on income, including corporation tax, but not including taxes on income consisting of remuneration paid out of the Federal Consolidated Fund.

   ii) Taxes on the sale and purchase of goods, imported, exported, produced, manufactured or consumed.

   iii) export duties on cotton

b) The making of grants-in-aid by the federal government to the provincial governments.

c) The exercise by the federal government and the provincial governments of the borrowing powers conferred by the constitution.

d) Examine the question of continuation of payment of royalties on crude oil and of surcharge on natural gas collected by the federal government to the provincial governments.

e) Any other matter relating to finance referred to the commission by the President.

Before we proceed to comment on the above TOR, it is useful to trace through the evolution of revenue sharing arrangements in the country. Table 1 gives composition of the divisible pool) taxes which were shared between the two levels of government and the proportion in which these were shared. It seems that the trend, with the exception of the 1974 NFC award, has been to increase revenue transfers to the provinces. In the first five awards, upto the 1974 award, this was achieved by sharing fewer taxes but by an increase in the provincial share in the divisible pool taxes. In the 1990 NFC award a change in strategy was apparent and expansion was achieved through inclusion of new taxes, specifically excise duties on some commodities in the pool.

TABLE 1

EVOLUTION OF REVENUE SHARING ARRANGEMENTS
[*Divisible Pool Taxes*]

Divisible Pool		SHARED REVENUE SOURCES[a]					
		Raisman 1951	**NFC 1961-62**	**NFC 1964**	**NFC 1970**	**NFC 1974**	**NFC 1990**
A.	INCOME TAX[a]						
	! Personal	50%	50%	65%	80%	80%	80%
	! Corporate	)	50%	65%	80%	80%	80%
B.	SALES TAX	50%	60%	65%	80%	80%	80%
C.	EXCISE DUTIES						
	! Tea	100%	60%	65%	80%	)	)
	! Tobacco	100%	60%	65%	80%	)	80%
	! Sugar	)	)	)	)	)	80%
	! Betelnut	100%	60%	65%	80%	)	)
D.	EXPORT DUTIES						
	! Cotton	)	100%	65%	80%	80%	80%
	! Jute	)	100%	65%	80%	)	)
E.	ESTATE AND SUCCESSION DUTIES	)	100%	)	100%	)	)
F.	CAPITAL VALUE TAX ON IMMOVABLE PROPERTIES	)	100%	)	100%	)	)

[a] Share of the provinces.
[b] Excluding taxes on income consisting of remuneration paid out of federal consolidated fund.

Table 2 gives the implied current transfers to the provinces under the different awards. This indicates that successive awards (with the exception of the 1974 NFC award) have tended to increase provincial access to federal tax revenues. In addition, the 1990 NFC extended the principle embodied in Article 161 of the Constitution which provides for transfer of royalty on natural resources to the province of origin by the inclusion of surcharge on natural gas and royalty on crude oil. As such, there has been an effort towards decentralisation of the fiscal base and greater transfers to the provincial governments in Pakistan which have over the years played an increasingly important role in the provision of basic social and economic services like education, health, irrigation, roads etc. in the country.

We now analyse some of the major implications of the TOR.

TABLE 2

TOTAL FEDERAL TRANSFERS[?] TO PROVINCES UNDER VARIOUS REVENUE SHARING AWARDS, 1993-94

	Divisible Pool Transfers to Provinces [*Rs in Million*]	**Divisible Pool Transfers to as % of Federal Tax Revenues**
Raisman Awards [1951]	26750	12.8
National Finance Commission Award [1961-62]	48015	23.1
National Finance Commission Award [1970]	56183	27.0
National Finance Commission Award [1970]	69628	33.4
National Finance Commission Award [1974]	62028	29.8
National Finance Commission Award [1991]	73528	35.3
[?] Gross revenue including costs of collection.		

