Research Report No. 8

NATIONAL FINANCE COMMISSION: 1995 INTER-GOVERNMENTAL REVENUE SHARING IN PAKISTAN

SOCIAL POLICY AND DEVELOPMENT CENTRE

NATIONAL FINANCE COMMISSION: 1995

INTER-GOVERNMENTAL
REVENUE SHARING IN PAKISTAN

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FORWARD

The ***Social Policy and Development Centre (SPDC)*** has recently been established as a non-governmental institution with the objective of focusing on social sector research and policy analysis in Pakistan. The goal of ***SPDC*** is to support the process of meeting basic human needs consistent with the national goal of social development.

In an effort at dissemination of its research, ***SPDC*** has prepared this report in the context of the recently constituted National Finance Commission on federal revenue sharing transfers to the provincial governments. Provincial governments in Pakistan have the principal responsibility for delivery of social services like education, health, water supply and sanitation, etc. which are largely financed by fiscal transfers from the federal government. The reports contains papers on the evolution of revenue sharing in Pakistan, comparison with international practice, evaluation of some recent changes, implication of some impending changes, the federal perspective and the respective provincial positions on revenue sharing.

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EVOLUTION OF REVENUE SHARING ARRANGEMENTS

The history of revenue sharing in the sub-continent can be traced back to pre-partition days. Since partition six revenue-sharing awards have been announced in Pakistan. The first award

TABLE 1.1
EVOLUTION OF DIVISIBLE POOL IN VARIOUS AWARDS

	Divisible Pool	SHARED REVENUE SOURCES[a]					
		Raisman 1951	NFC 1961-62	NFC 1964	NFC 1970	NFC 1974	NFC 1990
A.	INCOME TAX[b]						
	• 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%	100%	65%	80%	)	)
E.	ESTATE AND SUCCESSION DUTIES	)	100%	)	100%	)	)
F.	CAPITAL VALUE TAX ON IMMOVABLE PROPERTIES	)	100%	)	100%	)	)

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

was the Raisman award of 1951. This was followed by National Finance Commission awards in 1961-62, 1964, 1970, 1974 and 1990. The last award was delayed for a considerable period. Two NFCs were formed in 1979 and 1985 but no award was announced due to lack of consensus among the federating units. In this paper we trace the evolution of revenue sharing arrangements, in Pakistan highlighting the trend both in the taxes shared between the federal and provincial governments and the basis of distribution among provinces.

1.1 THE DIVISIBLE POOL

Table 1.1 gives composition of the divisible pool - taxes which were shared and the proportion in which these were shared between the federation and the provinces combined in the various Awards. 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, up to the 1974 award, this was achieved by sharing fewer taxes but by an increase in the provincial share in the divisible pool. 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 1.2
SIMULATED TOTAL FEDERAL TRANSFERS? TO PROVINCES UNDER VARIOUS REVENUE SHARING AWARDS IN 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 [1964]	56183	27.0
National Finance Commission Award [1970]	69628	33.4
National Finance Commission Award [1974]	62028	29.8
National Finance Commission Award [1990]	73528	35.3

? Gross revenue including costs of collection.

Table 1.2 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.

1.2 REVENUE SHARING FORMULA

TABLE 1.3
EVOLUTION OF REVENUE SHARING FORMULA AMONG FEDERATING UNITS

Award	Tax	Sharing Criteria (Weight)
RAISMAN 1951	Sales Tax Income Tax & Excise Duties Export Duties	Collection (100%)[?] Preassigned Shares (100%) Preassigned Shares (100%)
NFC 1961-62 NFC 1964	Sales Tax	Collection (30%); Preassigned Shares (70%)
NFC 1970	Others Taxes	Preassigned Shares (100%)
NFC 1974 NFC 1990	All Taxes	Population (100)

Table 1.3 highlights the evolution of revenue sharing formula in Pakistan. The principle of allocation of a portion of the revenues in the divisible pool was recognised in the initial awards. Accordingly, sales tax revenues were distributed by the Raisman award on the basis of collections from the federating units. The exception to this was collection from Karachi port which was allocated on the basis of preassigned shares. The weight of collection was, however, reduced to 30 percent in the subsequent three awards of 1961-62, 1964 and 1970.

For the remainder of revenues, preassigned shares formed the basis of distribution. These shares are given in Table 1.4 and appear to be broadly in line with population shares (as per the last Census prior to the announcement of award), although there are some visible differences. In the Raisman award of 1951 Punjab and Balochistan got a lower share than justified on the basis of their population while Sindh and NWFP got higher shares. In the NFC award of 1970 Punjab's preassigned share was lower than its population share while that of the other provinces was higher.

TABLE 1.4
PREASSIGNED SHARES OF PROVINCES OF PAKISTAN IN VARIOUS AWARDS

(*Percent*)

Province	Raisman 1951	NFC[d] 1961-62	NFC[d] 1964	NFC 1970	NFC 1974	NFC 1990
Punjab	59.39[b] (63.58)	)	)	56.50 (62.23)	60.25 (60.10)	57.87 (57.87)
Sindh	24.14[c] (18.71)	)	)	23.50 (20.45)	22.50 (22.62)	23.29 (23.29)
NWFP	15.32 (14.10)	)	)	15.50 (14.01)	13.39 (13.40)	13.54 (13.54)
Balochistan	1.15 (3.61)	)	)	4.50 (2.31)	3.86 (3.88)	5.30 (5.30)
TOTAL	**100.00**	)	)	**100.00**	**100.00**	**100.00**

Since the NFC award of 1974 collection has been discarded as a criterion for revenue sharing. Also, the use of preassigned shares has been abandoned and reliance is being placed on population shares of the respective provinces. This has tended to mitigate against the interests of the three smaller provinces of Pakistan.

In conclusion, it appears that, by and large, the divisible pool between the federation and federating units has evolved within the broad, highly progressive overriding philosophy of promoting fiscal decentralisation and thereby strengthening the resource base of the provinces and making them more dynamic as service delivery agencies in the country. As opposed to this the revenue sharing formula, has remained stagnant over the last seventeen and whatever changes have been made prior to that have been ad-hoc and opaque. As such, in its deliberations the 1995 NFC should preserve the traditions set by previous NFCs as far as the divisible pool and its sharing between different levels of government is concerned and invoke a dynamic spirit in the revenue sharing formula by make it more progressive, efficient, equitable and forward looking.

INTERNATIONAL PRACTICE OF REVENUE SHARING

Inter-governmental transfers are the dominant source of revenues for subnational governments in most developing countries. The need for inter-governmental transfers arises due to the existence of vertical and horizontal imbalances. Vertical imbalance refers to mismatch between revenue means and expenditure needs at different levels of government, while horizontal fiscal imbalance refers to difference in the gap between revenue raising ability and expenditure needs for a particular level of government. Reasons for these imbalances are as follows:

- i) Inappropriate expenditure and tax assignment;
- ii) limited and or unproductive tax bases, especially at the sub-national level;
- iii) differential net fiscal benefit across regional governments; and
- iv) fiscal inequity and inefficiency.

Differentials in fiscal benefits particularly highlights the problem of difference in natural resources endowment and difference in fiscal capacity among sub-national jurisdictions. In such a situation the higher level of government use its tax transfers and expenditure policies to reduce these fiscal imbalances.

Table 2.1 indicates the share in revenues and expenditure among national and sub-national governments in seven developing countries, both in the absence of and with transfers. The table reveals that from the viewpoint of revenue collection national governments dominate and the share of sub-national governments is small. This is most pronounced in the case of Pakistan where provincial governments generate only 5 percent of revenues. This rises to 6 percent in the case of Indonesia, 10 percent in Malaysia, 32 percent in India and a maximum of 64 percent in Brazil. International comparisons clearly reveal that sub-national governments are generally endowed with few fiscal powers and the effort at resource mobilisation is limited.

