FISCAL DECENTRALIZATION IN PAKISTAN, REVENUE TRENDS PROVINCIAL SPENDINGS AND NFC AWARD CRITERIA

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Abstract

Fiscal decentralization, a concept being practiced globally, is defined as the transfer of responsibilities, with regard to revenue collection and expenditure, from federal to provincial governments, with a view to achieving economic efficiency and improving governance. In Pakistan, this concept has been realised through the National Finance Commission (NFC) Award, which distributes federal revenue from its divisible pool among the federations and provinces. However, in contrast to NFC's perceived aim of enhancing provincial autonomy and improving governance (through fiscal decentralization), provincial governments' dependence on federal fiscal support has not been reduced, as desired. In addition to this continued dependence, provinces have also exhibited very marginal growth/development. Though NFC awards have been formulated very diligently, with the population as its bedrock. Yet, various provinces, besides claiming for unjust fiscal distribution, also point fingers towards the federal government's various unmanaged/unaddressed issues, like population over-centricity (in NFC), undue federal liabilities, and continued financing of devolved ministries, as a reason for their below-par performance/ governance. Thereby, warranting fresh work on the NFC award, to include various essential futuristic factors, in addition to existing ones, retaining population at its axis. To analyse Pakistan's fiscal decentralisation framework with special focus on revenue trends, social sector expenditures (health, education), and provincial contributions with a view to recommending a balanced cum futuristic distribution, for the next NFC award.

Keywords: Fiscal Decentralization, National Finance Commission (NFC) Award, Provincial Autonomy, Revenue Distribution, Governance and Development

Introduction

Pakistan is a federal democratic form of Government. Being a federation, most of the revenue is collected by the federal government and then distributed between the federal and provincial governments. The **Divisible Pool** refers to the total collection of federal tax revenues that are distributed between the federal government and the provinces under the NFC Award[2]. The **Vertical Distribution** refers to the division of resources between the federal government and the provinces. For example, under the 7th NFC Award, approximately 57.5% of the divisible pool is allocated to the provinces, while the remaining share is retained by the federal government. Lastly, the **Horizontal Distribution** refers to how the provincial share is distributed among the provinces themselves.

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For instance, within the provincial share, Punjab, Sindh, KPK, and Balochistan receive different percentages based on agreed criteria such as population, poverty, and revenue generation. For ease of understanding, the fiscal distribution framework can be viewed in two steps: first, the total revenue is divided between the federation and provinces (vertical distribution), and second, the provincial share is further distributed among provinces (horizontal distribution).

Pre-independence Revenue Sharing (Niemeyer Award)

Before independence, the Niemeyer Award under the 1935 Act was followed to distribute the resources between the federal and provincial governments. Under this award, sales tax was a provincial subject, while 50% income tax collections were also redistributed to the provinces.[5] In addition, NWFP was given an annual grant of Rs 10.5 million.

Post-Independence Revenue Sharing (Raisman Award)

As per the formula, to overcome the poor financial situation arising from partition, the federal government was given a 50 percent ad hoc share of sales tax to cope with its financial crisis. Out of the proceeds of 50 percent income tax, the East Pakistan government got 45 percent of the federal divisible pool while West Pakistan got the 55 percent share. Under this award, the subvention to NWFP was Rs 12.5 million.[6]

Revenue Sharing Under One Unit

All four provinces of Baluchistan, NWFP, Punjab, and Sindh of West Pakistan were declared as one unit in 1955. Two awards for the years 1961 and 1964 were announced during that period.

Under the 1961 Award

Out of the divisible pool, East Pakistan and West Pakistan got 54 percent and 46 percent shares. 30 percent of sales tax was specified for the provinces on the basis of their collection. Duties on agricultural land and capital value tax on immovable property were given to the units as per their collection.

1964 National Finance Commission

The divisible pool consisted of collections from income tax, sales tax (30 percent of sales tax was distributed as per collection in each province), excise duty, and export duty.
The respective shares out of the divisible pool between the federal and provincial governments were 35:65 percent. The share of East Pakistan and West Pakistan remained unchanged at 54 percent and 46 percent, respectively.[7]

National Finance Committee 1970

A national finance committee was set up in 1970 to recommend the intergovernmental resource sharing. The divisible pool remained unchanged; the share of the federal and provincial governments in the divisible pool was allocated to be 20:80 percent, respectively. After the separation of East Pakistan, 4 provinces that constituted West Pakistan continued to receive their respective shares in the same proportion as stated above.