Federal Transfers to Provinces

A study of the TOR of the newly established NFC shows a clear reversion from the trend described above in so far as the size of the divisible pool is concerned. In fact, the newly announced divisible pool of taxes is identical to the 1974 NFC award. Its implementation would imply a decline in transfer to the provinces of over Rs 11 billion at the 1994-95 fiscal base (see table 3). That is, if transfer to the provinces had taken place in accordance with the newly announced divisible pool, (assuming unchanged shares of the federation and the provinces) the provinces would have received over 13 percent lower transfers in 1994-95 than they actually did. Transfers to the province of Punjab, Sindh, NWFP and Balochistan would be lower by Rs 6.4 billion, Rs 2.6 billion, Rs 1.6 billion and Rs 0.6 billion respectively.

Furthermore, clause(d) of the TOR states that the NFC will also "examine the question of continuation of payment of royalties on crude oil and surcharge on natural gas". As such, it appears that there may also be a possibility of discontinuation of these straight transfers provided to the provinces under in the 1990 NFC award. These aggregated to over Rs 9 billion in 1994-95 as shown in Table 3. Discontinuation of these would lead to a revenue loss of as much as Rs 4.6 billion and Rs 3.7 billion to the provinces of Balochistan and Sindh respectively which are the main beneficiaries of these transfers.

TABLE 3

FEDERAL TRANSFERS TO THE PROVINCES
1994-95

(Rs in Billion)

	Punjab	**Sindh**	**NWFP**	**Balochistan**	**Total**
UNDER 1990 NFC AWARD	**50.3**	**24.8**	**11.5**	**11.1**	**97.7**
! Divisible Pool Transfers	48.9	19.7	11.5	4.5	84.6
! Straight Transfers[?]	1.4	5.1	)	6.7	13.1
UNDER 1974 NFC AWARD[??]	42.9	18.5	9.9	6.0	77.1
! Divisible Pool Transfers	42.5	17.1	9.9	3.9	73.4
! Straight Transfers	0.4	1.4	)	2.1	3.8
TOTAL DECREASE IN TRANSFERS	7.4	6.3	1.6	5.2	20.5
! Decrease in Divisible Pool Transfers	6.4	2.6	1.6	0.6	11.2
! Decrease in Straight Transfers	1.0	3.7	)	4.6	9.3

SOURCE:

! Explanatory Memorandum on the Budget, 1995-96.

! Government of Pakistan, Finance Division, Islamabad.

? Payments of royalties, surcharges and excise duty on either gas or oil transferred to the provinces on the basis of collection have been referred to as straight transfers in the Report of NFC, 1990.

?? As noted the TOR of the New NFC implies provisions very similar to those of the 1974 NFC Award.

On the whole, the TOR of the new NFC provides for substantially lower federal transfers to the provinces than they are currently receiving. The total decline can potentially be as high as Rs 20.5 billion. As such, how this will be acceptable to the provincial governments is not clear?

As far as the federal government is concerned the TOR is clearly very favourable. Given that the overall macro-economic environment is not very supportive (the inflation rate is high, the federal tax revenue generation is constrained, the federal budgetary deficit is high and IMF pressures are heavy), the federation wants to retain more revenues than it currently does. This view is further strengthened by the perceptions of profligacy in expenditure and slackening of own revenue generation at the provincial level. Indeed, these have been features of provincial finances in the 80s. During this period provincial current expenditures increased annually at an average rate of over 17 percent while own revenues increased only marginally at the rate of 10 percent.

It needs, however, to be emphasised that the lack of financial discipline at the provincial level was largely a legacy of the delay in the announcement of a new NFC award (the award of 1990 was overdue by 12 years) and the inadequacy of the 1974 NFC award under which revenue transfers continued to take place. Because the provision of 1974 award were inadequate to finance the on-going operations of the provincial governments, there was resort to ad-hoc, discretionary revenue-deficit grants. At their peak in 1987-88, these grants were Rs 17 billion, equivalent to about 2 percent of the GDP and financed over one-fourth of provincial current expenditures. Access to residual revenue deficit grants distorted provincial fiscal behaviour by providing an incentive to increase expenditure, lower fiscal effort, show a higher revenue deficit and thereby get a higher federal grant. Also, the federal government took over the responsibility of provision of some provincial responsibilities as contained in the Concurrent List of Constitution like SCARPS, flood control, fertiliser subsidy, universities etc.

