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Briefing Paper

NATIONAL FINANCE COMMISSION (NFC) AWARDS IN PAKISTAN:
History, Issues, and Way Forward

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Contents

ABBREVIATIONS:

CCI	Council of Common Interests
FATA	FATA Federally Administered Tribal Areas
FBR	FBR Federal Board of Revenue
FBS	FBS Federal Bureau of Statistics
FDP	FDP Federal Divisible Pool
GDP	GDP Gross Domestic Product
GST	GST General Sales Tax
HDI	HDI Human Development Index
IFC	IFC Indian Finance Commission
IMF	IMF International Monetary Fund
KP	KP Khyber Pakhtunkhwa
LG	LG Local Government
NFC	NFC National Finance Commission
NMDs	NMDs Newly Merged Districts
PFC	PFC Provincial Finance Commission
PIDE	PIDE Pakistan Institute of Development Economics
PRSP	PRSP Poverty Reduction Strategy Paper
SDPI	SDPI Sustainable Development Policy Institute
UNDP	UNDP United Nations Development Programme
UNHCR	UNHCR United Nations High Commissioner for Refugees
VAT	Value-Added Tax

1-INTRODUCTION:

The globalization and its associated challenges have transformed the concept of decentralization from being merely the business of local governments to a broader concept of governance. By transferring payments to lower tiers of government, the central government involves all federating units in the economic development of the country. Fiscal Federalism, or fiscal decentralization, has remained an important area of debate for experts, especially since World War II, when worldwide initiatives for revamping institutional structures in an emerging world gained momentum.

The word “federation” is derived from the Latin word “Foedus,” meaning “Covenant” or a written statute or agreement.[1] It refers to the circulation of power in an organization between a vital authority and its constituent units, providing constitutional guarantees of protection and safeguards. Pakistan, as a federal state, operates through different tiers of government: the federal government at the center, four provincial governments, and a third tier of local governments, comprising district, tehsil, and union administrations.

The Constitution of Pakistan divides functions between the federal and provincial governments. The main functions of the federal government set out in the “federal list,” which includes foreign policy, currency, and defense. The concurrent list, which contains subjects that can be dealt with by both the federal and provincial governments, includes education and health. Any subject that does not fall in either list becomes the responsibility of the provincial governments as residual powers.

The National Finance Commission (NFC) Award facilitates the distribution of financial resources among the provinces of Pakistan by the federal government on an annual basis. Certain types of taxes collected in each province are pooled and then redistributed according to the NFC formula. The taxes included in the pool are income taxes, general sales taxes, wealth taxes, capital gains taxes, and customs duties. The inclusion of taxes in the distribution pool and the formula for distribution remain subjects of debate.

The NFC Award is a constitutional obligation under Article 160 of the Constitution of the Islamic Republic of Pakistan, 1973. It mandates the government to compose the NFC Award at intervals of no more than five years to ensure amicable resource distribution among the federation and its respective units. Provinces subsequently redistribute revenues among lower tiers of government through a revenue-sharing formula via the Provincial Finance Commission (PFC) Awards. The state functions in this manner, with the central government collecting most of the revenues and redistributing them vertically between the federal and provincial governments and horizontally among the provinces.

Despite the structured mechanisms for fiscal distribution, significant challenges remain. Since the 7th NFC Award, there has been no new award or change in the distribution formula. Issues such as the financial allocations for Khyber Pakhtunkhwa (KP) and the Newly Merged Districts (NMDS) continue to be unresolved, creating fiscal strains and highlighting the need for an updated NFC Award with consensus.

2-BACKGROUND:

The distribution of financial resources in federal systems is an inherently complex and politically charged process. While developed federations have established sustainable systems for resource allocation over centuries, Pakistan’s federal structure continues to grapple with challenges arising from its centralized legacy.

Resource sharing between the federation and the federating units has been a fundamental aspect of governance in Pakistan since its inception. Initially, the Niemeyer Award, formulated under the Government of India Act 1935, was adopted for allocating resources among the federal and provincial governments in British India. Following the creation of Pakistan, this award continued to be applied,

1 *https://www.britannica.com/topic/federalism*

although with some adjustments, such as changes in the railway budget and the sharing of income and sales taxes. This system remained in place until March 30, 1952.