National Finance Commission (NFC) as per the 1973 Constitution

As per the 1973 constitution, it was made obligatory for the government to compose NFC at an interval not extending more than 5 years for amicable resource distribution among the federation and its respective units.[8]

First NFC Award 1974

The first NFC was constituted on 09 February 1974[9,] and its salient features were: Divisible Pool Taxes consisted of income tax, sales tax, and export duty on cotton. Resources were vertically distributed among federal and provincial governments at a fixed ratio of 20 to 80 percent. The share of the provinces was distributed on the basis of population. Annual grants of Rs 50 and Rs 100 million, respectively, were also allocated to the Baluchistan and NWFP governments to compensate for their weak financial situation.

Second NFC Award 1979

The second NFC was constituted on 11 February 1979. However, it was unable to finalize its recommendations. Therefore, resource distribution was conducted as per the 1974 NFC award.

Third NFC Award 1985

The third NFC was constituted on 25 July 1985. However, the Commission's recommendations could not be finalized, and resource distribution from divisible pools remained the same as of the 1974 NFC.

Fourth NFC Award 1990

The 1990 NFC award came up with recommendations in April 1991[10]. Salient features of the award were: The divisible pool was enlarged & consisted of income tax, sales tax, export duty, excise duty on tobacco, and excise duty on sugar (New addition). The provincial share in the divisible pool taxes remained at 80%.

The provincial share in the divisible pool taxes was distributed according to population. Grants-in-Aid were allocated to Provinces. Net proceeds of development surcharge on natural gas and royalty on crude oil were made as straight transfers to provinces. Net profit from hydroelectric stations was to be paid by WAPDA.

Fifth NFC Award 1996

The 5^{th} NFC was announced in February 1997. Salient features of the 1996 Award were: The entire FBR taxes, excluding Excise duty on natural gas and Income tax paid out of the Federal Consolidated Fund, were made part of the divisible pool taxes: The provincial and federal share in the divisible pool taxes was fixed at 37.5% and 62.5% percent. Provincial share in the divisible pool taxes was to be distributed based on the population of each province. The net proceeds of development surcharge on natural gas and royalty on crude oil were continued as straight transfers. The Grants-in-Aid to the provinces were allotted. The collection charges were recommended at 5% on the divisible pool taxes and 2% in case of straight transfers.

Sixth NFC Award 2000

The sixth NFC could not finalize the award due to divergent views on the basic issues. The then Chief Ministers and Finance Ministers of the provinces reposed confidence in the then President of Pakistan for revision of the Distribution of Revenues and Grants-in- Aid Order, 1997, enhancing the provincial share in the Divisible Pool Taxes. Accordingly, the Distribution of Revenues and Grants-in-aid Order, 2006 was issued.[11]

7th NFC Awards 2010

Pakistan's 7^{th} NFC Award was given legal cover on 10^{th} May, 2010, officially named Distribution of Revenues and Grants-in-Aid Order, 2010[12]. It came hand-in-hand with the 18^{th} Amendment, which transformed the relationship between the Centre and the provinces by devolving several key subjects, including Human development, education, and health, to the provinces.

The Key Features of the 7^{th} NFC Award include the increase in Provincial Share. The most notable aspect of the 7^{th} NFC Award was the increase in the share of provincial governments from the divisible pool (federal tax revenues). From the vertical distribution, provinces' share was increased from 47.5% to 56% for the first year (2010–11) and 57.5% from the second year onward. The increased provincial share marked a significant step toward fiscal decentralization[13]. The sum assigned to provinces is to be distributed as per the following percentages:-

(1)	Punjab	51.74 %
(2)	Sindh	24.55 %
(3)	KPK	14.62 %
(4)	Baluchistan	9.09 %
(5)	Total	100 %

Second, the shift from Population-Based Distribution to Multi-Criteria Formula. For the first time, multiple indicators were adopted in the 7th NFC Award for the determination and distribution of provincial shares in the divisible pool of taxes and duties on a horizontal basis, whereas in all the previous NFC awards, population had remained the sole criterion. By recognizing factors like poverty, revenue generation, and geographic challenges (e.g., sparse population density in Baluchistan), the award aimed to address disparities and empower less-developed provinces like Baluchistan and Khyber Pakhtunkhwa (KPK)[14]. The new formula was approved as follows:-

1) Population (82% weightage)
2) Poverty and backwardness (10.3%)
3) Revenue collection/generation (5%)
4) Inverse population density (2.7%)

Sales tax on services was considered a provincial subject. The major components are: Income tax, wealth tax, capital value tax, taxes on sales and purchases of goods (Imports, exports, produced or consumed), export duties on cotton, customs duties, federal excise duties, any other tax that may be levied by the federal government.

Provincial Contributions/ Own Revenue Generation

The introduction of 5% weightage for revenue collection/generation created incentives for provinces to enhance their own revenue collection capabilities. This was closely linked with significant provincial autonomy provided by the 18th Amendment. [15]The General sales tax on services, duties regarding the succession of properties, estate duty, and capital gains became provincial taxes. Also, the net proceeds of the excise duty on oil and natural gas and royalty on natural gas went to the provinces (Article 161).