TABLE 2.1
EXTENT OF VERTICAL IMBALANCE AND MAGNITUDE OF FISCAL TRANSFERS IN SOME DEVELOPING COUNTRIES
[Percentage]

Heads	Revenue Share Without Transfers	Trans-fers	Revenue Share with Transfers	Expend-iture Share	Surplu/Deficit Without Transf-ers	Surplu/Deficit With Transf-ers
Argentina (1989)						
National	62	-5	57	53	9	4
Sub-National	38	5	43	47	-9	-4
All Levels	100	0	100	100	0	0
Brazil (1990)						
National	36	-2	34	34	2	0
Sub-National	64	2	66	66	-2	0
All Levels	100	0	100	100	0	0
Colombia (1986)						
National	85	-22	63	67	18	-4
Sub-National	15	22	37	33	-18	4
All Levels	100	0	100	100	0	0
India (1989)						
National	68	-24	44	54	14	-10
Sub-National	32	24	56	46	-14	10
All Levels	100	0	100	100	0	0
Indonesia (1990)						
National	94	-12	82	83	11	-1
Sub-National	6	12	18	17	-11	1
All Levels	100	0	100	100	0	0
Malaysia (1991)						
National	90	-3	87	84	6	3
Sub-National	10	3	13	16	-6	-3
All Levels	100	0	100	100	0	0
Pakistan (1995)						
National	95	-28	67	75	20	-8
Sub-National	5	28	33	25	-20	8
All Levels	100	0	100	100	0	0

Expenditure share are higher for sub-national governments, even though national governments general account for the major share in expenditure. The importance of provincial governments appears to be somewhat low in Pakistan and highlights the greater centralisation of functions. However, within the sample of countries covered in table 1, Pakistan appears to have the largest vertical imbalance, followed by Colombia and India. It is not surprising, therefore, that the share of transfers in among the highest for Pakistan. Almost 29 percent of the revenues collected by the national government are transferred through revenue sharing arrangements to sub-national governments in Pakistan, as compared to 35 percent in India, 26 percent in Colombia, 13 in Indonesia and so on.

2.1 CANDIDATE TAXES FOR REVENUE SHARING

Table 2.2 indicates the international practice of revenue sharing in eleven developing countries. The most commonly shared taxes are income tax, followed by sales tax or VAT and excise duties. Out of eleven developing countries income tax is shared in nine countries, where sharing percentage varies from 17 percent to 85 percent. All of these countries except India and Pakistan transfer less than 50 percent of the total collection to lower level of governments.

TABLE 2.2
TAXES SHARED WITH SUB-NATIONAL GOVERNMENTS

Country	Shared Taxes	Percentage
ARGENTINA	VAT	53.90
	Income Tax	48.70
	Asset Tax	49.00
	Excise Tax	49.00
	Financial Service Tax	49.00
	Fuel Tax	53.00
BRAZIL	Income Tax	21.50
	Payroll Tax	66.70
	Tax on Industrial Products	21.50
	Taxes on Hydroelectricity & Minerals	45.00
COLOMBIA	All Federal Tax	23.00
	Beer Tax	40.00
	VAT	50.00
INDIA	Income Tax	85.00
	Excise Duties	45.00
	Estate Duty	100.00
INDONESIA	Royalties on Oil and Gas	70.00
	Forestry Royalties	35.00
JAPAN	Income Tax	32.00
	Liquor Tax	32.00
MALAYSIA	Import and Excise Duties on Oil	30.00
	Export Duty on in, etc.	10.00
MEXICO	Income Tax	17.35
NIGERIA	All Federal Tax	31.50
PAKISTAN	Income Tax	80.00
	Sale Tax	80.00
	Excise Duties on Sugar and Tobacco	80.00
	Excise Duty and Royalty on Gas	100.00
	Surcharge on Gas	100.00
	Profit from Hydro-electricity	100.00
PHILLIPINES	All Federal Taxes	20.00

Sales tax or VAT is shared by five countries. Pakistan being the only country with transfers as high as 80 percent, others sharing around or below 50 percent. As far as the excise duty is concerned more than 60 percent of the selected countries include this tax in their divisible pool. Tax sharing criteria varies from 23 percent to 80 percent, with a median of 32 percent among seven countries. However, Pakistan being the exceptional, all other countries sharing less than 50 percent of excise duties. Lastly, the commonly known straight transfers i.e., taxes like royalty/surcharge on gas and oil, profit from hydroelectricity etc. are shared on the bases of collection in Pakistan followed by Brazil and Indonesia with different criteria of sharing. However, countries like Nigeria and Colombia have opted for a neutral approach, i.e., all federal taxes are included in their divisible pool.

TABLE 2.3
CRITERIA FOR REVENUE SHARING AMONG SUB-NATIONAL GOVERNMENTS

Country	Sharing Criteria	Percentage
ARGENTINA	Population Development Gap Inverse Population Density	65.00 25.00 10.00
BRAZIL	Population Area Per Capita	
COLOMBIA	Population Equal Share	70.00 30.00
INDIA	***Income Tax*** Population Distance of Income Per Capita Collection Backwardness ***Excise Duty*** Population Income Adjusted Total Population Backwardness Distance of Income Per Capita Projected Budget Deficits	 22.50 45.00 10.00 11.25 25.00 12.50 12.50 33.50 16.50
INDONESIA	Collection	100.00
JAPAN	Collection	100.00
MALAYSIA	Collection	100.00
MEXICO	Population Collection	50.00 50.00
NIGERIA	Minimum Responsiblity of Government Populaion Social Development Factor Collection	40.00 40.00 15.00 5.00
PAKISTAN	***All Taxes*** Population ***Straight Transfers*** Collection	 100.00 100.00
PHILLIPINES	Population Land Area Equal Share	70.00 20.00 10.00

SOURCE: Te Reform of Inter-governmental Fiscal Relations in Developing and Emerging Market Economies, World Bank, Policy and Research Series 23

2.2 CRITERIA OF

REVENUE SHARING

As far as the sharing of these taxes are concerned the criteria varies across countries. Table 2.3 shows that population and collection are the most commonly used criterion among state. Countries like Indonesia, Japan and Malaysia practice single criterion for revenue sharing i.e. collection. However, Pakistan is the only country using population as the sole base for revenue sharing. The point to be noted is no other country except Pakistan relies totally on population. Others have assigned weights to population which varies from 25 percent to 70 percent as shown in the table. Apart from this, majority of the countries have adopted multiple criteria; for example, India; which also includes backwardness, distance factor and per capita income, in revenue sharing criteria. Similarly, countries like Argentina, Brazil and Philippines include development gap, land area and equal shares as part of their revenue sharing criteria.

All in all, after studying the international practice of revenue sharing criteria it appears that Pakistan has adopted a very skewed revenue sharing formula with exclusive reliance on population. Inclusion of criteria like backwardness, collection, equal share and land area in the revenue sharing could also be considered. However, while constructing the divisible pool, factors like difference in fiscal capacity and natural resource endowment should not be ignored. Also, the exclusion of excise duties from the TOR of new NFC appears to be in contrast with international practice as the international comparison clearly indicates that seven out of eleven countries includes this tax in revenue sharing.

AN EVALUATION OF THE 1990 NFC AWARD

The tenure of the 1990 National Finance Commission (NFC) award is to end in June 1996. The new NFC has already been constituted by the President of Pakistan to review revenue-sharing arrangements between the federation and the federating units. In fact, the first meeting of the newly constituted NFC has already been held on 27th December 1995. It is thus time to evaluate the 1990 NFC award and see its dynamic budgetary consequences on both the provincial and federal governments. Was the 1990 award too liberal in transferring resources from the federal to the provincial governments? Did it have any structural impact on public finances? Did it remedy some of the distortions existing in provincial finances? and finally did it severely affect the federal financial position? We address these questions in this article.

TABLE 3.1
DIVISIBLE POOL TRANSFERS TO THE PROVINCES
[*Rs in Billion*]

Heads	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96
Divisible Pool Transfers	**32.1**	**47.5**	**54.4**	**69.4**	**84.6**	**102.2**
Export Duty on Cotton	2.6	1.5	0.4	0.3	0	0
Taxes on Income	14.3	19.4	25.5	33.7	40.7	50.1
Taxes on Sales	15.2	16.3	18.2	24.4	32.7	37.6
Sugar	)	3.4	3.9	4.2	4.3	5.0
Tobacco	)	6.8	6.4	6.8	6.9	9.5
Straight Transfers	**1.7**	**10.4**	**10.7**	**12.2**	**13.1**	**10.2**
Royalty on Crude Oil	)	1.1	1.0	1.1	1.0	1.0
Surcharges on Gas	)	7.4	7.7	8.7	8.4	4.1
Excise Duty on Natural Gas	1.1	1.2	1.3	1.5	2.6	3.2
Royalty on Natural Gas	0.5	0.6	0.6	0.9	1.1	1.4
Profit from Hydro-Electricity	)	6.1	6.3	6.6	7.9	8.1

The NFC award of 1991, under which revenue transfers are currently taking place, was acclaimed to be a historic achievement of the previous government. Among the special features of the award is that it increased revenue sharing transfers (see Table 3.1) to the provinces and thereby promoted fiscal decentralisation. In fact, the common perception, particularly at the federal level, is that the award transferred too many resources to the provinces. In 1991-92, the first year of implementation of the award, for example, revenue sharing transfers to the provinces increased by Rs 25 billion. However, this was partly neutralised by a number of factors over which the provincial governments had little or no control. First, there was a steep decline in other forms of fiscal transfers including non-obligatory grants, development grants etc. This is illustrated by Table 3.2. If revenue sharing had taken place according to the provision of the 1990 NFC award in 1990-91, even though the gross increase in federal revenue sharing transfers would have been about Rs 23 billion, the net increase, after allowing for reduction in grants, would have been much lower at about Rs 7 billion only.

