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Time for a rethink

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The PTI government convened the first meeting of the reconstituted 9th National Finance Commission (NFC) on February 6 to discuss the strategy for a new NFC award. The attempt to hear what provincial representatives had to say about the current fiscal position and discuss strategies for deliberation over the new NFC award. The 576 seats were transferred to all four provinces from the federal divisible pool based on the 7th NFC Award. Four indicators were used to determine the respective share of each province: population (82 percent); poverty/backwardness (10.3 percent); revenue collection/generation (five percent); and inverse population density (2.7 percent).

Based on these indicators, Punjab got a share of 51.74 percent from the divisible pool, Sindh obtained 24.55 percent, Khyber Pakhtunkhwa got 14.62 percent, and Balochistan gained 9.09 percent. The federal government would transfer Rs648 billion to Sindh, Rs426.6 billion (including one percent to compensate for the war on terror) to Khyber Pakhtunkhwa, and Rs233 billion to Balochistan, with a total of Rs2,590 billion going to all four provinces in 2018-19.

Two major changes were introduced in the 7th NFC Award to end the deadlock between the centre and the provinces, including a 10-percentage point reduction in the share of the federal government in the divisible pool and the use of multiple criteria, in addition to population, for the distribution of resources. These changes might have far-reaching implications for the fiscal management of the country and could place a huge burden on the federal government to borrow so as to overcome the budget deficit. It becomes difficult for the federal government to meet the expenditures of development, defence pensions, salaries and debt-servicing from the remaining 42.5 percent of the taxes.

The choice of indicators for the distribution of resources also has inherent flaws. There is a need to rethink the mix of multiple indicators, their definition, and assigned weight. In this and coming articles, we will explore the implications of each indicator for the 9th NFC Award. In this article, we will consider the poverty and backwardness indicators.

In the 7th NFC Award, after taking the average of three different sources of poverty data, the distribution of poverty was 23.17 percent in Punjab, 23.42 percent in Sindh, 27.83 percent in KP and 25.62 percent in Balochistan. This translated into a share of 2.39 percent for Punjab, 2.41 percent for Sindh, 2.87 percent share for KP and 2.64 percent for Balochistan in the divisible pool. In the current fiscal year, Punjab gets Rs62 billion, Sindh gets Rs62 billion, KP obtains Rs74 billion, and Balochistan gains Rs68 billion from the divisible pool due to the poverty-distribution pattern.

This shows that any reduction in poverty will lead to a lower share in the divisible pool. A study titled 'Intergovernmental Transfers: An Evaluation of Mechanism and Design of Transfers in Pakistan' argues that revenue distribution should not be based on indicators that are likely to generate perverse incentives. The poverty level is one such indicator. The use of poverty as an indicator acts as a disincentive for the provinces to alleviate poverty because the poorer a province, the greater its entitlement under the NFC Award.

Let's consider the current state of poverty across the four provinces. According to the official poverty line based on the cost of basic needs (CBN), 24.3 percent of our population lives below the poverty line in Pakistan. The official poverty estimates are based on the Household Integrated Economic Survey (HIES) published by the Pakistan Bureau of Statistics. The updated poverty line for 2015-16 is Rs3,250.28 per adult equivalent per month

Using the same data with the same poverty line, 20.8 percent were poor in Punjab, 32.2 percent were poor in Sindh, 18.1 percent were poor in KP and 42.2 percent were poor in Balochistan in 2015-16. According to the Multidimensional Poverty Index (MPI), 31.4 percent are poor in Punjab, 43.1 percent in Sindh, 49.2 percent in KP and 71.2 percent in Balochistan.

Under the new distribution, the poverty-related allocation will be as follows: Punjab will get Rs49 billion (1.89 percent), Sindh will obtain Rs76 billion (2.93 percent), KP will gain Rs43 billion (1.65 percent) and Balochistan will get Rs99 billion (3.84 percent) from the divisible pool due to the poverty-distribution pattern in the current fiscal year.

This shows that the poverty indicator acts as a disincentive for KP and Punjab, which have shown impressive progress in reducing poverty over the last few years. In addition, the indicator favours those provinces where the poverty-reduction rate is very low like Sindh and Balochistan.

How do we improve this measure? The objective of transferring resources to the provinces is to promote development and alleviate poverty. Keeping this in mind, the following criteria should be discussed among the centre and the provinces in the upcoming meeting on the NFC Award. The poverty indicator should be split into two parts. The first part considers the magnitude of poverty and the second part incorporates the changes in the poverty rates over the last five years.

Both the money metric as well as multidimensional-poverty indices should be considered with different weighting schemes to find the magnitude and changes in poverty rates. For example, MPI has declined from 38.1 percent in 2010-11 to 31.4 percent in 2013-14 in Punjab (a 17.6 percent decline) while Sindh, KP and Balochistan have witnessed a decline of 10 percent, 10.5 percent, 6.1 percent, respectively.

If this arrangement is used with equal weight to both the magnitude and change in poverty rates, the new allocation would be as follows: Punjab would get Rs60 billion, Sindh would gain Rs50 billion, KP would obtain Rs74 billion and Balochistan would get Rs82 billion from the divisible pool due to the poverty-distribution pattern in the current fiscal year.

This shows that even though there is a similar poverty rate in KP and Punjab, KP will get a greater share due to the massive progress made to alleviate poverty. The weighting pattern of both proposed indicators can also be discussed among the centre and the provinces. There is also a need to discuss the utilisation of poverty-related resources in social-protection programmes. This calls for rethinking the allocation mechanism.

The new NFC ought to debate whether or not the annual social-protection budget of a provincial government should be less than the amount of the divisible pool based on poverty and backwardness indicators.

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