The powers of provincial governments were also enhanced with respect to revenue generation and natural resources as follows:- The mineral oil and natural gas within a province or its territorial waters now vest jointly and equally in the Federal Government and that Province (Article 172). Also, the provinces can now raise domestic and international loans subject to the conditions and limits specified by the National Economic Council (Article 161).

A key feature of the 7th NFC Award was the long-overdue recognition of Baluchistan's needs. Its share from the divisible pool was guaranteed at Rs. 83 billion in FY12, more than double its FY10 share. Baluchistan's share was based on budgetary projections, not actual tax collection by the Federal Board of Revenue (FBR), with any shortfall covered by the federal government. This arrangement has continued since FY12. Similarly, KPK received 1% of the divisible pool to offset costs from the war on terror, allowing both provinces to benefit directly from their unique circumstances.[16]

Fiscal Trends - Since 7th NFC Award (2010-2024)

Despite constitutional provisions requiring a new NFC Award every five years, the 8th, 9th, and 10th NFC Awards have not been finalized. The 7th NFC Award has remained the operative arrangement throughout this period. Fiscal deficit has been persistently large and increasing due to lower revenue generation and more expenditures by the government. In FY23, the government fiscal deficit stood at 7.8% of GDP, and the budget was estimated to be Rs 5,588 Bn in 2024. Over the past decade and a half, the deficit averaged 6.2% of GDP, a notch below the South Asia regional average of 6.3%. Federal finances show a similarly widening gap, particularly after FY 2020, reaching a budget estimate deficit of Rs 3,294 Bn. The COVID-19 pandemic in 2020 significantly impacted Pakistan's fiscal position. Government revenue plummeted due to economic contraction, while expenditures rose as the government introduced relief packages to mitigate the pandemic's effects. However, the fiscal deficit at the provincial level is more alarming at Rs 3,707 Bn with an increase rate of 466%.[17]

The fiscal situation has also been significantly shaped by the post-COVID economic recovery phase. During the pandemic (FY2020–21), Pakistan's GDP growth contracted to around -0.9%, while government revenues declined due to reduced economic activity. At the same time, expenditures increased sharply due to emergency relief measures, including the Ehsaas Programme and health sector spending. As a result, the fiscal deficit widened to approximately 8–9% of GDP during this period. In the post-COVID phase, Pakistan continues to face elevated fiscal pressures, including high inflation (exceeding 25% in recent years), rising debt servicing costs, and commitments under IMF programmes. Public debt has crossed 70% of GDP, significantly constraining fiscal space. These factors have complicated both federal and provincial financial management and reduced the government's ability to allocate resources toward development and social sectors.[18]

Tax revenue has grown 5.5 times since 2010, but it remains insufficient. From 2010 23, the tax-to-GDP ratio has fluctuated between 9% and 12%. In FY23, Pakistan's aggregate tax revenue stood at 11.6% of GDP, with 92% of revenues collected at the federal level. The tax-to-GDP ratio reached 10.2%. Pakistan's tax revenue falls short of 15% of GDP, which is considered the minimum required tax revenue by developing countries to fund basic government functions. Provincial tax generation, particularly from agriculture and property sectors, remains limited. Recent fiscal developments (FY2023-24 estimates) indicate continued challenges in improving the tax-to-GDP ratio, which remains below the desired threshold for sustainable economic growth. Inflationary pressures and structural inefficiencies in tax collection further exacerbate the situation.[19]

Since the 18th Amendment in 2010, public spending on education and health has gradually increased but remains low relative to international norms. Together, Pakistan's public spending on education and health was 3.4% of GDP in FY20, one of the lowest in South Asia and significantly lower compared to the global average of 11.2%.

Before the 7th NFC Award, an average of 2.12% of GDP was being spent on the education sector; however, the percentage has kept fluctuating, with an average of 1.94% of GDP after the 7th NFC Award. This is 17% less than the pre-NFC award spending. This places Pakistan among the lower ranks globally and regionally in terms of spending on education. Education spending globally averages around 4.5% to 5% of GDP. Countries in South Asia, including India, spend approximately 3.5% of GDP on education. Additionally, the education sector continues to face challenges arising from post-COVID learning losses, which have further widened disparities in access and quality across regions.20

Before the 7th NFC awards an average of 0.57 % of GDP was being spent on the health sector; however, the percentage has kept increasing, with an average of 0.94% of GDP currently**.** Pakistan ranks quite low in global health spending as a percentage of GDP, significantly below the global average and the WHO recommendation of 5%. The COVID-19 pandemic also exposed structural weaknesses in the healthcare system, highlighting the need for increased and more efficient provincial spending in this sector.21

Fiscal Distribution Model of India

In India's federal structure, state governments enjoy strong autonomy with a clear demarcation of subjects between the central and state governments. However, the fiscal relationship is characterized by a large vertical imbalance. The central government in India collects over 60% of government revenue and spends about 45% of government expenditure. To remove this imbalance and decentralize the fiscal authority, the constitution provides a mechanism wherein the Union shares both the authorities (spending the money and collecting revenue) between the Union & State government and as well as among the states.