TABLE 3.2
CHANGE IN FEDERAL TRANSFERS DUE TO THE 1990 NFC AWARD, 1990-91

[Rs in Billion]

Province	Transfer Without The 1990 Award	Transfer With The 1990 Award	Change in Transfers
PUNJAB	**24.1**	**26.3**	**2.2**
Divisible Pool Transfer	18.6	24.2	5.6
Straight Transfers[?]	0.1	1.1	1.0
Grants	5.4	1.0	-4.4
SINDH	**11.9**	**12.7**	**0.8**
Divisible Pool Transfer	7.5	9.8	2.3
Straight Transfers[?]	0.6	2.2	1.6
Grants	3.8	0.7	-3.1
N.W.F.P.	**9.4**	**11.8**	**2.4**
Divisible Pool Transfer	4.3	5.6	1.3
Straight Transfers[?]	0.0	6.0	6.0
Grants	5.1	0.2	-4.9
BALOCHISTAN	**5.4**	**7.4**	**2.0**
Divisible Pool Transfer	1.7	2.2	0.5
Straight Transfers[?]	0.9	5.1	4.2
Grants	2.8	0.1	-2.7
TOTAL	**50.8**	**58.2**	**7.4**
Divisible Pool Transfer	32.1	41.8	9.7
Straight Transfers[?]	1.6	14.4	12.8
Grants	17.1	2.0	-15.1

[?] Includes proceeds from royalty and excise duty on gas, surcharge on gas, royalty on crude oil and profits from hydro-electricity.

SOURCE:
- Explanatory Memorandum of the Budget
- Annual Budget Statements

Second, the federal government announced the Pay Committee awards in June 1991 and subsequently there have been two more awards which have further consumed the potential improvement in the fiscal position of the provinces by increasing their expenditure liabilities. The federal government has had the tendency to unilaterally announce increases in the salaries and benefits of government employees, the incremental expenditure burden of which has to be financed entirely by the provincial governments from their revenues. These measures have a larger financial impact on the provincial governments because of their larger employment in relation to the federal government. Finally, on the development account there has been a significant decline in the rate of increase of federal development loans to the provincial governments. During the period 1985-86 to 1990-91, prior to the 1990 NFC award, federal loans to provincial governments increased at an annual rate of almost 14 percent. In the post NFC era this growth rate has declined to about 3 percent only. Therefore, the perception that provinces have had a big increase of federal transfers in the aftermath of the 1990 NFC award is largely a misnomer.

The NFC award of 1990 came after a gap of twelve years (due since 1979). The delay in the renewal of inter-governmental fiscal relations in the country meanwhile led to a number of interim arrangements which were defective and distortionary in character. The provinces had run into large, chronic deficits on the current account, indicating the growing inadequacy of divisible pool transfers as per the provisions of the 1974 award. Consequently, as an ad-hoc provision, deficit grants and other subventions were used increasingly to support the on-going operations of the provinces. At their peak in 1987-88, these grants were Rs 17 billion, equivalent to about 2 percent of the GDP and financed over one-fourths of the provincial current expenditure.

These interim arrangements, however, led a number of problems. On the one hand, the high and growing dependence on ad-hoc fiscal transfers mitigated against financial autonomy and, on the other hand, the implied residual access to grants left provinces with little incentive either to mobilise their own resources or to economise on their expenditure. Provincial own revenues grew only modestly, at about 11 percent, while provincial current expenditures increased at a rapid rate, approaching 18 percent. Therefore, there was fast growth simultaneously both in divisible pool transfers and in grants and in the inability of the provincial governments to generate revenue surpluses for self-financing part of their development program.

The 1990 NFC increased the flow of mandatory transfers to the provinces and very importantly removed the distortionary element in grants and substituted it by a system of fixed special grants. The provinces were made responsible for their own revenue deficits and surpluses. As such, the distortionary incentive environment existing prior to the announcement of the award has been largely eliminated. In addition, since the award ensured an increase in the revenue sharing transfers on the recurring account, provincial governments were asked to self-finance a component of their development programs. This has been enforced by a perceptible decline in the flow of cash development loans to the provinces. Therefore, a structural change in the type of flows between the federal and the provincial governments has taken place following the implementation of the 1990 award. Mandatory revenue-sharing transfers on the recurring account have substituted not only for non-development and development grants but also for federal loans on the development side.

It thus becomes important to see whether or not provincial fiscal management has improved in the post 1990 NFC era? In lieu of the increased federal transfers on the current account, provincial recurring expenditures have tended to grow more rapidly at the annual rate of about 16 percent during the last four years as compared to 14 percent during the four years immediately preceding the award (see Table 3.3). However, the higher growth rate reflects, first, the impact of the frequent pay revisions announced by the federal government and, second, the very rapid growth in expenditures on law and order of over 27 percent per annum by the government of Sindh in response to the problems in Karachi. Also, the growth rate of current expenditures immediately prior to the award was artificially depressed by the ceiling placed on non-obligatory deficit grants by the federal government.

TABLE 3.3
SUMMARY OF GROWTH RATES OF PROVINCIAL FINANCES PRE-AND POST-1990 NFC AWARD
[*Four Provincial Governments Combined*]

Annual Growth Rate (%)

Heads	Pre-1990 NFC [1985-86 to 1990-91]	Past-1990 NFC 1990-91 to 1994-95]
General Revenue Receipts	**11.8**	**21.7**
Federal Tax Assignments	22.2	33.2
Own Tax Revenues	14.9	8.6
Own Non-Tax Revenues	11.0	6.8
Non-Development Grants	-4.5	-32.9
Recurring Expenditure	**14.3**	**16.4**
Development Expenditure	**14.8**	**13.7**
Development Revenue Receipts	26.1	12.8
Net Capital Receipts	17.2	1.4

Provincial revenues from own sources have not demonstrated the same buoyancy as in the period prior to the announcement of the 1990 NFC award, although the frequency of taxation proposals in provincial finance bills has increase greatly in recent years (See Appendix). Part of the fall in growth rate is due to the poor performance of the largest source of revenue, stamp duties, in Punjab due to the slump in the real estate market in the province. Other taxes like motor vehicle tax, tax on professions, trades and callings, etc, excises, have shown greater buoyancy despite the fact that the growth rate of the economy has declined in the 90s and many tax bases have been stagnant, especially in Sindh.

The growth rate of development expenditure has declined somewhat from 15 percent between 1985-86 and 1990-91 to 14 percent after 1990-91. This is, of course, a reflection of the decline in the growth rate of capital transfers from the federal government. However, it is reassuring to note the fact that the provinces have made an appreciable effort to contribute to their development outlays. In the last four years prior to the award, provinces accumulated a revenue deficit of about Rs 12 billion. The situation has been dramatically different in the four year after the award. Over the period 1991-92 to 1994-95 provinces generated a combined revenue surplus of Rs 23 billion which has been diverted to finance development activities in the provinces thereby reducing their dependance on federal development loans.

In summary, the story of provincial fiscal management in the post 1990 NFC era is not one of total success but one in which gradually steps are being initiated in the right directions and provincial finances are being placed on a sounder footing. It is, therefore, important that the signals given and the environment created by the 1990 NFC award remains intact so that desired changes in the structure of provincial finances continue to take place.

Turning now to federal finances, it has been alleged that the 1990 NFC award has transferred far too many federal resources to the provincial governments and thereby is partly responsible for the current malaise in federal finances. It needs to be appreciated that the special feature of the 1990 award was not so much the increase but rather the change in the form of transfers from the federation to the province. Ad-hoc discretionary transfers like non-obligatory grants, development grants etc. have either been fully or partially substituted by mandatory revenue sharing transfers thereby making the flows of funds more transparent. Moreover, since the component of self-financing of the provincial development plans has increased, there has been a significant decline in the growth of federal development loans to the provinces.

If the 1990 NFC award had not been implemented and trend growth in non-development and development grants had continued, the federal government would have made Rs 67 billion higher transfers as grants to the provinces than they actually did over the period 1991-92 to 1994-95. In addition, decline in the growth of federal development loans has meant a reduction in cash development loans to the provinces of a tune of Rs 12 billion. As such, the savings to the federation due to the award and the consequent structural changes are significant. During this same period additional revenue sharing transfers to the province have been of Rs 106 billion. This implies that the additional net transfer on the recurring account (net of savings on grants) made to the provinces in the last four years is Rs 39 billion and not Rs 106 billion as would initially appear. As such, incremental provincial transfers have resulted in only a marginal increase in federal recurring liabilities, of less than 4 percent, and thereby could have contributed only nominally to the federal deficit. In fact, if the reduction in the case development loan is also taken in this calculation the net increase in flows to the provinces will be even lower.