In 1955, all provinces of West Pakistan were consolidated into a single administrative unit, often referred to as the "One Unit," while East Pakistan was maintained as a separate entity. As a result, after the creation of the One Unit, there were effectively only two administrative units in Pakistan—East and West Pakistan. During this period, two awards were introduced, one in 1961 and another in 1964, to address the resource-sharing requirements. However, resource distribution was limited to these two units, effectively sidelining the diverse needs and identities of smaller provincial territories that previously existed.

The first comprehensive NFC Award, presented under the leadership of Mr. Zulfikar Ali Bhutto's government in 1974, marked a significant development in resource allocation. This award included fewer taxes in the divisible pool, comprising only income tax, sales tax, and export duties. The criterion for resource redistribution was solely based on population, which disproportionately affected provinces with smaller populations. The fixed ratio for vertical distribution of resources between the federal and provincial governments was set at 20:80. Punjab's share increased from 56.50 percent under the 1970 Award to 60.25 percent, while the other three provinces—Sindh, Baluchistan, and NWFP (Now Khyber Pakhtunkhwa)—suffered reductions in their shares, with Sindh facing the most significant setback due to population being the sole criterion.

After a prolonged gap of nearly 16 years, the fourth NFC Award, introduced during Prime Minister Nawaz Sharif's tenure in April 1991, represented a milestone in Pakistan's fiscal federalism. This award not only broke the impasse but also garnered a consensus among stakeholders. The 4th NFC Award significantly enhanced the provincial share in revenues collected by the federal government, increasing it by approximately 18 percent compared to the 1974 Award. This was a notable stride towards fiscal decentralization and financial autonomy for the provinces.

One of the landmark achievements of the 4th NFC Award was the acknowledgment of the provinces' right to net hydel profits, development surcharges on gas, and excise duties on crude oil. These were transferred as "straight transfers" to the provinces, ensuring a more equitable distribution of resources.

Building on these gains, the 5th NFC Award was announced in 1997 under Prime Minister Nawaz Sharif's government. This award expanded the divisible pool by including all federal taxes and increased the provincial share from 18 percent to 37.5 percent, a significant jump towards greater fiscal decentralization. However, the allocation criteria still relied heavily on population, which continued to be a point of contention for smaller provinces.

The 6th NFC Award, announced in 2006, was introduced during General Pervez Musharraf's regime. Although it did not make substantial changes in the formula for revenue distribution, it did increase federal transfers to provinces and emphasized the importance of provincial autonomy. Despite these provisions, the lack of consensus on a comprehensive formula made this award more of a stopgap measure than a long-term solution.

The 7th NFC Award in 2009, however, was a landmark achievement in Pakistan's fiscal federalism. Presented during the Pakistan People's Party (PPP) led coalition government under Prime Minister Yousaf Raza Gillani, it introduced a multi-dimensional formula for revenue distribution, moving beyond population as the sole criterion. For the first time, factors such as poverty, revenue generation, and inverse population density were included, addressing long-standing grievances of smaller provinces like Baluchistan and Khyber Pakhtunkhwa (KP). The provincial share in the divisible pool was increased to 57.5 percent, and Baluchistan's share was significantly enhanced to ensure fiscal stability in the region. KP was allocated 1 percent of the divisible pool as compensation for the impact of the war on terror.

Despite the progress made in the 7th NFC Award, no subsequent award has been finalized. Since 2009, there have been no significant changes to the revenue-sharing formula, and issues such as the share for Khyber Pakhtunkhwa and the inclusion of the newly merged districts (NMDs) remain unresolved. These delays and the absence of a new NFC Award highlight the need for a renewed consensus to address emerging fiscal challenges and ensure equitable resource distribution among the federation and its federating units.

Resource Distribution under Various NFC Awards Year-wise[2] are given in table below.