As per Article 270 and 280(3)(a) of the Indian Constitution, the Finance Commission determines the percentage of the divisible pool that is to be assigned to the states (vertical distribution) and the percentage that is to be allocated to states inter-se (horizontal distribution). In the past, indicators such as population size, area, forest cover, and infrastructure index distance (from the average of the top three states), per capita income distance (from the average of the top three highest states), inverse income, poverty ratio, and index of backwardness were considered for determining these tax devolutions. For performance incentivisation, indicators measuring tax collection, tax effort (tax/gross state domestic product [GSDP]), and fiscal discipline were incorporated in various Finance Commission formulae.[22]

Finance commissions recommend grants-in-aid to help states provide comparable levels of services, at comparable tax rates, while ensuring a budget balance in the revenue account.[23] There are broadly three types of grants-in-aid:-

- **Gap Filling Grants.** To meet the difference between assessed current expenditure and projected revenue, the state's share of central taxes.
- **Local Bodies Grants**. To supplement the resources of local bodies.
- **Specific Purpose Grants.** Conditional transfers given to states to ensure minimum standards of certain basic services, provide grants for natural disasters, cover the capital expenditure needs of states in certain sectors and incentivize better fiscal management and planning amongst states.

Finance Commission of India

The Finance Commission is a quasi-judicial body under Article 280 of the Constitution of India. The President of India constitutes the Finance Commission every fifth year or earlier as he deems fit.[24]

The Finance Commission is comprised of a chairman and four other members, and they are appointed by the President. The Chairman of the Finance Commission is a person who has good experience in dealing with public affairs. A current Judge from a High Court, or such a person who is qualified to be appointed as a judge of the High Court.

15th Finance Commission of India

The 15th Finance Commission of India recommended the vertical distribution of resources between the Union and the states at 51% and 49% of the divisible pool, respectively. Horizontal distribution of resources among the states, the Commission recommended a criterion to determine each state’s share in central taxes, and the weight assigned to each criterion.[25] Income distance is the distance of a state's income from the state with the highest income. The income of a state has been computed as the average per capita GSDP during the three years between 2016-17 and 2018-19. A state with a lower per capita income will have a higher share to maintain equity among states.

The Terms of Reference of the Commission required it to use the population data of 2011 while making recommendations. Accordingly, the Commission used 2011 population data for its recommendations. The demographic performance criterion has been used to reward efforts made by states in controlling their population. States with a lower fertility ratio will be scored higher on this criterion. This criterion has been arrived at by calculating the share of the dense forest of each state in the total dense forest of all the states. This criterion has been used to reward states with higher tax collection efficiency. It is measured as the ratio of the average per capita own tax revenue and the average per capita state GDP during the three years between 2016-17 and 2018-19. The criteria, along with the weightage given to each criterion adopted for horizontal distribution of resources in the 15th NFC report, are given below:

Criteria for Devolution in %ages			
Criteria	**14^{th} FC (2015-20)**	**15^{th} FC (2020-21)**	**15^{th} FC (2021-26)**
Income Distance	50.0	45.0	45.0
Area	15.0	15.0	15.0
Population (1971)	17.5	-	-
Population (2011)	10.0	15.0	15.0
Demographic Performance	-	12.5	12.5
Forest Cover	7.5	-	-
Forest and Ecology	-	10.0	10.0
Tax and fiscal efforts	-	2.5	2.5
Total	**100**	**100**	**100**

In addition to recommending the vertical and horizontal distribution of resources, the commission also handles the responsibility to advice on the methods for augmenting the resources possessed by a state and also suggests the measures to supplement the resources of Tier-III government, i.e., the municipalities and the *panchayats*. But it is important to make it clear here that the recommendations forwarded by the Finance Commission of India are not binding on the government, and they are only advisory in nature.

That means it is on the Centre to decide whether to accept the recommendations of the commission on providing grants to the states, and a state doesn't have a legal right to necessarily receive the benefit recommended towards it by the Finance Commission.

However, the Finance Commission is a constitutional body and is quasi-judicial in structure, so the recommendations of the Commission are considered by the Government of India.

Evaluation of NFC Awards: 1974 - 2024.