All in all, it appears that the 1990 NFC award is beginning to result in some favourable structural changes in provincial fiscal behaviour, which if continued could lead to substantial improvement in provincial financial management. The substitution of mandatory revenue account transfers for distortionary ad-hoc grants and development loans will encourage economy in provincial expenditures; increase in provincial own fiscal effort and higher provincial self-financing of development programs. Simultaneously, decline in cash development loans has implied lower debt servicing liability for the provinces. Furthermore, the award has, contrary to perceptions, not resulted in a big incremental burden on federal finances. It is, therefore, important that the newly constituted NFC preserves the spirit of the 1990 NFC award and further strengthens the structural changes initiated in its aftermath.

STRAIGHT TRANSFERS TO PROVINCES

The National Finance Commission decides on two types of transfers from the federation to the provinces. The first type is transfers from the divisible pool while the second consists of straight transfers. The former are allocated among the provinces on the basis of a revenue-sharing formula specified by the NFC. As opposed to this, straight transfers are distributed solely on the basis of collection, according to the provisions of article 161 of the Constitution. Also, revenues from taxes which form part of straight transfers are not to be credited to the Federal Consolidated Fund but remitted directly by the collecting agency to the provincial governments. In these ways, such transfers are `straight' in character.

TABLE 4.1
MAGNITUDE OF STRAIGHT TRANSFERS

[Four Provinces Combined]

[Rs in Billion]

Heads	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96
Royalty on Natural Gas	0.5	0.6	0.6	0.9	1.1	1.9
Excise Duty on Natural Gas	1.2	1.2	1.3	1.5	2.6	3.2
Gas Development Surcharge	)	7.4	7.7	8.7	8.4	4.1
Royalty on Crude Oil	)	1.2	1.1	1.1	1.0	1.0
Profits from Hydro-Electricity	)	6.1	6.4	6.6	7.9	8.1
TOTAL	**1.7**	**16.5**	**17.1**	**18.8**	**21.0**	**18.3**

Straight transfers specified in Article 161 are excise duty and royalty on natural gas as well as net profits from bulk generation of power at a hydro-electric station. In the 1974 NFC award only the former were included in straight transfers. The 1990 NFC award substantially expanded transfers. Not only were hydro-electricity profits included but, in a liberal interpretation of the constitutional provisions, gas development surcharge and royalty on crude oil were also transferred to the provinces. The terms of reference of the 1995 NFC include a clause calling for examination of the question of continuation of payment of these two sources of revenue to the provincial governments.

Importance of straight transfers has greatly increased for the provincial governments (see Table 4.1). In the first year after implementation of the 1990 NFC award the additional transfers on this account to the provinces was almost Rs 15 billion, as compared to the increase of Rs 8 billion in divisible pool transfers (due to inclusion of excise duties on sugar and tobacco). In 1994-95 it is estimated that straight transfers represented 20 percent of the total transfers mandated by the 1990 NFC (see Table 4.2).

TABLE 4.2
IMPORTANCE OF DIFFERENT TYPES OF TRANSFERS
1994-95

[*Rs in Billion*]

Province	Divisible Pool Transfers	Straight Transfers	Total
PUNJAB	48.9 (97)	1.5 (3)	50.4 (100)
SINDH	19.7 (79)	5.1 (21)	24.8 (100)
N.W.F.P.	11.5 (60)	7.8 (40)	19.3 (100)
BALOCHISTAN	4.5 (40)	6.7 (60)	11.2 (100)
TOTAL	**84.6 (80)**	**21.1 (20)**	**105.7 (100)**

Figures in brackets are row percentages

SOURCE: Explanatory Memorandum on Budget, MOF, GOP.

Dependence on straight transfers varies substantially among provinces. The lowest share of 3 percent is in Punjab

TABLE 4.3
SHARE OF PROVINCES IN STRAIGHT TRANSFERS
1994-95

[*Percent*]

Straight Transfer	Punjab	Sindh	NWFP	Balochistan	Total
Royalty on Natural Gas	17.6	37.8	)	44.6	100.0
Excise Duty on Natural Gas	6.1	35.2	)	58.7	100.0
Gas Development Surcharge	7.0	38.0	)	55.0	100.0
Royalty on Crude Oil	42.6	57.4	)	)	100.0
Profits from Hydro-Electricity	1.7	)	98.3	)	100.0
TOTAL	**7.1**	**24.2**	**37.0**	**31.7**	**100.0**

which receives relatively small shares in most sources (see Table 4.3). In the case of Sindh, the dependence is to the extent of 21 percent. Sindh receives significant shares in sources related to natural gas and has the major share in the royalty on crude oil. Both Balochistan and NWFP rely heavily on straight transfers. For the former the share currently is the highest at 60 percent. It receives large shares primarily in gas related revenues, due largely to exploitation of reserves at Sui. The dependence on straight transfers in the case of NWFP is 40 percent. Transfers consist of hydro-electricity profits from the Tarbela dam and are substantial in magnitude.

Straight transfers have, however, represented a fairly inelastic source of revenue to the provinces. Between 1991-92 and 1994-95 the annual growth rate in the overall magnitude of straight transfers has been only 8 percent, as compared to 21 percent in the case of divisible pool transfers. In 1995-96, it is anticipated that total transfers may actually fall, due primarily to the reduction in revenues from gas development surcharge (see Table 4.1). This source of revenue is being squeezed with major adverse implications for the future fiscal status of the province of Balochistan.

A number of issues arise in the context of straight transfers. First, as mentioned above, the federal government has raised the issue of transfer of revenues from the gas development charge and royalty on crude oil which are not strictly mandated by the Constitution. This will lead to a decline in straight transfers by about Rs 5 billion and have a disproportionate impact, in particular, on the finances of Balochistan. The gas development surcharge is any way a declining source of revenue and either it is substituted by a higher fixed excise duty or measures will have to be taken to restore this source of revenue. This will involve raising net profits per unit of gas sold through increases in consumer prices, especially for low price domestic consumers and fertilizer plants, which reflect increases in costs as high cost (with higher well-head prices) fields like Qadirpur, Kadanwari, etc., are exploited more intensively.

Second, there is the issue of computation and payment of profits from hydro-electricity. In an explanatory note, the Constitution says that net profits shall be computed by deducting from the revenues accruing from the bulk supply from the bus-bars of a hydro-electric station at a rate to be determined by the Council of Common Interests, the operating expenses of a station, which shall include any sums payable as taxes, duties, interest or return on investment, depreciation and element of obsolescence, overheads and provision for reserves. It is not clear whether these principles have been adequately reflected in derivation of net profits from the power generated by the Tarbela Dam. Application of the formula needs to be made more transparent.

Also, the government of NWFP has complaints about delays in payment of profits by WAPDA. Levy of a surcharge by WAPDA to finance payment of these profits appears to be in violation of the principles mentioned above. Further, it is necessary in future to ensure that WAPDA has enough incentives to make substantial investments in projects like the Ghazi Barotha dam and that provincial governments do not pre-empt most of the profits.

Third, another issue relates to the sharing among the provinces of the gas development surcharge. This surcharge is essentially equivalent to net profits from the gas extraction, transmission and distribution after allowing for costs and a guaranteed rate of return an assets of companies like Sui Southern Gas and Sui Northern Gas. As such, net profit per unit of gas is higher from fields like Sui which were developed much earlier and have lower well-head prices. This is not reflected in the current formula which allocates revenues from the surcharge on the basis of volume of gas extracted from each province. The consequence is that currently there is a substantial subsidy from Balochistan to Sindh and Punjab. This will need to be reviewed and an appropriate formula developed which is more equitable and reflects the quantum of net profit generated from each field.

Altogether, straight transfers represent a less well-known and under studied source of transfers to the provincial governments. They are important, especially to the smaller provincial governments of Pakistan. It is hoped that the 1995 NFC will devote more time to identifying mechanisms for protecting these transfers and evolving methods of computation and sharing which are more rational and equitable.

TERMS OF REFERENCE OF THE 1995 NFC: IMPLICATIONS FOR THE PROVINCES

Existence of significant fiscal imbalances resulting from skewed allocations of fiscal powers and functional responsibilities to the federal and provincial governments in the country has led to the establishment of extensive revenue sharing arrangements between the two levels of governments. These inter-governmental revenue transfers take place in accordance with the provisions of the National Finance Commission (NFC) award 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. As such, the President of Pakistan has recently constituted the NFC to review revenue sharing arrangements in the country. 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 step.