Year	Federation Provincial Distribution(Vertical Distribution)	Provincial Horizontal Distribution			
		Punjab	Sindh	Khyber Pakhtunkhwa	Baluchistan
1974	20:80	60.25	22.5	13.39	3.86
1979	20:80	57.97	23.34	13.39	5.30
1985	Interim				
1990	20:80	57.87	23.29	13.54	5.30
1996	62.5:37.5	57.88	23.38	13.54	5.30
2000	Interim				
2006	55:45	57.36	23.71	13.82	5.11
2009	44:56	51.74	24.55	14.62	9.09

3-SALIENT FEATURES OF THE 7th NFC AWARD:

The 7th NFC Award (2009) marked a milestone in Pakistan's fiscal federalism by introducing significant changes to the resource distribution mechanism, addressing long-standing grievances of the federating units. This award was unique in achieving unanimous consensus among all provinces and the federal government, reflecting a balanced and equitable approach to resource allocation.
The share of provinces in the divisible pool was increased from the previous level of 47.5% to 56.0% in the first year and 57.5% in the remaining years of the award. This substantial increase represented a significant shift toward fiscal decentralization, allowing provinces greater financial autonomy. Additionally, the federal government agreed to reduce its collection charges from 5% to 1%, ensuring higher net transfers to provinces from the divisible pool.

Province	% share in the divisible pool under 7th NFC Award	% Reduction Share	Additional Budget %
Punjab	51.74	1.27	48
Sindh	24.55	0.39	61
KP	14.62	0.26	79
Baluchistan	9.09	+1.82%	175

Percentage Share of 7th NFC Awards in the Divisible Pool and Percentage Reduction or Increase of Share and Additional Budget*
The 7th NFC Award redefined both vertical (federal vs. provincial) and horizontal (inter-provincial) distribution of resources.

2 *https://www.sbp.org.pk/reports/quarterly/fy20/First/Complete.pdf*

Recognizing the role of Khyber Pakhtunkhwa as a frontline province in the ongoing war against terror, it was allocated 1% of the divisible pool, amounting to approximately 1.83% of the provincial pool. Similarly, Baluchistan's share in the divisible pool was significantly increased to 9.09%. To accommodate this adjustment, Punjab, Sindh, and Khyber Pakhtunkhwa agreed to proportionally reduce their shares, demonstrating provincial solidarity.

For the first time, the 7th NFC Award moved beyond population as the sole criterion for resource distribution among provinces. A multi-dimensional formula was introduced, incorporating weighted parameters such as population (82%), poverty and backwardness (10.3%), revenue generation and collection (5%), and inverse population density (2.7%). This formula ensured a more equitable distribution of resources, addressing disparities between provinces.

Indicators	Weight	Punjab	Sindh	KP	Baluchistan
Population Share	82.0	57.36	23.71	13.8	5.1
Backwardness	10.3	23.16	23.41	27.82	25.61
Revenue Generation Collection	5.0	44.0	50.0	5.0	1.0
Inverse Population Density	2.7	4.34	7.21	6.54	81.92
Total Share	100	51.74	24.55	14.0	9.09

Revenue Sharing Formula for the 7th NFC Award, 2009[3]
Provinces were empowered to collect sales tax on services, a move aimed at enhancing their revenue generation capacities

To assign weights to poverty and backwardness, the NFC utilized data from the 1999-2000 Poverty Reduction Strategy Paper (PRSP) and Human Development Index (HDI) reports of 2003-04 and 2007-08 by the Federal Bureau of Statistics (FBS). The average of these reports was used to ensure fairness and avoid disputes over individual studies. Revenue generation and collection were measured using proxies such as electricity consumption and withholding tax collections. This innovative approach ensured transparency and reduced potential conflicts among provinces.

This award was a groundbreaking achievement in Pakistan's fiscal history, addressing economic disparities among provinces and empowering them with greater financial autonomy. Its innovative approach to revenue distribution, based on multiple criteria, set a precedent for future awards. The inclusion of factors like poverty, revenue collection, and inverse population density highlighted the commitment to equitable resource sharing, fostering national unity and provincial harmony.