Over 33 years, from 1974 to 2007, the divisible pool shifted from a narrow base (initially limited to income tax, sales taxes, excise and export duties) to a broader base (more inclusive formula including various other taxes). In 1st award, resources were distributed 20% to federal and 80% to provincial governments, with population as the sole horizontal distribution criterion. 2nd award, though inconclusive, recalculated distribution using the 1981 census. 3rd award adjusted the divisible pool, and 4th again was inconclusive, while the 5th award reversed the vertical share to 62.5% federal and 37.5% provincial. The 7th award shifted to 42.5% federal and 57.5% provincial, introducing a multi-criteria formula. Presently, the federal government manages national tasks with 40% resources, while provinces handle 60% but contribute less to national responsibilities.

Fiscal autonomy was granted to the provinces after the 18th amendment; however, this has resulted in fiscal independence, as despite receiving 60% of the resources, provinces are not liable to share expenditure details with the federal government. KPK was allotted with 1% additional share (from the net divisible pool) for their engagement in the war against terror and capacity enhancement (Swat and Malakand districts). Over the period of time, the law and order situation kept on fluctuating in KPK, as displayed. However, new responsibilities in the form of federally administered tribal areas merger have appeared for KPK.[26]

NFC in Pakistan, in contrast with contemporary models, is composed of political leaders instead of technocrats. Political leaders, constrained by public pressure and the potential backlash from their constituencies, have often been found reluctant to take bold decisions that could reduce their province's share in the NFC, barring one odd time. This has seriously affected the process, resulting in several inconclusive awards, which in turn have negatively impacted the fiscal landscape of Pakistan. One of the key components of the NFC award is population, which, post 7th NFC award (based on 1998 census), has increased exponentially. As per the latest census 2023, the population of Pakistan significantly increased to 241.49 million as compared to 132.35 million in 1998 (63% increase).

Province-wise population comparison is as follows:-

Province	Population - 1998		Population - 2023		Comparison	
	Population	%age	Population	%age	Inc	Dec
Punjab	73.62 Mn	55.6%	127.68 Mn	52.87%		2.73%
Sindh	30.44 Mn	23%	55.69 Mn	23.1%	0.1%	
KPK	17.74 Mn	13.4%	40.85 Mn	16.9%	3.5%	

Baluchistan	6.57 Mn	5%	14.89 Mn	6.16%	1.16%	
ICT	0.80 Mn	0.6%	2.36 Mn	0.97%	0.37%	
FATA	3.18 Mn	2.4%	-	-	-	
Total	132.35 Mn	100%	241.49 Mn	100%		

There is a need for a reappraisal of the existing NFC award with a view to redistributing fiscal resources, corresponding to the actual population size. Presently, provinces are exploiting the 18th constitutional amendment; "*the share of the provinces in each award of the NFC shall not be less than the share given to the province in the previous award*". Hence, no consensus on NFC in favour of provinces.

The federal government is facing difficulties in managing its primary obligations, as 63.8% of the budget is consumed in debt servicing and defence budget. Thereby leaving less cushion for other responsibilities including, managing AJ&K and GB territories, running civil government, and managing emergencies. Block distribution of federal budget 24-25, indicating federal income and expenditure summary is appended below:-

	Head	**Amount in Trillion**
Total budget		***18.877***
Income Summary	FBR receipts (revenue)	12.970
	Non-tax revenue	4.845
	Total revenue	***17.815***
Expenditure Summary	Interest payment	9.775
	Defence affairs & services	2.122
	Pensions	1.014
	Grants, transfers to provinces, a others	1.777
	Subsidies	1.363
	Running of civil government	0.839
	Provision of emergency a others	0.313
	Development and lending	1.674
	Transfer to provinces	7.438
	Total Expenditure	***26.315***
	Federal Budget Deficit	***8.500***

Though 60% of total revenue is taken by the provinces, they do not contribute towards any major federal obligation. Whereas the federal government receives 40% of revenue, yet, they are answerable to international lenders. This results in a fiscal deficit at the federal level, forcing them to opt for further loans to repay old loans. This resulted in 650% increase in federal loans post 7th NFC award in comparison to 416% increase in the same period before the 7th award. Another important reason for the rapid increase in domestic loans is the increase in interest rates by the federal government. In Pakistan's present context, 1% increase in interest rate by the State Bank of Pakistan increases the domestic loan by almost 300 billion rupees. Details of loans are appended below:-

Unjustified Spending on Devolved Ministries, BISP & PSDP

Although several ministries have been devolved to the provinces after the 18th amendment, the federal government continues to allocate funds for these sectors. By reducing only these expenditures, the federal government can save almost 1900 trillion rupees per year. Details appended below:-

Area of saving	**Amount saved**
Devolved ministries	328 Bn
BISP	600 Bn
PSDP	743 Bn (Less Federal projects)
Subsidies	1300 Bn
Expenditure Reductions	**3041 Bn**

Devolution of Power Down to the District Level

The spirit behind the devolution of social sector ministries to provinces vis-à-vis increases in provincial share was based on forward positioning of resources to ensure availability of these facilities at the public's doorstep. Provincial finance commissions are, by and large, not fully activated, which has resulted in a financial barrier at the provincial headquarters level.