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.

The objective of this article is to identify some of the key implications of the TOR on provincial governments in Pakistan.

5.1 FEDERAL TRANSFERS TO PROVINCES

Since independence, the trend in intergovernmental fiscal relations in Pakistan, with the exception of the 1974 NFC award, has been to increase revenue transfers to the provinces thereby promoting greater decentralisation of public sector tax revenues. However, the TOR of the newly established NFC shows a clear reversion of this trend. Excise duties on tobacco and sugar have been excluded from the divisible pool. The newly announced divisible pool of taxes is, therefore, identical to the 1974 NFC award. Its implementation would imply a decline in transfer to the provinces of about Rs 14 billion at the 1995-96 fiscal bases. That is, if transfer to the provinces take place in accordance with the newly announced divisible pool (assuming unchanged shares of the federation and the provinces), the province would receive 14 percent less in 1995-96 then they are budgeted to.

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 some straight transfers provided to the provinces under in the 1990 NFC award. These aggregated to over Rs 5 billion in 1995-96 and benefit mostly the provinces of Balochistan and Sindh.

5.2 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 identical to the provisions of 1974 NFC award. Table 5.1 presents the extent of revenue losses to the four provincial

TABLE 5.1
EXTENT OF REVENUE LOSS TO THE PROVINCES DUE TO THE DECLINE IN FEDERAL TRANSFERS, 1995-96

(*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	9529	13.2	85.2
SINDH	5571	16.4	104.7
NWFP	1960	8.2	92.8
BALOCHISTAN	2701	20.6	484.9
TOTAL	**19761**	**13.8**	**103.1**

SOURCE: Annual Budget Statements of the provincial governments.
[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.

governments if the provisions of 1974 NFC award were operative. On the whole, provinces will lose about 14 percent of their general revenue receipts. This clearly would affect the provincial fiscal position substantially. 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 a doubling of own revenues immediately (see Table 1). 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.

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 falls 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 1 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 have been discretionary and have been in the past used as political levers. Therefore, this option may seriously undermine provincial autonomy.

One other possible scenario is that, like in the pre-1990 NFC era, the provinces carry huge revenue deficits and have greater access to development loans from the federal governments. This arrangement is intrinsically to the disadvantage of the provincial governments because development loans are given at near market rates of interest and thereby, unlike revenue-sharing transfers, carry debt servicing obligations. Therefore, from the provincial point of view the most preferable from of federal transfer is mandatory revenue-sharing transfers.

5.3 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. Other possible options of partially compensating for the reduction in revenue-sharing transfers like greater access to discretionary grants or development loans constitute inferior options as the former is ad-hoc and undermines provincial autonomy while the latter puts a heavy debt servicing burden on the provinces.

THE FEDERAL PERSPECTIVE

The deliberations of the newly constituted National Finance Commission (NFC) have commenced and the respective positions of the federation and the federating units regarding future inter-governmental revenue sharing arrangements have been unveiled. The provincial view of the federal position is that it is somewhat unsympathetic and devoid of a proper understanding of the provincial fiscal status. This view has largely been formulated on the bases of the terms of reference (TOR) of the new NFC which contracts the pool of shareable taxes (the divisible pool) through the exclusion of excise duties on sugar and tobacco and opens up the question of transferring surcharge on gas and royalty on crude oil to the provinces. A substantial reduction in federal transfers to the provinces is, therefore, implied by the TOR and to that extent the provincial apprehension regarding the federal position is justified.

The basic question is what factors have instigated such an action on the part of the federal government? It appears that the federal lack of willingness to share tax revenues with the provinces is a consequence of, first, the current state of federal finances, with a high and rising budget deficit. The federal government has the primary responsibility of controlling the national budgetary deficit and retire and service huge borrowings undertaken to finance development activities in the country. The budget deficit has remained around 5.8 to 7 percent of the Gross Domestic Product (GDP) in the last few years. Pakistan is committed to bring this down to 4.6 percent as per the loan conditionalities of the standby credit negotiated recently with the IMF. On top of this, the debt servicing burden has been mounting, the current level being Rs 157 billion, equivalent to 47 percent of the federal current expenditure.

Second, the federal government as per the Constitutional provisions, shares the two most buoyant and fast growing taxes - sales and income taxes) with the provinces. Pending reforms in the taxation structure will further increase the revenue significance of these taxes. The government is committed to bring down import tariffs which would lead to substantial revenue losses on account of import duties. Further development of sales and income taxes is the prime feasible option to compensate the government for this revenue loss but, given the revenue sharing arrangements, 80 percent of the benefit of this federal effort will be transferred to the provinces. Over the period 1991-92 to 1994-95, 75 percent of the additional revenues generated by the federal government through taxation proposals have been in the income and the sales taxes.

Table 6.1 demonstrates that actual transfers by the federal government from the divisible pool have tended to significantly exceed the level projected by the NFC in 1990. Cumulatively, additional transfers of about Rs 10 billion had been made upto 1994-95 to the provinces. This has been achieved primarily by the exceptional performance of

TABLE 6.1
PROJECTED AND ACTUAL DIVISIBLE POOL TRANSFERS ACCORDING TO 1990 NFC AWARD

[*Rs in Billion*]

Heads	1991-92	1992-93	1993-94	1994-95	1995-96
Income Tax					
Projected by 1990 NFC	15.0	17.8	21.1	25.0	29.7
Actual[?]	19.4	25.5	33.7	40.7	50.2
Difference[??]	4.4	7.7	12.6	15.7	20.5
Sales Tax					
Projected by 1990 NFC	19.1	22.5	26.5	31.2	36.8
Actual	16.3	18.2	24.4	32.7	37.6
Difference	-2.8	-4.3	-2.1	1.5	0.8
Excise Duties on Tobacco and Sugar					
Projected by 1990 NFC	10.0	11.6	13.4	15.6	18.1
Actual	10.3	10.3	10.9	11.2	14.5
Difference	0.3	-1.6	-2.5	-4.4	-3.6
Export Duty on Cotton					
Projected by 1990 NFC	3.3	3.8	4.3	5.0	5.8
Actual	1.5	0.4	0.3	0.0	0.0
Difference	-1.8	-3.4	-4.0	-5.0	-5.8
Total					
Projected	47.4	55.7	65.3	76.8	90.4
Actual	47.5	54.4	69.3	84.6	102.3
Difference	0.1	-1.3	4.0	7.8	11.9

income tax during the period which has more than compensated for shortfalls in revenues from excise duty on tobacco and sugar and the phasing out of the export duty on custom.

Finally, there exists, in the federal circles, the perception of profligacy in expenditures and lack of own revenue generation at the provincial level. Indeed, these have been features of provincial finances in the 80s. During this period provincial current expenditure increased annually at an average rate of over 17 percent while own revenues increased only marginally at the rate of 10 percent. Currently combined provincial tax revenues are only 0.6 percent of the GDP. This is far lower than the level attained in the early 70s of about 1.2 percent of the GDP. Potential areas of taxation like agricultural income, urban property, services sectors, vacant land, capital gains, etc. still remain either untapped or under developed. Furthermore, the performance in recovering costs of service provision leaves a lot to be desired. The extent of recurring cost recovery in economic sectors like irrigation, agriculture, highways, etc. is only about 20 percent. The situation with respect to the social sectors is worse with only about 3 percent recovery of recurring costs. Altogether, it is felt that provincial own revenues can be increased substantially, by about 1 percent of the GDP. This will imply doubling of provincial revenues over the projected level. As such, the federal government is for the view that the provinces should first adequately exploit their own revenue potential and then legitimately claim and expect a share in federal taxes. This is the only feasible strategy if the national budget deficit is to be brought down significantly.

On the whole, the above factors explain the federal government's reluctance to transfers additional revenues to the provinces. Its dilemma is understandable and the forces are important enough not to be overlooked or ignored. But is the only solution to the above problems a decline in mandatory revenue sharing transfers to the provinces?

The federation may prefer to resolve the problems by creating the proper incentive environment for the provinces, reposing more confidence in their ability to be a responsible tier of government and giving them the right policy direction rather than taking punitive actions like a substantial cut in revenue sharing transfers leading to severe dislocation in the short run. Given this overriding view there are, one feels, two possible options which should be tried first to relieve the pressures on federal finances without significantly affecting the fiscal position of the provincial governments. First, the federal government could hand back all the Concurrent List functions it took over from the provinces in the 80's prior to the announcement of the 1990 NFC. This could significantly reduce federal expenditure liabilities.

