Fiscal federalism

The stagnant fiscal space and mounting debt repayment requirements pose enormous challenges to long-run fiscal sustainability.

Apart from budgetary space and debt obligations, the rules of the game defined under the National Finance Commission (NFC) could be a significant source that undermines long-run fiscal sustainability. Based on the 7th NFC Award, 57.5 percent of resources are transferred to the provinces. The 18th Amendment has made the NFC Award inflexible by requiring that the provinces' share shall not be less than what is decided in the 2009 NFC Award (57.5 percent of the divisible pool).

The non-flexibility clause added complexity and distorted the dynamic nature of the NFC Award. Higher transfers and increased spending needs have placed an enormous burden on the federal government, which borrows to finance the budget deficit. A fiscally-constrained central government is finding it difficult to meet development financing needs, defence, pension, salaries, and debt-servicing from the remaining 42.5 percent of the divisible pool.

There is a need to assess whether the existing state of affairs can continue indefinitely, or if all the federating units assume the joint responsibility of anchoring sustainability and progress. Debt servicing, development, defence, and natural calamities (like Covid-19 and floods) necessitate better coordination and collective efforts.

A joint, coordinated effort is needed to develop a dynamic NFC formula. The resource distribution formula should contain the right set of incentives so that every federating unit puts in its best effort without externalising its expenditures upon others.

The PIDE Policy Viewpoint titled 'Fiscal Federalism in Pakistan: Need for a Revisit', provides the mechanism to revisit the fiscal arrangement among federal and provincial governments. According to the brief, no systematic approach has been adopted to capacitate and encourage the provinces for their own source revenue generation. This has resulted in long-term administrative and financial dependence on the centre. The major pressure for resource generation has been on the centre and the FBR.

It is equally important to note that the federal government has overstretched itself by indulging in purely provincial matters. To mention a few, the federal government provides funds for roads, rural development (MNA funds), gender issues, SDG allocations, subsidy on fertilizers, Ehsaas/BISP, etc. This is against the basic premise of decentralisation and thus compromises the expected efficiency gains.

Each tier of the government should work in its domain and be encouraged to undertake spending based on indigenous initiatives and needs. If backed by adequate domestic revenue-raising efforts, such spending would promote greater accountability from the local electorate. This would also discourage the flypaper effect, resulting in higher spending efficiency. Compromised capacity and contested decision space can give rise to duplication of efforts, inefficiencies, and lack of ownership; examples include higher education, health, poverty alleviation programmes (Ehsaas/BISP and SDGs).

Administrative empowerment encourages provinces to contribute to the country's development by streamlining their capacities and incorporating better voice and accountability from the local people. Decentralisation should reduce provinces' dependence on the centre, allowing it to concentrate more on national issues. The economic loss due to the absence of a capacity-building mechanism and foregone resources in the provinces needs to be resolved.

In the wake of tight fiscal space and increasing targeted spending, the policy viewpoint recommends matching grants from the central divisible pool as one of the criteria. This will develop a larger political consensus on major socio-economic initiatives. For example, SDG spending can be financed from the NFC based on a matching grant. Pakistan utiliced the matching grants mechanism in the 1996 NFC Award.

To make the NFC a dynamic resource-sharing mechanism, the Council of Common Interest (CCI) can be used as a forum to decide common socio-economic goals for each year on a rolling basis. The currently reserved 'one percent share of Khyber Pakhtunkhwa (for the war against terror)' can be utilised against the most urgent needs through the CCI with mutual consensus – for example: health emergency (Covid-19), floods, Fata merger, dams, SEZs in each province or alike. Consensus can be developed to form even a larger fund where the centre and the provinces could pool resources for a greater national development agenda – CPEC, national grid, mega-development projects, and resource and mineral extraction. Once completed, the royalties can be redistributed as per contributions.

Fiscal equalisation is an internationally accepted criterion; however, there is a need to revisit the current 'need-based' NFC allocations. This is indicated through significant allocations being made on a population basis. We need to move towards incentive-based resource allocation. Reduce the weight of 'population' – being a flat indicator of expenditure needs only. Instead of revenue collection, more weight should be allotted to revenue generation or revenue growth.

A certain percentage should be allotted to the income gap or the HDI-gap to encompass quality of life in the formula within the need-based elements. Subsequently, allocate a specific portion to the indicators of 'tax effort (measured as difference between tax collection and tax potential)'. It would be important though to cap the negative figures (especially in the case of Balochistan and natural calamity/pandemic) and promise a benchmark figure to achieve consensus.

To streamline the utilisation of poverty-related resources in social-protection programmes, the new NFC may ensure that the annual social-protection budget of a provincial government should not be less than the amount of the divisible pool based on poverty and backwardness indicators. This can be managed through conditional transfers, making it mandatory for provinces to utilise funds meant for social protection on related avenues only.

The success of the NFC depends on PFCs – this needs to be embedded in the fiscal transfers formula. Political consensus for the NFC Award needs to be built based on economic principles. This can be facilitated through commissioning a permanent NFC secretariat at the CCI, managed by professionals and supported by a continuous stream of data.

In a nutshell, there is a need to make the criteria dynamic. Pakistan has been following formula transfers which change rarely. In contrast, the resource distribution mechanism around the world is dynamic and regularly revisits the indicators, their weights, and the mechanism to address the changing needs and provide adequate incentives for enhancing efficiency. This is what the NFC in Pakistan needs to focus on the most.

The writers are economists who work at the Pakistan Institute of Development Economics (PIDE).