The 1990 NFC award eliminated this distortionary incentive environment by increasing federal transfers and eliminating revenue-deficit grants. It is, therefore, important to see whether or not provincial fiscal management improved in the post 1990 NFC era? One simple way of looking at this is to compare the actual fiscal position of each province with that projected at the time of the announcement of the 1990 NFC award. These projections are contained in the NFC Report, 1990. By and large, the final fiscal position of the three bigger provinces is better than that expected at the time of the announcement of the 1990 NFC award. Punjab has improved its final fiscal position by controlling its expenditures to a level lower than it was expected to, generating higher own revenues and also getting somewhat higher federal transfers than projected. Sindh has shown improvement in the fiscal position largely through generating higher own revenues and getting higher federal transfers. However, the province has made little attempt at controlling expenditure below the projected level.

NWFP has been partially successful in controlling its expenditure to a level below it was expected to, has raised more revenues and has thereby shown improvement in the final fiscal position even though federal transfers have been lower than expected in some years. Balochistan is the only province where the final fiscal position is worse than projected due to an inability of the provincial government to adhere to projected levels of expenditure and own revenue generation coupled with a lower federal transfer than expected.

Therefore, the story of financial management at the provincial level is, by and large, an encouraging one. Even though all is not well yet, the provinces are increasingly becoming aware of the issues and solutions to them and the trend is towards improvement. The 1995-96 budgets are an example of this. All the four provincial governments have announced substantial taxation proposals even though the federal fiscal effort was unexpectedly low. Punjab, Sindh, NWFP and Balochistan propose to generate additional revenues of Rs 750, 480, 63 and 40 million respectively in 1995-96. On the expenditure side, it is encouraging to see that the growth rate of non-development expenditure is lower in the post 1990 NFC era in the case of all provinces than in the decade of the 80s.

Provincial Fiscal Status

With the new revenue-sharing arrangements in the offing, what is the likely future fiscal fate of the provincial governments? The pertinent question is that if the 1974 NFC provisions became inadequate in the 80s, what impact will a replication of it have on provincial finances now? As already noted, the TOR of the newly announced NFC is similar to the provisions of 1974 NFC award. Table 4 presents the extent of revenue losses to the four provincial governments if the provisions of 1974 NFC award were operative. On the whole, provinces would have lost 20 percent of their general revenues receipts. This clearly would have affected the provincial fiscal positions substantially. In fact, the provinces would have had a revenue deficit of about Rs 12 billion, as opposed to a surplus currently of about Rs 9 billion combined. In this scenario to attain a break-even position on the revenue account, the provinces will either have to enhance own revenues substantially or depend on federal grants from the federal government or both. The former is next to impossible because it implies 123 percent increase in own revenues immediately (see table 4). Provinces in Pakistan have been allocated residual fiscal powers and most of the buoyant and broad based taxes like income tax, sales tax, customs and excise duty have been pre-empted by the federal government.

TABLE 4

EXTENT OF REVENUE LOSS TO THE PROVINCES DUE TO THE DECLINE IN FEDERAL TRANSFERS 1993-94

(Rs in Billion)

Province	Potential Reduction in Federal Transfers[a]	Potential Reduction in Transfers as % of Provincial General Revenue Receipts[b]	Potential Reduction in Transfers as % of Provincial Own Revenues[c]
PUNJAB [R]	7.4	13.9%	71.1%
SINDH [PA]	6.3	23.9%	152.1%
NWFP [R]	1.6	9.0%	95.5%
BALOCHISTAN [R]	5.2	50.0%	1108.7%
TOTAL	**20.5**	**19.0%**	**123.5%**

SOURCE:
Annual Budget Statements of the Provinces.
Table 3.

[a] Potential reduction implied by the TOR of the newly constituted NFC.
[b] General Revenue Receipts include provincial own revenues, federal tax assignments, federal non-development grants and profits from hydro electricity.
[c] Own Revenues includes provincial tax and non-tax receipts.