Federal Receipts Vis-à-vis Provincial Receipts and Expenditures

The revenue trends in Pakistan reveal a slow improvement in both federal and provincial receipts, where federal receipts have shown steady growth only in the year 2017/18. Whereas provinces have displayed a continuous, slow increase during the same period. It is further substantiated by the stagnant tax-to-GDP ratio since 2010 (8.9% in 2010 vs. 8.8% in 2023).[27] Post 7th NFC award gap between revenue and expenditure has widened significantly in the case of provinces from 686 billion in 2010 to 3707 billion in 2023. During the same period Federal reduced the gap between receipts and expenditures from 37 billion in 2010 to 3294 billion in 2023.[28]

This indicates that due to an increased share in vertical distribution, provinces increased their expenditures and are not focused on improving their receipts. However, the federal gap has increased due to repayment of debt services and an increase in defence expenditures.

Below are several factors that contribute to poor revenue generation in provinces:-

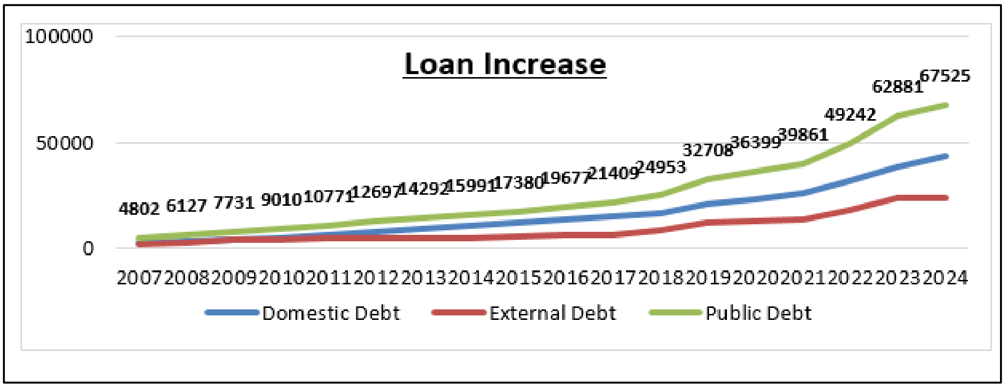
(a) Lack of administrative capacity at the provincial level.

(b) Political resistance to broadening the tax base.

(c) Limited economic activity in some provinces.

(d) Dependence on federal transfers to meet their expenditure needs reduces the incentive to develop their own revenue sources.

Provincial governments are increasingly reliant on federal transfers. Provincial tax collection, particularly from the agriculture and property sectors, remains limited. In 2023, all provinces collected only Rs 650 billion in taxes, against their total current and development expenditures of Rs 5038 billion. Whereas the federation collected 12 times more than the provinces. This led to fiscal deficits and increased borrowing by the federal government. Improving provincial revenue generation and expenditure efficiency will reduce excessive reliance on federal transfers and strengthen the overall fiscal resilience of the state.



Provincial Expenditure Pattern in Social Sector (Education and Health)

Education Sector

Post 7th NFC award, a decrease of 17% was observed in the education sector. In the year 2010, the education sector received 2.05% of total GDP in comparison to 1.5% in the year 2023. Despite this decline, the indicators have either remained consistent or improved. This phenomenon indicates that these ministries work more efficiently under provincial governments:-

Indicator	2009-10 (%)	2021-22 (%)
Literacy rate	57	62.8
Punjab	59	66.3
Sind	59	61.8
KPK	50	55.1
Baluchistan	45	49.5
Access to Electricity	40.4	70
Availability of Drinking Water	66.1	78
Availability of Toilet	60.4	79
Availability of the boundary wall	62.3	79

Health Sector

Before the 7th NFC awards an average of 0.57 % of GDP was being spent on the health sector; however, the percentage almost doubled, with an average of 0.94 % of GDP. This increase also improved overall health indicators, as shown below.

Health Indicator	2009	2015	2022
Country Life Expectancy	66.5	66.7	67.8
Life Expectancy at Birth (years)	66.5	65.7	67.3
Infant Mortality Rate (1,000 live births)	65.1	62.2	39.4
Source: World Bank, International database; Planning Commission			

Re-evaluating Population Centric Horizontal vs. Futuristic Framework

Persistent reliance on population as the primary criterion and ignoring factors like climate change, cyber potential, and artificial intelligence no longer aligns with evolving challenges and future needs. To create a more balanced and forward-looking framework, it is essential to reduce the population in the formula and introduce new criteria such as climate change vulnerability, technological innovation, cyber security, and artificial intelligence.