The criteria used for financial distribution vary from region to region and country to country, and they are not fixed but change over time. Population remains one of the major indicators for distribution. Significant weight was given to income distribution in India, but population weight is also considered. In the 10th Indian Financial Award (IFA), fiscal discipline was not given any weight, while it was equally considered in the 11th and 12th awards. Similarly, the index of infrastructure was considered in the 12th IFC Award. Therefore, there is no fixed formula or set of indicators. The most important thing is the consensus among the states or all stakeholders and adopting the fundamental principles of equity and equality.

3 *https://file.pide.org.pk/pdfpideresearch/wp-0073-fiscal-federalism-in-Pakistan-the-7th-national-finance-commission-awardand-its-implications.pdf*

Criteria	10th IFC	11th IFC	12th IFC
Population	20	10	25
Income Distance	60	62.5	50
Area	5	7.5	10
Index of Infrastructure	5	5	-
Tax Effort	10	7.5	7.5
Fiscal Discipline	-	7.5	7.5

Weights Criteria under the 10th, 11th, and 12th Indian Financial Commission Awards (%) [4]

4-ENHANCED ROLE OF THE COUNCIL OF COMMON INTERESTS (CCI):

Following the 18th amendment and abolition of the concurrent list, national planning and economic coordination have become a joint responsibility of the federal and provincial governments. Supervision and management of public debt, federal regulatory authorities, and inter-provincial coordination are new entries under the list of joint responsibilities. For this purpose, institutional strength and mechanisms are very important. Several institutions responsible for managing public finances and delegation of fiscal powers include the Council of Common Interests (CCI), NEC Planning Commission, NFC, Implementation Commission, Public Service Commission, and Debt Management Office. The CCI now has an enhanced role as provinces have gained considerable fiscal space and autonomy following the recent reforms.[5]

Article 153 of the 1973 constitution provides for the CCI to address disputes between the center and a province or between provinces. The 18th constitutional amendment designated the CCI as a constitutional safeguard, with its financial decisions deemed final and irreversible. This amendment revitalized previously dormant institutions like the CCI and the National Economic Council (NEC), addressing long-standing demands from smaller provinces for their activation. By establishing clear procedures for their functioning, the amendment strengthened federal-provincial relations and advanced provincial autonomy.

The meetings of CCI are rare, making it ineffective as an institutional mechanism for conflict resolution. However, the 18th Amendment has provided for a periodical presentation of the CCI report to both houses of parliament. It has extended the membership of CCI by adding three federal cabinet members, made its quarterly meetings mandatory, provided for a permanent secretariat, and expanded its mandate to include supervision and control over related institutions.[6] Tasked with formulating policies on matters listed under Part II of the Federal Legislative List, the CCI is required to meet at least once every three months, ensuring consistent provincial representation in decisions of mutual interest.

These steps have been designed to overcome its previously sporadic functioning and potentially increase its importance. The CCI's role must be enhanced to empower it as a monitoring body that not only monitors inputs such as budget allocations, revenue shares, and intergovernmental transfers but also outcomes like changes in interprovincial and regional distribution, growth rates, unemployment, and improvements in key services such as education, health, and water supply.

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4 *https://file.pide.org.pk/pdfpideresearch/wp-0073-fiscal-federalism-in-Pakistan-the-7th-national-finance-commission-awardand-its-implications.pdf*

5 *CCI and NEC: Waseem, M. (2010). Enhanced Role of the Council of Common Interests. Lahore University of Management Sciences.*

6 *Article 153 and the 18th Amendment: Muhammad, Sabir. (2011). Financial Implications of the 7th NFC Award. Social Policy and Development Centre (SPDC).*

The CCI should also promote public-private partnerships to take on additional expenditure responsibilities.[7]

5-MAJOR IMPLICATIONS IN THE 7th NFC AWARD:

The passing of the 18th Amendment and the 7th NFC Award is highlighted as a step towards provincial autonomy, but it comes with significant financial and administrative implications. These changes require serious adjustments in development and non-development expenditures, workforce arrangements, and legal issues.

