

Economic reforms: Part - XLVIII

Before we close the subject of fiscal federalism, we discuss the implications of the 7th NFC Award and the resulting state of fiscal affairs in the country.

The Award, which remains in the field, had transferred a very big share of resources to provinces, without commensurate reduction in federal expenditures, which created a serious crisis for running the federal government.

To do so, we review the state of fiscal affairs as it prevailed during 2009-10, the year before the start of the 7th NFC and examine its consequences since then. For the purpose of this analysis, we have combined all federal revenues and analyze what share is being transferred to the provinces and what is left for the federal government to meet its expenditures. This would allow a true assessment of revenue sharing, as it covers both the divisible pool as well as other transfers except provincial receipts which are not subject to sharing. In a way, this would reflect an overall resource picture and its sharing between federation and provinces.

In 2009-10, 32 percent of gross revenues were transferred to provinces. In the first year of the 7th Award, this share rose to a staggering 46.6 percent. The adverse impact of this shift was quite visible in the first year of the Award. In 2009-10, the federal share was sufficient to meet federal expenditures on debt servicing and defence, and left a sizeable cushion to meet other expenditures. But the following year 2010-11, the federal share was insufficient by a significant margin to cover even these expenditures. Since then, and to this day, the federal share does not cover these two expenditures. Of course, the rest of the expenditures are met through borrowings, which is, therefore, the primary reason for the bludgeoning fiscal deficit in the country and consequent rise in public debt.

What was the thinking of the NFC when it reached an Award that has so fundamentally altered the structure of revenue sharing between federation and provinces? Most of the assumptions made by the commission on the evolution of fiscal arrangements have failed to materialize. We mention three key forecasts made as part of its proceedings and contrast them with actual outcomes.

First, on the revenue side, the NFC projected that gross federal revenue would rise from 13.5 percent of GDP gradually to 16.4 percent in the final year of the Award, 2014-15. Well, the actual outcome was 13.4 percent and hasn't shown any major improvement in subsequent years. Second, after setting new principles of expenditures, which accorded primacy to provincial expenditures, the commission had forecast that the federal share in total expenditures would decline from 72 percent in 2009-10 to 55 percent in the final year 2014-15. There was no identification of heads from where such massive reduction in federal expenditures would be obtained. The actual share of federal expenditures, however, has declined only marginally to 67 percent, on average, during the period 2010-2018.

Finally, the most significant assumption was regarding the level of overall fiscal deficit (OFD), or the level of borrowings, to meet the gap in revenue and expenditure. The commission, working at a

time when there was an ongoing IMF programme, made modes projections for an acceptable level of OFD. The acceptable OFD was projected to decline from 4.2 percent in 2010-11 to 2.8 percent in 2014-15. Against this target, their own projection showed that its likely path was from 5.5 percent in 2010-11 to 4.1 percent in 2014-15, significantly higher than the desired level.

The resolve was that they would plug this gap through extra revenue effort and economy in expenditure. The actual outcomes are far worse. The average OFD during 2010-18 (even beyond NFC term) has amounted to 6.7 percent, nearly four percentage points higher than the desirable level of deficit.

Evidently, all the major assumptions underlying the Award failed to materialize. Consequently, the federal government is saddled with acute shortage of resources to meet its expenditures, and instead depends heavily on borrowing. Consider fiscal year 2017-18. The gross revenue was Rs4,696 billion, of which Rs2,217 billion (47.2 percent) was transferred to the provinces, leaving Rs2,479 for the federal government. On the expenditures side, debt servicing and defence together amounted to Rs2,594 billion, which exceeded net-revenue by Rs115 billion. This pattern was set immediately after the NFC and has continued unabated.

To further appreciate the weak federal finances, consider the full fiscal account. The federal current expenditure was Rs3,814 billion, which was higher than net revenues by Rs1335 billion. This means that this is the level of borrowing to finance current expenditures (such as salaries of employees). With an additional development spending of close to Rs900 billion, total deficit came to Rs2243 billion (or 6.7 percent of GDP), which is the level of borrowing and addition to public debt. Such high level of deficit is untenable and unsustainable. What is implicit in this high level of deficit is an explosive growth in public debt. The primary deficit – defined as deficit net of interest payments – is persistently existing. This means that one needs to borrow even to make interest payments, a situation also known as ‘debt trap’. Through this period, the debt-to-GDP ratio has climbed from a low 50 percent to a high 70 percent.

This precarious state of fiscal finances requires immediate correction. Notwithstanding its technical side, the distribution of revenue is a political problem. In their wisdom the politicians have gone overboard in shifting the resources in favour of the provinces. Obviously, within the constitutional framework a solution has to be found to restore the fiscal health of federation. Article-160 has plenty of flexibility as it requires periodical deliberations to see the viability of a given arrangement.

Clearly, the existing arrangement is unviable. The credit worthiness of the federal government – so preciously required for international affairs, trade and investments – is in jeopardy. It is an issue that requires cool deliberations among the top leaders of the country. They will have to rise above their parochial interests to reach a realistic arrangement that protects the federal government’s credit worthiness, provides enough cushion so that national infrastructure projects can be financed and enables the federal government to meet the needs of balanced development across Pakistan as well as meet unforeseen contingencies in any part of the country.

To be continued

The writer is a former finance secretary. Email: waqarmkn@gmail.com

Waqar Masood Khan