Second, the federal government can cutback on other forms of transfers to the provinces like discretionary grants and cash development loans. Substitution of discretionary grants with mandatory revenue sharing transfers has the advantage of making transfers transparent while promoting provincial autonomy. The ceiling on the provincial cash development loans has the merit of lowering both federal debt and the downstream debt servicing obligations of the provinces. It will also compel the provinces to generate higher revenue surpluses, either through resource mobilisation or economy in current expenditure, to sustain the growth in development expenditure.

Finally, the federal government may promote the process of resource mobilisation by the provinces through a matching grant scheme linked to the quantum of taxation proposals, of the type tried in the early 90s. The province of Punjab was quick to take the signal and in the first year after institution of the scheme mobilised higher revenues of the tune of Rs 750 million. Contingent on the credibility of the federal government to honour its commitments, this scheme can indeed provide a major stimulus for higher provincial effort.

PROVINCIAL POSITIONS ON REVENUE SHARING

Inter-governmental transfers mandated by the NFC are of great importance to provincial governments in Pakistan as they currently represent 80 percent of revenue receipts and finance over 86 percent of current expenditure by these governments. Therefore, the fiscal status in the medium run of provincial governments hinges crucially on the nature of the NFC award. For example, the 1990 award expanded the divisible pool significantly and substantially increased straight transfers. This enabled the provinces to arrive at a consensus on the revenue sharing formula, which remained linked to population only. The liberal dispensation on transfers increased the flows of funds to each province and pre-empted acrimonious debate among provinces on which criteria should be included in the formula. This had been the fate of earlier NFCs constituted in 1985 and 1988. The contraction in the divisible pool implied by the TOR of the 1995 NFC and the possibility that some straight transfers may also be eliminated indicates that this time there might be greater discussion on the formula to be adopted for sharing resources from the divisible pool among the provinces.

One of the basic functions of a federation is to collect some taxes centrally and allocate them among the federating units in such a way that differences in level of provision of basic services are reduced to the extent possible. Such an equalisation program can foster a greater sense of participation of members and can be viewed as the glue which holds a federation together. In principle, a properly designed transfers scheme can reduce distortions caused by fiscally induced migration by equalising net fiscal benefits across provinces and thereby promoting economic efficiency. Ideally, therefore, while revenues in the central (divisible) pool may be reverted to the federating units on the basis of the `derivation' principle (that is, collection) there is need for balancing the transfers through fiscal equalisation grants to states which have limited taxable capacity.

In Pakistan, the goal of fiscal equalisation appears to have been taken very seriously to the extent that divisible pool transfers are linked solely to population implying that each province receives the same per capita transfer. However, the position of Sindh is that it contributes substantially more on a per capita basis to the divisible pool and, therefore, collections should also be used as a criterion for revenue sharing. Balochistan argues that being the largest province in terms of land area but with very low population density, unit costs of provision of services are higher and, therefore, the same level of revenues per capita translates into a lower level of provision of services. Also, Balochistan is the most backward province of the country and it feels that on the grounds of needs higher transfers are required to increase the coverage of basic services like water supply, primary education, health, roads, etc.

However, inclusion of straight transfers and special non-development grants alters significantly the effective distribution of federal current transfers (see Table 7.1).

TABLE 7.1
MAGNITUDE OF FEDERAL TRANSFERS ON THE CURRENT ACCOUNT TO PROVINCES
1995-96

[*Rs in Billion*]

Province	Divisible Pool Transfers	Straight Transfers	Grants	Total Transfers
PUNJAB	59.2 (57.9)	1.6 (8.7)	)	60.8 (50.1)
SINDH	23.8 (23.3)	4.2 (22.8)	0.7 (100.0)	28.7 (23.7)
N.W.F.P.	13.8 (13.5)	8.0 (43.5)	)	21.8 (18.0)
BALOCH-ISTAN	5.4 (5.3)	4.6 (25.0)	)	10.0 (8.2)
TOTAL	102.2 (100.0)	18.4 (100.0)	0.7 (100.0)	121.3 (100.0)

Figures in brackets are column percentages.

SOURCE:
- Explanatory Memorandum on Budget, Ministry of Finance, Government of Pakistan.
- Annual Budget Statements, Provincial Governments.

Divisible pool share's mirror the population distribution of 1981. Straight transfers are more skewed. The biggest beneficiary is NWFP which receives almost 44 percent of such transfers due largely to profits from hydro-electricity. Balochistan comes next with a share of 25 percent representing primarily gas related revenues. Sindh receives a share of 23 percent, close to its population share. The largest province, Punjab, has the smallest share of only 9 percent in straight transfers. As far as grants are concerned, these were largely phased out by the 1990 NFC. Currently, Sindh only receives a special grant of Rs 700 million.

Given the pattern of straight transfers and grants the two smaller and traditionally considered `backward' provinces, NWFP and Balochistan, end up receiving substantially higher per capita transfers than the national average. Therefore, the case for explicitly reflecting `backwardness' in the criteria for revenue sharing from the divisible pool does not appear to be very strong in the presence of large straight transfers to the backward provinces. In fact, the 1990 NFC recognised that the expansion of straight transfers to cover hydro-electricity profits and gas development surcharge had tilted the transfers in favour of the two smaller provinces. Consequently, a special grants scheme was introduced envisaging an annual grant of Rs 1000 million for three years to Punjab and Rs 700 million for Sindh for five years as compared to only Rs 200 million and Rs 100 million respectively for NWFP and Balochistan for three years. Balochistan and NWFP may, however, ague that even though their respective shares in total federal transfers on the current account are higher their ability to generate revenues from own sources is limited due to lower taxable capacity.

Also, as a result of varying levels of development activity, the pattern of backwardness has altered dramatically in the country. Bulk of the differences in levels of coverage of basic services are to be found in the rural areas of the country as compared to the urban areas where basic service deficiencies are less pronounced and municipal governments, private sector and NGOs are more active. Provincial governments remain the principal delivery agent for basic services like primary education, water supply, health, etc., in rural areas. The Social Action Program (SAP) launched with international donor support focusses on this area. Contrary to common perceptions, NWFP no longer appears to be backward province in terms of rural quality of life indicators. Backwardness in Balochistan is persistent while the rural areas of Sindh appear to have slipped in the national ranking (see Table 7.2).

TABLE 7.2
RANKING OF PROVINCES IN INDICATORS OF QUALITY OF LIFE IN RURAL AREAS

INDICATOR	YEAR	PUNJAB	SINDH	N.W.F.P	BALOCHISTAN
? **EDUCATION**					
• Rural Literacy Rate	1988	1	2	3	4
• Rural Primary Male School Enrollment Rate	1990	1	4	2	3
• Rural Primary Female School Enrollment Rate	1990	1	3	2	4
? **HEALTH**					
• Rural Health Centres	1992	2	4	3	1
• Basic Health Units	1992	2	4	3	1
• Rural Infant Mortality Rate	1992	2	3	1	4
? **WATER SUPPLY**					
• Rural Water Supply	1992	2	3	1	4
? **ELECTRIFICATION**					
• Rural Household Access to Electricity	1989	2	3	1	4
? **ROADS**					
• Rural Road Network	1991	1	3	2	4

SOURCE: Federal and Provincial Government publications.

Currently, Balochistan remains the most backward province in terms of rural literacy, female primary school enrollment rate, rural infant mortal rate, rural water supply, rural electrification and roads. Sindh has fallen behind in male primary school enrollment rate and rural health services. NWFP currently has the best coverage of rural water supply and electricity and is closely behind Punjab in a number of other indicators. Altogether, if backwardness is recognised formally as a measure of needs then Balochistan and Sindh may have to be targeted, rather than NWFP and Punjab.

It is interesting that while Sindh makes a disproportionate contribution to divisible pool tax revenues it still is characterised by relative rural backwardness. This is a reflection of the sharp urban-rural dichotomy in the province. Karachi, despite law and order problems and stagnation in the regional economy, remains the principal point of tax collection in the country. Almost 65 percent of revenues from income and sales tax accrue from Sindh. However, it is not correct to assume that the entire tax burden of these revenues falls on the people of Sindh. Given the nature of economic activity in the country with concentration at the only port, Karachi, there exists a serious apportionment problem with regard to allocation among the provinces of effective tax collections. In income tax, for example, the share of Sindh is high because of the concentration of head offices of large-scale industrial and commercial establishments in Karachi. Bulk of the import sales tax collections naturally accrue from Karachi. It is only in the case of domestic sales tax where there is correspondence between tax collections and burden, even though this tax has not yet become an effective consumption tax and continues to be levied primarily at the manufacturing stage. Therefore, the only component of the divisible pool which can potentially be allocated on the basis of collection is the domestic sales tax.