Implications for National Interest and Stability

Fiscal decentralization in Pakistan is not merely an economic arrangement but has significant implications for national interest and state stability. A persistent fiscal imbalance, where the federal government faces resource constraints while bearing major responsibilities such as defence, debt servicing, and national security, can undermine its ability to respond effectively to internal and external challenges. At the same time, limited improvements in provincial revenue generation and expenditure efficiency affect human development outcomes, which are critical for long-term economic strength and social stability. Weak fiscal coordination between federal and provincial governments may also create governance gaps, impacting service delivery and public trust.

This imbalance also has direct implications for defence financing. As a significant portion of national resources is transferred to provinces under the current NFC framework, the federal government is left with limited fiscal space to meet its core obligations, including defence expenditures. In the context of evolving regional security dynamics, including developments following Operation *Bunyan-um-Marsoos* and ongoing geopolitical tensions such as the US/ Iran - Israel conflict, the lack of assured and adequate federal resources may constrain defence preparedness, modernization efforts, and strategic response capabilities.[29] Furthermore, rising public debt and continued reliance on external financing pose risks to economic sovereignty. Therefore, a balanced fiscal framework that ensures both provincial autonomy and adequate federal capacity is essential for safeguarding Pakistan's national interests. In addition, Pakistan's geopolitical environment further amplifies the importance of a robust fiscal framework.[30]

Recommendations

The following recommendations are proposed with a view to improving fiscal efficiency while safeguarding national economic stability and strategic interests. As the relative law and order situation in KPK is still not very stable, and KPK is also sharing the burden of the merger of erstwhile FATA, so 1% additional grant instead of the law and order situation in KPK may be considered.

As each member in the NFC represents a stakeholder and the issues discussed are very sensitive, it is suggested that this award must not be politicised. Suggested composition of NFC is as follows:-

A person with experience in public affairs, appointed by the Prime Minister in consultation with the Chief Ministers.

(a) 1 x Retired judge (High / Supreme Court) for legal advice.

(b) 1 x Expert in financial matters.

(c) Federal Finance Minister.

(d) 4 x Chief Ministers.

(e) 4 x Technocrat members, one from each province.

Since the population of Pakistan increased to 241.49 million in 2023, as compared to 132.35 million in 1998 (82.46% increase),[31] hence there is a dire need to recalculate funds distribution on the basis of the census 2023. This can be done by issuing a Presidential order under Article 160 (6) of the Constitution of Pakistan.

As several awards remained inconclusive, it is suggested that in case of no consensus, any formula agreed by max members may be adopted as an interim award till reaching a consensus. This will require a constitutional amendment in Article 160(3) A.

By gradually reducing the interest rate, the government can automatically reduce the burden of debt servicing (9.775 trillion). Almost 30% debt servicing is of foreign loans, whereas 70% debt servicing is of local loans.[32] By reducing the interest rate, local loans will drastically reduce (as 1% decrease in interest rate almost reduces interest repayments by almost 300 billion rupees). The federal government must improve its foreign exchange reserves, which will have an impact on the interest rate.

After the 18th Amendment, the federal government must stop unnecessary projects for the social well-being. Amid severe fiscal constraints, the federal government must stop spending over Rs 328 billion on 17 devolved ministries that fall in the provincial domain. Subsidies given by the government are misused, reflecting elite capture (As per World Bank figures, the poorest 1/5th of the population received 9.8% of total subsidies while the richest segment received 38%).[33] Provincial governments must spend 2.5% of their budget on the education and health sectors. Projects recommended to be closed/ shifted to provinces along with their net effect on the budget are appended below:-

i. Benazir Income Support Programme -0.60 trillion
ii. Public Sector Development Programme - 0.74 trillion
iii. Subsidies- 1.3 trillion

Area of saving	**Amount saved**
Devolved ministries	328 Bn
BISP	600 Bn
PSDP	743 Bn (Less Federal projects)
Subsidies	1300 Bn
7.5% from the divisible pool	970 Bn

Total Deficit	8500 Bn
Expenditure Reductions	3941 Bn
Remaining Debt	4559Bn

If federal and provincial governments take these steps, then, hypothetically, considering the current interest to remain fixed and we avoid taking new loans, the federal government shortfall will reduce from 8500 Billion to almost 4500 billion. This 4500 billion can also be overcome by increasing tax to gross domestic product ratio, which may be a big challenge, and by reducing interest rates. Accumulative effects are as to accrue maximum benefits from fiscal independence, provinces must activate provincial finance commissions, and resources must be devolved down to the division level following the same formula by implementing local governments and empowering them financially. This apparently may take time and require additional staff at the division level; however, following the ***Out of the Box solution*** will reduce additional human resources. In this regard, the "***Facility Level Management System***" may be launched in all schools and hospitals, linked with provincial ministries.

(1) **Requirement Submission**. Schools and hospitals submit requests for items (furniture, medicines, and staff) through the online system.