I-FISCAL ADJUSTMENTS:

There appears to be more space in provincial budgets for diversion to flood relief, rehabilitation, and reconstruction compared to the federal budget, which envisages a fall in development spending according to the IMF. Following the reforms, the federal government expected provinces to generate a large revenue surplus and limit their development expenditure to eventually build up cash balance. However, the 2010-11 provincial budgets reveal that larger transfers have not led to visible profligacy in current expenditure by provincial governments, there is evidence of potential lack of planning and waste in resource allocation. [8]

The seventh NFC Award was announced amidst a low and stagnant tax to GDP ratio. High dependency on fiscal transfers to finance sub-national expenditures was seen as a disincentive for tapping the sub-national tax base. An important question in designing the new federal transfers system was whether it would motivate provinces to improve their fiscal management, keeping in view the years of progress has yielded no positive results.[9]

II-TAX TO GDP RATIO:

The low and stagnant tax to GDP ratio remained a challenge, with a high dependency on fiscal transfers. This has led to a high dependency on fiscal transfers and limited fiscal space for development projects.[10]

III- THE LACK OF ROBUST MECHANISM FOR TAX COLLECTION:

Under the 1935 Government of India Act, sales taxes on goods were assigned to the states (provinces) while services to the center. Following the Pakistan General Sales Tax Act 1948, this was reversed for Pakistan, and services became a provincial assignment, hence levying of taxes on ‘Goods’ by the federation and ‘Services’ by the provinces. More recently, and effective from July 1, 2010, Value Added Tax (VAT) has become applicable on all economic activities, covering all ‘Supply of Goods’ and ‘Rendering of Services’, with very limited exceptions. The 18th amendment has reiterated the right of the provinces to levy and collect the GST on services, which was also the principle agreed to in the 7th NFC Award. However, fissures have clearly emerged in the tussle over the administration of the GST on services. [11]

But why is it difficult to implement VAT in provinces? To start with, the process is bound to take at least 3 to 5 years and requires serious consultation amongst provinces. Provinces also lack the capacity to deal with cross-provincial taxation and GST on interprovincial transactions and to implement any kind of crediting or refund mechanism. Further, there are complexities in implementing ‘place of supply’ rules. In addition, according to a World Bank report, the Federal Board of Revenue (FBR) has little incentive to collect this tax due to a small collection fee and the fact that revenues are to

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7 Capacity Building: Ghaus, P. (2010). Decentralization and Its Implications. Social Policy and Development Centre (SPDC).

8 Revenue Collection and Mobilization: Muhammad, Sabir. (2011). Financial Implications of 7th NFC Award and its Impact on Social Services. Social Policy and Development Centre (SPDC).

9 Fiscal Adjustments: Khan, Ashfaque, H. (2011). Financial Implications of the 7th NFC Award and its Impact on Social Services. Pakistan Institute of Development Economics

10 *https://thefridaytimes.com/16-Mar-2024/pakistan-s-taxation-woes-compounded-by-nfc-failures*

11 Provincial VAT on Services: Kasbati, S. (2010). Implementation of VAT on Services.

be returned to provinces.[12]

IV- CENTER'S CONCERN OVER VERTICAL DISTRIBUTION OF DIVISIBLE POOL:

The provincial governments' 57.5% share of the divisible pool of federal taxes has been a contentious issue. Critics argue this allocation has strained federal revenues, leaving limited resources to manage debt servicing and leading to significant federal budget deficits. However, the constitutional provision under Article 160(3A) guarantees that the provincial share cannot be reduced without a constitutional amendment, making this a fixed aspect of fiscal policy unless changes are enacted. The large share allocated to provinces has left the federal government with inadequate funds to meet essential expenditures, particularly debt servicing, worsening budget deficits.

Provinces, relying on substantial federal transfers, have shown little initiative in developing their own revenue streams. Despite having powers to levy significant taxes, like sales tax on services and agricultural income tax, the tax-to-GDP ratio at the provincial level remains at a low 0.8%, declining from over 1% in 2017-18.

V-POLICY CONSTRAINTS ON PROVINCIAL GOVERNMENTS:

Provincial governments in Pakistan face limited borrowing powers, requiring special permission even during emergencies. In contrast, Indian states borrowed up to 3% of GDP in 2022-23. Additionally, Pakistani provinces are expected to generate cash surpluses, with a target of Rs.650 billion for 2023-24, which constrains their fiscal flexibility further.