Domestic sales tax is, in fact, the only tax which has historically been shared in Pakistan either wholly or partly on the basis of collection. In the Raisman award of 1951 this component of the sales tax was distributed entirely on the basis of collection while the import sales tax was given to the provinces on the basis of pre-assigned shares. Upto the 1970 NFC award a component of the sales tax continued to be shared on the basis of collection. This practice was first abandoned by the 1974 NFC and carried further by the 1990 NFC.

TABLE 7.3
SHARE OF PROVINCES IN DIFFERENT CENSUSES, 1951 TO 1981

[*Percent*]

Year	Punjab	Sindh	N.W.F.P	Balochistan	Pakistan?
1951	63.58	18.71	14.10	3.61	100.00
1961	62.23	20.45	14.01	3.31	100.00
1972	60.10	22.62	13.40	3.88	100.00
1981	57.88	23.29	13.54	5.30	100.00

Another contentious issue on which there is sharp disagreement among the provinces relates to which population figures to use even if population continues to enjoy the maximum weight in the revenue sharing formula. Historically, since 1951 in the share of Sindh and Balochistan has tended to increase while that of Punjab and NWFP has declined (see Table 7.3). The former two provinces are inclined to argue that this trend has persisted in the post-1981 Census period upto 1995-96, the benchmark year for the next NFC award. However, in the absence of a recent Census, revenue shares have remained frozen at the 1981 level. Sind's position, for example, is that on the basis of extrapolation of inter-censal growth rates between 1972 and 1981, its population share has expanded by about one percentage point. Therefore, it is losing out on transfers annually by over Rs 1000 million. Balochistan demonstrated a high inter-censal growth rate and is also keen that population estimates are updated. It is not clear, however, in the absence of a recent Census, how the population shares can be revised from those prevailing in the last Census of

1981. Recognition of this problem by the NFC will require some ad-hoc provisions which may not be acceptable to all the provinces.

Altogether, the issue of the appropriate revenue sharing formula remains difficult and is complicated by a contraction in the total size of transfers. In the initial negotiations, Sindh and Balochistan will emphasise on the need to update population estimates. Sindh will ask for a premium on the basis of its higher share in collections and greater needs arising from its inability to remove rural backwardness. Balochistan will present its case for higher allocations than justified on the basis of population on the grounds of higher unit costs of provision and backwardness. Punjab and NWFP will have a stronger interest in preserving the status quo. The former will argue strongly for the same coverage of the divisible pool as specified by the 1990 NFC.

At this stage, it needs to be emphasised that the nature of the revenue sharing formula will depend upon the size of the divisible pool and which straight transfers are retained by NFC. Table 7.4 highlights the provincial shares in overall federal transfers on the current

TABLE 7.4
MAGNITUDE OF FEDERAL TRANSFERS ON THE CURRENT ACCOUNT UNDER VARIOUS SCENARIOS
[1995-96]

[*Rs in Billion*]

Province	Population Share in 1981 and 1995?	TRANSFERS IN DIFFERENT SCENARIOS??			
		Scenario I	Scenario II	Scenario III	Scenario IV
PUNJAB	57.88 (54.28)	60.8 (50.1)	59.8 (51.5)	52.4 (49.1)	51.4 (50.6)
SINDH	23.28 (24.47)	28.7 (23.7)	26.5 (22.8)	25.3 (23.7)	23.1 (22.7)
N.W.F.P.	13.54 (13.76)	21.8 (18.0)	21.8 (18.8)	19.9 (18.6)	19.9 (19.6)
BALOCH-ISTAN	5.30 (7.49)	10.0 (8.2)	8.0 (6.9)	9.2 (8.6)	7.2 (7.1)
TOTAL	100.0 (100.0)	121.3 (100.0)	116.1 (100.0)	106.8 (100.0)	101.6 (100.0)

? Extrapolated on basis of inter-censal (1972 to 1981) trends
?? income tax = IT, sales tax = ST, ED = excise duties on tobacco and sugar gas excise duty = GED, gas royalty = GR, gas development surcharge = GDS, Crude oil royalty = COR, hydroelectricity profits = HEP

S C E N A R I O S	*Divisible Pool Transfers*	*Straight Transfers*
SCENARIO I	IT, ST, ED	GED, G, GDS, COR, HEP
SCENARIO II	IT, ST, ED	GED, GR, HEP
SCENARIO III	IT, ST	GED, GR, GDS, COR, HEP
SCENARIO IV	IT, ST	GED, GR, HEP

SOURCE:
- Statistical Year Book, Federal Bureau of Statistics
- Explanatory Memorandum on Budget, Ministry of Finance, Government of Pakistan.

account under different scenarios. A number of conclusions emerge from this analysis, as follows:

(i) If, as specified in the TOR, excise duties on tobacco and sugar are withdrawn from the divisible pool but gas development surcharge and royalty on crude oil are retained in straight transfers then the respective shares (as of 1995-96 tax bases) in Scenario III are estimated at 49.1 percent for Punjab, 23.7 percent for Sindh, 18.6 percent for NWFP and 8.6 percent for Balochistan (if the divisible pool is shared solely on the basis of 1981 population). The sharpest decline in transfers is in the case of Punjab followed by Sindh in relation to the present arrangements. Effectively, the overall share of Punjab will fall significantly below its estimated current population share. In the case of Sindh, the share will be somewhat below its currently population share while the shares of NWFP and Balochistan will be substantially higher.

As such, in this scenario the case for incorporating backwardness into the revenue-sharing formula is not so strong. However, Sindh could be compensated somewhat by introducing the collection factor at least partially in the context of distribution of revenues from the domestic sales tax. This will lead to a decline in shares both of Punjab and NWFP. Since the former has a share much below its population share there may be a need to balance the award by giving Punjab a special grant.

(ii) If alongwith withdrawal of excise duties from the divisible pool, the gas development surcharge and royalty on crude oil are excluded from straight transfers then Balochistan is the biggest loser in Scenario IV. In this case backwardness will have to be introduced explicitly as a criterion in the revenue sharing formula to compensate Balochistan at least partially for the loss. Beyond this, collections in domestic sales tax may have to be given some weight to benefit Sindh. On top of this, a more elaborate special grants scheme will be required, especially targeted towards Punjab.

In summary, the 1995 NFC has a difficult task ahead in terms of achieving consensus on the revenue-sharing formula in the face of a cut back in federal transfers. It is hoped that the federal and provincial governments will demonstrate the spirit of accommodation which is required to strengthen the federation.

EVOLUTION OF REVENUE SHARING ARRANGEMENTS

INTERNATIONAL PRACTICE OF REVENUE SHARING

AN EVALUATION OF THE 1990 NFC AWARD

STRAIGHT TRANSFERS TO PROVINCES

TERMS OF REFERENCE OF THE 1995 NFC: IMPLICATIONS FOR THE PROVINCES

THE FEDERAL PERSPECTIVE

PROVINCIAL POSITIONS ON REVENUE SHARING

STATISTICAL APPENDIX

STATISTICAL APPENDIX

TREND IN FINANCES FINANCES OF PUNJAB GOVERNMENT
1985-86 TO 1995-96

[*Rs in Million*]

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96
General Revenue Receipts	29407	38693	42912	53052	60505	72073
Federal Tax Assignment	18673	28721	32387	41374	50469	60867
Own Revenue Receipts	8073	8810	8484	10399	9990	11186
Tax Revenue	4650	5323	4744	5711	5397	5878
Non-Tax Revenue	3423	3487	3740	4688	4593	5308
Non-Devevelopment Grants	2661	1162	2041	1279	46	20
Recurring Expenditure	31376	37053	43040	49092	56245	68484
Revenue Surplus (+)/Deficit (-)	-1969	1640	-128	3960	4260	3588
Development Revenue Receipts	2743	1687	1961	988	3381	3229
Net Capital Receipts	7865	8342	7536	9523	5041	1436
Federal Loan	7615	7951	7327	9019	6588	2515
Others	250	391	209	504	-1547	-1079
Development Expenditure	10358	11371	11674	7793	12954	14029
Total Expenditure	41734	48423	54714	56885	69199	82514
Cash Balance Utilisation	1719	-399	2194	n.a	n.a	n.a

Source: Annual Budget Statements of the Provincial Governments

TREND IN FINANCES FINANCES OF SINDH GOVERNMENT
1985-86 TO 1995-96

[*Rs in Million*]