(2) **Review and Approval**. Provincial ministry staff review and approve the submitted requests based on guidelines and resource availability.

(3) **Procurement Process**. Upon approval, the ministerial staff initiates the procurement process, including obtaining quotes and completing legal formalities.

(4) **Purchase and Transportation**. Items are purchased, and logistics are arranged for transportation to the respective facility.

(5) **Delivery Confirmation**. Items are delivered to the school or hospital, and a confirmation receipt is generated.

(6) **Feedback Submission**. After receiving the items, the facility provides feedback on quality and satisfaction through the system.

(7) **Query Closure**. The user setup closes the query, and the system generates reports for future planning and resource allocation.

Implementing this cheap and quick solution, a lot of resources and human resources can be saved. As a test trial case, this may be implemented on 1 x division and its districts in KPK. Moreover, to fulfil obligatory responsibilities of the federal government, it is recommended that the vertical distribution of resources should be increased from 42.5% and 57.5% for the federal government and provinces, respectively, to 50% each.

Federal government to manage remaining resources by increasing tax revenue in addition to other steps mentioned in recommendations. To create a conducive environment to bring all stakeholders on the same page, necessary trust-building steps may be initiated. This amendment will require a constitutional amendment. This adjustment is critical to ensure that the federal government retains sufficient fiscal capacity to meet core national responsibilities, including defence, debt servicing, and macroeconomic stabilization, which are essential for national security and sovereignty.

The present NFC award, especially the horizontal distribution of resources, was launched with the mutual consensus of all provinces. The panel is cognisant of the fact that a shift to an efficiency-based distribution formula is not possible overnight. So, the panel recommends initiating a debate on the need for moving towards an efficiency-led resource distribution for which a constitutional amendment is required. The panel has prepared a few guidelines to be gradually implemented for the next 4 x NFC awards. These include: - Population, with the highest weightage of 82% for horizontal distribution of resources, leads to uneven distribution of resources among the provinces. Hence, cut the population's weightage down by at least 10% in the next two NFC awards; later, further reduce it by another 15% in the subsequent two awards to ultimately bring its weightage to 50%. This will bring parity between the most populated and least developed provinces on one hand, and will also disincentivize population growth.

Keeping its current weight, replace absolute poverty with poverty distance as an indicator. Poverty distance is the difference between the provincial poverty and the richest province. This will increase the share of provinces with relatively more poverty. No change in the current weightage of 2.7%. This will continue helping Baluchistan, as it has a higher inverse population density compared to other provinces.

Replace the existing indicator of absolute tax revenue with tax collection efforts, i.e., the difference between the revenue collected and the estimates of revenue potential. Also, increase the weight for this indicator to 10% in the next two awards.

Weightage to efficiency indicators (Forest cover) as the new criteria (for next award only; to be changed for every award, keeping in view the future circumstances) to accrue huge ecological benefits, and the opportunity cost in terms of area not available for other economic activities, which becomes an indicator of fiscal disability. This indicator may be replaced by development in Information technology.

The population growth criterion has been used to reward efforts made by states in controlling their population. Provinces with a lower fertility ratio will be scored higher on this criterion. A proposed formula is as follows:-

Existing Formula - 7th NFC Award		**Proposed Formula - Next Award**		**Comment**
Indicator	Weight (%)	Indicator	Weight (%)	
Population	82%	Population	72%	• *Deviation* • Reduce by 15% per year in the next 2 awards
Poverty	10.30%	Poverty Distance	10.3%	• *Composition changed*
Inverse population density	2.7%	Inverse population density	2.7%	• *No Change*
Tax revenue	5%	Tax Effort (tax revenue - tax potential)	10%	• *Composition Changed* • Weight doubled
		Forest Cover	4%	• *New addition* • Futuristic in nature, counter future trends
		Population Growth	3%	• *New Addition*

These measures aim to align fiscal decentralization with emerging global challenges while ensuring that national priorities such as economic resilience, technological advancement, and security preparedness are adequately supported. Aligning fiscal criteria with future-oriented indicators such as technological development, climate resilience, and human capital will enhance Pakistan's competitiveness and long-term economic security in an evolving global environment.

Conclusion

After critically analysing the 7th NFC Award and the broader framework of fiscal decentralization in Pakistan, it can be concluded that while the horizontal distribution mechanism remains largely balanced, there is a need for targeted adjustments to incorporate emerging economic and technological realities. Greater emphasis is required on improving vertical distribution and strengthening accountability mechanisms to ensure effective utilization of resources by provinces. Fiscal decentralization must be viewed not only as an economic tool but also as a means of strengthening national integration, governance capacity, and long-term stability. A balanced approach that preserves provincial autonomy while ensuring adequate federal capacity is essential for addressing Pakistan's economic challenges and enhancing its position as a stable and resilient state.

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