VI-DECLINE IN FEDERAL TRANSFERS AND SOCIAL EXPENDITURES:

Federal transfers to provinces have dropped from 5.7% of GDP in 2017-18 to 5% in 2022-23 due to the declining federal tax-to-GDP ratio. This reduction has negatively impacted provincial spending on essential services like education and health, which fell from 3.2% of GDP in 2017-18 to 2.9% in 2021-22. This decline has contributed to Pakistan's drop in the UNDP Human Development Index from medium to low levels.

The constrained fiscal environment has had a direct impact on social spending. Addressing these challenges requires coordinated efforts at both federal and provincial levels to enhance revenue generation and fiscal discipline .[13]

VII-FATA'S EXCLUSION FROM FISCAL TRANSFER:

The situation regarding Khyber-Pakhtunkhwa's (K-P) share in the National Finance Commission (NFC) Award post the merger of the Federally Administered Tribal Areas (FATA) into the province in 2018 raises several constitutional and equity-based concerns.

Violation of Constitutional Principles:

The historic 25th amendment to Pakistan's Constitution in 2018 merged FATA into Khyber Pakhtunkhwa to integrate the region into the national mainstream. However, six years later, the region's 6.1 million inhabitants (provisional results digital census 2023) remain excluded from the NFC's intergovernmental transfer mechanism. NFC transfers aim to achieve fiscal equalization across regions, with the 7th NFC award incorporating multi-indicator criteria like population, poverty, revenue, and inverse density to promote regional parity. The exclusion of FATA's developmental needs violates the principle of "Finance Follows Function," also, as the province is burdened with the region's historic developmental lag without adequate resources. Since 2018, Khyber Pakhtunkhwa has struggled to serve this additional population with higher developmental needs, compounded by scattered populations, militancy, and past neglect.

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12 World Bank Report: World Bank (2010). Provincial Tax Administration in Pakistan.
13 https://www.brecorder.com/news/40295409 (Dr. Hafiz A Pasha Former Federal Minister)

Decades of neglect as a federal territory have left FATA with extreme poverty and poor service delivery. The Planning Commission estimated a poverty rate of 73.3% in FATA (2018-19), compared to 41.8% in Baluchistan and 21.9% nationally. FATA's low fiscal capacity and high service delivery costs due to sparse populations and historical neglect make equalization transfers essential. Globally, fiscal equalization ensures sub-national governments provide similar services irrespective of residents' location. Inhabitants of Merged Areas urgently need such transfers to achieve parity in essential services and contribute to national economic growth. Precedents like Baluchistan's special grant under the 7th NFC and Sindh's subvention for forgone tax revenues highlight the need for similar support for KP to address FATA's development needs effectively.
Yet, K-P's share in the NFC Award has remained stagnant at 16.42%, falling short of the 19.6% share to which the province is constitutionally entitled based on its revised population. This is a clear violation of constitutional provisions aimed at ensuring proportional resource allocation. This is a clear violation of constitutional provisions aimed at ensuring proportional resource allocation.

Unjust Impact on Khyber Pakhtunkhwa:

The merger brought substantial governance and developmental responsibilities to K-P, including integrating FATA into the provincial administrative framework. These responsibilities have added to the financial burden of the province, which now needs increased resources to:

1. Bridge Development Gaps: FATA historically suffered from underdevelopment due to its unique administrative setup under the Frontier Crimes Regulation (FCR). Its integration demands significant investment in infrastructure, education, healthcare, and governance.
2. Address Poverty and Backwardness: The region has some of the lowest socio-economic indicators in the country, necessitating targeted fiscal interventions.
3. Strengthen Security and Stability: The area remains vulnerable to extremism and requires robust security measures, which place an additional financial strain on the provincial government.

Adverse Consequences:

The current situation has several undesirable implications:

1. Delayed Development: Insufficient funds slow down much-needed development in the merged districts, exacerbating existing disparities.
2. Provincial Strain: K-P is forced to stretch its limited resources, compromising its ability to address broader provincial priorities.
3. Erosion of Federal Unity: Ignoring K-P's rightful share in the NFC award fosters grievances and weakens the federation's cohesion.