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96
General Revenue Receipts	12918	19325	21621	25535	31810	34054
Federal Tax Assignment	7916	14990	16548	21034	24795	28034
Own Revenue Receipts	3362	3635	3390	33801	4945	5321
Tax Revenue	1562	1903	2024	2371	3129	3360
Non-Tax Revenue	1800	1733	1366	1430	1816	1961
Non-Devevelopment Grants	1640	700	1683	700	2070	700
Recurring Expenditure	16286	19123	21095	25739	31107	34771
Revenue Surplus (+)/Deficit (-)	-3368	202	526	-204	703	-716
Development Revenue Receipts	2182	2452	700	1921	3790	1070
Net Capital Receipts	4522	6104	1761	8172	9047	5293
Federal Loan	3091	3646	2893	5685	5909	1070
Others	1431	2458	-1132	2487	3138	4223
Development Expenditure	6353	5878	5757	6418	13257	14394
Total Expenditure	22639	25002	26852	32157	44364	49165
Cash Balance Utilisation	-3017	888	4550	2282	8986	4940

Source: Annual Budget Statements of the Provincial Governments

TREND IN FINANCES FINANCES OF NWFP GOVERNMENT 1985-86 TO 1995-96 [*Rs in Million*]						
	1990-91	**1991-92**	**1992-93**	**1993-94**	**1994-95**	**1995-96**
General Revenue Receipts	10209	14134	15809	17776	21262	23960
Federal Tax Assignment	4302	12432	14104	15892	19255	21843
Own Revenue Receipts	1190	1300	1500	1675	1997	2112
Tax Revenue	430	436	527	634	724	726
Non-Tax Revenue	760	864	973	1041	1273	1386
Non-Devevelopment Grants	4717	402	205	209	10	5
Recurring Expenditure	10282	12737	14371	16636	19405	21972
Revenue Surplus (+)/Deficit (-)	-73	1397	1438	1140	1857	1987
Development Revenue Receipts	357	1021	497	760	2845	1778
Net Capital Receipts	4682	3437	3739	2507	4683	5019
Federal Loan	3854	2960	2819	2678	2570	2818
Others	828	477	920	-171	2112	2201
Development Expenditure	3834	5629	6575	5253	7862	7666
Total Expenditure	14116	18366	20946	21889	27266	29638
Cash Balance Utilisation					na	na
Source: Annual Budget Statements of the Provincial Governments						

TREND IN FINANCES FINANCES OF BALOCHISTAN GOVERNMENT 1985-86 TO 1995-96 [*Rs in Million*]						
	1990-91	**1991-92**	**1992-93**	**1993-94**	**1994-95**	**1995-96**
General Revenue Receipts	4495	8277	9475	10379	11682	13116
Federal Tax Assignment	2635	7833	8929	9803	11136	12552
Own Revenue Receipts	333	314	428	469	538	557
Tax Revenue	123	117	129	142	156	173
Non-Tax Revenue	210	197	299	327	382	384
Non-Devevelopment Grants	1527	130	117	107	7	7
Recurring Expenditure	5318	6534	8045	8825	9894	11024
Revenue Surplus (+)/Deficit (-)	-823	1743	1430	1554	1787	2092
Development Revenue Receipts	1286	750	473	921	627	658
Net Capital Receipts	2772	1617	1857	1192	2235	1890
Federal Loan	1430	1724	1986	2042	2495	2172
Others	1342	-107	-130	-850	-260	-282
Development Expenditure	2725	4275	4207	4366	4874	4918
Total Expenditure	8043	10809	12252	13191	14768	15942
Cash Balance Utilisation	-920	-172	-448	-698	-224	-278
Source: Annual Budget Statements of the Provincial Governments						

TREND IN FINANCES FINANCES OF FOUR PROVINCIAL GOVERNMENTS COMBINED
1985-86 TO 1995-96

[*Rs in Million*]

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96
General Revenue Receipts	57029	80429	89817	106742	125259	143203
Federal Tax Assignment	33526	63975	71968	88103	105655	123295
Own Revenue Receipts	12958	14060	13802	16344	17470	19176
Tax Revenue	6765	7779	7424	8858	9407	10137
Non-Tax Revenue	6193	6281	6378	7486	8063	9039
Non-Devevelopment Grants	10545	2394	4047	2295	2134	732
Recurring Expenditure	63262	75447	86551	100292	116651	136252
Revenue Surplus (+)/Deficit (-)	-6233	4981	3266	6450	8608	6951
Development Revenue Receipts	6568	5910	3631	4590	10644	6734
Net Capital Receipts	19841	19500	14893	21395	21006	13639
Federal Loan	15990	16280	15025	19424	17563	8575
Others	3851	3220	-132	1971	3443	5064
Development Expenditure	23270	27153	28213	23830	38947	41007
Total Expenditure	86532	102601	114764	124122	155598	177258
Cash Balance Utilisation	-2218	317	6296	1584	8762	4662

Source: Annual Budget Statements of the Provincial Governments

SUMMARY OF MAJOR PROVINCIAL TAXATION PROPOSALS FROM 1992-93 TO 1995-96

Taxation Proposals	Year of Implementation	Province
EXISTING TAXES		
Stamp Duties		
• Revision in Valuation Tables of Properties	1992-93 1995-96	Punjab Sindh
• Enhancement in Rates on Administrative and Legal Documents	1992-93/1993-94 1994-95/1995-96	Punjab/Sindh/ Balochistan/NWFP
• Enhancement in Rates on Property Related Documents	1992-93 1993-94 1994-95/1995-96	Punjab/NWFP Sindh Balochistan
• Enhancement in Rates on Bonds	1993-94 1994-95/1995-96	Sindh Balochistan
• Ad valorem rate of duty on bonds/debentures issued by public sector corporations or financial institutions	1994-95	NWFP
• Enhancement of Rates on Mortgage Deeds	1994-95 1994-95/1995-96	Sindh Balochistan
• Enhancement of Rates on Financial Instruments	1994-95 1994-95/1995-96 1995-96	Sindh Balochistan Punjab
• Withdrawal of Exemption to certain mortgage deeds	1995-96	Punjab
• Increase in the Minimum Duty Rate	1995-96	Punjab
• Stamp Duty on Cheques	1995-96	Sindh
• Levy of Duty on Allotment Order of Flats/Plots	1995-96	Sindh
• Levy of Duty on Recovery of Octroi and Zila Tax	1995-96	Balochistan
SOURCE: *Provincial Finance Acts, 1992 to 1995.*		

SUMMARY OF MAJOR PROVINCIAL TAXATION PROPOSALS FROM 1992-93 TO 1995-96

Taxation Proposals	Year of Implementation	Province
EXISTING TAXES		
Property Tax		
• Property Revaluation	1992-93	Punjab
• Levy of Surcharge or Increase in Rate	1993-94/95-96 1994-95	Sindh Punjab
• Extension of Rating Areas	1995-96	Sindh
Motor Vehicle Tax		
• Increase in MVT Rate	1992-93 1993-94 1994-95 1995-96	NWFP Sindh Punjab/Sindh/NWFP Sindh/NWFP/ Balochistan
• Introduction of Ad Valorem Registration Fees	1994-95	NWFP
Hotel Tax		
• Switch-over to Ad valorem Hotel Tax	1995-96	Sindh
• Introduction of tax on hotel with room rent exceeding Rs 500	1995-96	Balochistan
• Enhancement in the rates of Hotel Tax	1992-93/1995-96 1993-94	NWFP Sindh
Tax on Professions, Trades and Callings		
• Enhancement in Rates	1993-94/1994-95 95-96	Sindh Punjab
Land Revenue		
• Upward Revision of Mutation Fee	1994-95	Punjab/Balochistan
Paddy Development Fees		
• Enhancement in Rates	1993-94	Sindh
Cotton Fee		
• Increase in Fee	1995-96	Punjab
Electricity Duty		
• Enhancement in Rates	1995-96	Sindh
SOURCE: *Provincial Finance Acts, 1992 to 1995.*		

SUMMARY OF MAJOR PROVINCIAL TAXATION PROPOSALS FROM 1992-93 TO 1995-96

Taxation Proposals	Year of Implementation	Province
<u>**NEW TAXES**</u>		
• Fees on Car Dealers	1993-94	Sindh
• Non-Utilisation Tax on Mines	1993-94	Sindh
• Cess on Minerals (coals/marble)	1993-94/1995-96	Sindh/NWFP
• Development Fee for Port Infrastructure	1994-95	Sindh
• Fees on Marriage Halls	1994-95	Sindh
• Tax on Video Cassettes Traders	1994-95/1995-96	Punjab/NWFP
• Bed Tax on Hospitals	1994-95	Sindh
• Tax on Advertisements	1995-96	NWFP
• Licence Fees for Power Crushers	1995-96	NWFP
• Cess on Octroi and Export Tax	1995-96	Punjab
• Provincial Tax on Bank Cheques	1995-96	Punjab/NWFP

SOURCE: *Provincial Finance Acts, 1992 to 1995.*