On top of this, federal government has over the years demonstrated a tendency of encroaching on tax bases which fall under the domain of the provincial governments. For example, sales taxation of services has been included in provincial fiscal powers. However, the federal government has found an alternative route of tapping this tax base by levying excise duty on services. Initially it introduced an excise duty on telephones and then slowly the net was extended to include bank advances, travel agents, advertising agents etc. In the federal budget 1995-96 excise duty has further been extended to include other professional services like architects, chartered accountants, shipping agents etc.

The other way of restoring the provincial resource position is to allow access to federal grants to finance the fiscal gap created by the imbalance in the allocation of fiscal powers and expenditure responsibilities to the provincial governments. As is clear from table 4 that this is a large magnitude, even if provinces put in a higher resource mobilisation effort. In this option also the federal government will have to finance a substantial proportion of provincial expenditures but with one major difference. Unlike revenue sharing transfers which are mandatory and constitute a legislative claim of the provincial governments on the federal government, grants in Pakistan are generally discretionary and have been in the past used as political levers. Therefore, this option may seriously undermine provincial autonomy.

Provision of Services

If the resource position of the provinces deteriorates due to the reluctance of the federal government to give enough grants to fill the fiscal gap remaining even after higher provincial own effort then this will have a direct bearing on the provision of social and economic services which are prime provincial responsibilities. The worst casualty would be the Social Action

Programme (SAP) the implementation of which is primarily a provincial responsibility. As it is, lack of adequate recurring expenditure provisions has constrained successful implementation of SAP in the provinces. It is thus clear that the strong squeeze on provincial resource position implied by the TOR of the new NFC strongly conflicts and negates the government's commitment to the successful implementation of SAP in the country.

In conclusion, the new NFC will lead to a substantial reduction in the divisible pool transfers to the provinces and therefore deteriorate the fiscal position of the provincial governments. This will adversely effect the quantity and quality of service provision in the country and in particular will be a cause of a great setback to the SAP.

However, viewed from the other side of the table, the federal government's point of view of this whole issue of revenue sharing cannot be ignored. It shares income and sales taxes, the most buoyant and fast growing taxes with the provinces. Reforms in taxation structure are increasing the revenue significance of these taxes substantially. The government is committed to bring down import tariffs which will lead to substantial revenue losses. Further development of sales and income taxes is the prime feasible option to compensate the government for this revenue loss but, given the current revenue sharing arrangements, 80 percent of the benefit of this federal effort will be transferred to the provinces. Furthermore, the federal government has the primary responsibility of controlling the consolidated budgetary deficit and retire and service huge borrowings undertaken to finance development activities (including those of the provincial governments) in the country. Therefore, it wants to retain more of the revenues it generates and in particular is unwilling to share revenues from excise duties with the provinces. The federal government dilemma is understandable.

There are, one feels, two possible options to relieve the pressures on federal finances without significantly affecting the revenue position of the provincial governments. First, if the 1990 NFC provisions are continued beyond 1995-96, then the federal government could hand back the Concurrent List functions it took over from the provinces in the 80's prior to the announcement of the 1990 NFC. This will significantly reduce federal expenditure liabilities.

The provincial governments will shoulder these additional responsibilities by economizing on unproductive expenditure and generation of higher own revenues.

Second, the divisible pool may be expanded to include all federal taxes (including customs and excise duty) with a more equal sharing of the pool by the two tiers of governments. The merit of this option is that the revenue loss from custom duty and revenue gain from sales income tax reforms will be shared by both levels of government. It will also eliminate the distortionary incentive environment existing in the country which has forced the federal government to develop taxes outside the divisible pool to retain revenue gains. An example of this is the extension of federal excise duty net to unconventional areas like telephones, services, etc.

The above options have the advantage that both tiers of government give some and get some. It is important that the provincial governments are not the only losers in the process of negotiating a new revenue sharing formula otherwise the fate of the new NFC will not be very different from the 1979 and 1985 NFCs which were unable to announce an award due to a lack of consensus.