Without an increase in NFC allocations, K-P is left with inadequate resources to fulfill these critical responsibilities, hindering both the development of the merged districts and the province as a whole.

VIII-DECENTRALIZATION FROM PROVINCES TO LOCAL LEVELS:

The design incorporated in the Local Government Ordinance issued in 2001 drew inspiration from the system of 'basic democracies' implemented during the 1960s. The provinces were instructed to issue their own local government laws as long as the basic construction proposed by the center was not tampered with. The process of devolution since then has caused significant fiscal decentralization, doubling Local Government (LG) expenditure to 2.5% of the GDP.

Despite the transfer of a large number of functions to LGs, they have limited capacity to deliver. The LGs also have inadequate fiscal powers and hence make minimal fiscal effort to raise taxes. They have restricted administrative and financial autonomy to make decisions and carry out reforms. Moreover, the performance of the Provincial Finance Commission (PFC) has also remained poor, particularly in terms of fiscal equalization. Inadequate attention has been paid to capacity building and setting up monitoring and supervision bodies.

For fiscal equalization between rural and urban areas, incentives for higher fiscal effort at the local level, and conditional grants for some devolved functions are needed to achieve a minimum standard of provision throughout the province. International experience has shown that large transfers can reduce fiscal effort and create dependency, whereas performance-linked incentives in grants can lead to significant improvements. The use of a gap-filling approach to grants creates a tendency for LGs to raise expenditure and reduce fiscal effort, while inter-jurisdictional fiscal equalization in grants needs more attention. Therefore, dire attention is required to be paid to the PFC to smartly utilize the grants and for the development at the grassroots level.

IX-LACK OF ENVIRONMENTAL BUDGET:

Pakistan is highly vulnerable to climate change, ranking among the ten most affected countries in the world. Devastating events like the floods of 2010 and 2021 have led to severe economic and social disruptions. These disasters highlight the urgent need for fiscal policies that focus on climate issues. However, the National Finance Commission (NFC) Award has not prioritized budget allocations for climate mitigation and adaptation.

The 2010 floods caused over $10 billion in damage, displacing millions and crippling the agricultural sector. The 2021 floods further exacerbated these vulnerabilities, resulting in long-term impacts on food security, health, and infrastructure.

Despite the ongoing climate disasters, the NFC Award lacks a dedicated framework for allocating funds to address environmental challenges. This gap undermines the country's capacity to implement effective climate adaptation strategies and build resilience.

X-THE REFUGEE CRISIS:

Pakistan has one of the largest refugee and illegal alien national's population and more than 90 percent of this population comprises residents of Afghanistan. More significantly, 80 percent of these Afghans have been living for the last 40 years in Khyber Pakhtunkhwa province. The total number of registered or documented Afghans in Pakistan, according to UNHCR, is 2.18 million. Pakistani authorities' estimates also show the presence of 1.7 million undocumented, unregistered or simply illegal Afghans in Pakistan.
However, both the UNHCR figures regarding documented Afghans in Pakistan and Pakistani authorities' statistics about illegal Afghans appear to be inexact keeping in view the hitherto porous nature of their 2,640 kilometers-long international border. Moreover, there is also a big difference in UNHCR and Pakistan data about the total number of Afghans in Pakistan.

The UNHCR data suggest around 3.7 million Afghans living in Pakistan while Pakistani authorities say there are more than 4.4 million Afghans in Pakistan. Most registered and undocumented Afghans are living in the least economically developed provinces of Pakistan while Afghan nationals (legal or illegal) have a huge stake in K-P. The presence of a huge Afghan refugee population is an additional burden on K-P's financial, infrastructural, land and water resources. In this context the present multiple indicator criteria for distribution of the Federal Divisible Pool (FDP) without taking the Afghan refugee population as a factor is unrealistic and unjustified.
Unless the foundation of a modern vibrant economy is not laid in K-P particularly in the Merged Tribal Districts, the very factors of terrorism cannot be successfully addressed and the region cannot be mainstreamed.

Consequently, the country cannot be quarantined from the negative fallout of the prevailing situation there. So in the larger national interest of Pakistan there is a need to increase the share of the K-P in the NFC by jacking up the weightage of criteria of 'grant in war against terrorism.' Here it is also recommended that the foreign aid received in lieu of the country's efforts against terrorism may bemade part of the NFC as a special head and the nearly the entire funds allocated to KP. [14]

14 *https://tribune.com.pk/story/2516120/is-it-time-to-revisit-the-nfc-award*

6-COMPREHENSIVE RECOMMENDATIONS FOR ENHANCING FISCAL FEDERALISM IN PAKISTAN:

- Provinces need to focus fully on the potential of sales tax on services, agricultural income tax, and property taxes to enhance their revenue base.
- The federal government should expand the tax base and invest in effective collection mechanisms to generate greater tax revenue.
- Provincial Finance Commissions (PFC) should adopt effective criteria, such as the Multidimensional Poverty Index (MPI), to allocate resources for poverty reduction at the district level and better address Sustainable Development Goals and reforms for good governance.
- The devolution of subjects under the 18th Amendment should be phased and include proper transitional arrangements, particularly for vertical health, population programs, and higher education initiatives.
- Provinces must invest in improving their absorptive capacity to fully utilize transfers and increased revenues.
- Responsibility for natural resources, including oil, gas, and hydroelectric resources, should be fulfilled in letter and spirit as per constitutional provisions, ensuring provincial rights are recognized.
- The federal government and provinces should collaborate to address expenditures for regions like Azad Kashmir, GilgitBaltistan, and FATA, and share the burden of managing natural disasters and controlling terrorism.
- The rejuvenation of Provincial Finance Commissions is essential to improve service delivery at the local level.
- Each tier of government must work within its domain, emphasizing decentralization and indigenous planning and development strategies tailored to local needs.[15]
- Over the years, the deteriorating law and order situation has had a damaging effect on Pakistan's economy. On one hand, billions of rupees are being spent on combating militancy and maintaining law and order, while on the other, internal strife hinders both domestic and foreign direct investment (FDI). There is an urgent need to normalize the law and order situation to attract investment. The political leadership must come together and formulate a coherent policy, setting aside political differences.
- Specific allocation should be made for addressing environmental concerns, with a focus on sustainable development projects aimed at mitigating the impact of climate change. Provincial governments should be empowered to allocate resources for environmental conservation within their regions, ensuring a greener and more sustainable future.
- Special focus must be placed on the economic integration and development of FATA (Federally Administered Tribal Areas). Resources should be allocated for infrastructure development, education, and healthcare, helping bridge the socioeconomic gap between FATA and other provinces.
- The 7th NFC Award underscores the need for a more dynamic and responsive approach to fiscal federalism in Pakistan. As socioeconomic conditions evolve, so too must the criteria and mechanisms for resource distribution. Future NFC Awards should incorporate mechanisms that allow for periodic reviews and adjustments based on emerging challenges and opportunities faced by the provinces. This could include factors such as environmental vulnerabilities, demographic shifts, and new economic opportunities, ensuring that the fiscal framework remains relevant and effective in addressing the provinces' needs.

WAY FORWARD:

To ensure fair and effective financial resource distribution, Pakistan must address the structural and procedural challenges in its federal framework including;

•Establish Fixed Criteria: Introducing clear and transparent guidelines for resource distribution based on a mix of population, poverty levels, revenue generation, and other socio-economic

15 https://www.undp.org/sites/g/files/zskgke326/files/migration/pk/DAPIssue67thNFCAward.pdf

indicators.

•Strengthen Institutions: Empowering forums like the CCI and NFC to function independently and effectively, free from political interference.

•Periodic Reviews: Ensuring timely revisions of NFC Awards to reflect changing socio-economic realities and address grievances of federating units.

•Capacity Building: Enhancing the administrative and financial management capacity of provinces to utilize devolved resources effectively.

While the 18th Amendment and the 7th NFC Award were steps in the right direction, achieving true fiscal federalism in Pakistan requires continued efforts to balance provincial autonomy with national cohesion.

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