

FISCAL FEDERALISM AND PROVINCIAL DEVELOPMENT: ASSESSING THE IMPACT OF THE 7TH NFC AWARD ON KHYBER PAKHTUNKHWA

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Abstract

Fiscal federalism, the branch of public finance that studies how financial powers and responsibilities are divided between central and sub-national governments, offers a useful lens for understanding how Pakistan's provinces have developed since 1973. This paper applies that framework to Pakistan's 7th National Finance Commission (NFC) Award of 2009, examining its impact on provincial development in Khyber Pakhtunkhwa (KP). Using verified data from government budget documents, the Pakistan Economic Survey, World Bank project reports, and peer-reviewed and policy literature published between 2011 and 2026, the study finds that the 7th NFC Award represented a meaningful move toward the fiscal-federalist ideal of matching resources to need: it raised the provinces' combined share of the divisible pool to 57.5 percent, introduced poverty and revenue-effort criteria alongside population, and recognised KP's exposure to militancy through a dedicated one percent allocation. Federal transfers to KP consequently grew from approximately Rs151 billion in 2010-11 to a budgeted Rs1,342 billion in 2025-26, financing measurable gains in education spending, health expenditure, and poverty reduction. However, judged against core fiscal-federalism principles, most notably the fiscal-equivalence theory advanced by Olson (1969) and the decentralisation theorem developed by Oates (1972), the Award falls short in important respects: its formula still weights population at 82 percent, it has never been revised to reflect the 2018 merger of the former Federally Administered Tribal Areas (FATA) into KP, and the province's own-source revenue base remains too small to support genuine fiscal autonomy. These shortcomings culminated in 2026 in KP's decision to challenge the Award before Pakistan's Federal Constitutional Court. The paper concludes that provincial development in KP cannot be fully realised without a more dynamic, needs-responsive NFC formula and stronger provincial revenue mobilisation.

1. INTRODUCTION

Federal systems of government divide political and financial authority between a central government and its constituent units. The branch of public

finance that studies how this division of financial authority should be designed, and what effects it has on development, is known as fiscal federalism (Oates, 1999). In principle, a well-designed fiscal-

federal arrangement allows each level of government to raise and spend resources in line with its responsibilities, allocates functions to whichever level can perform them most efficiently, and channels resources toward the regions and populations that need them most (Musgrave, 1959; Tiebout, 1956).

Pakistan's own experiment with fiscal federalism is organised around the National Finance Commission (NFC), a constitutional body established under Article 160 of the 1973 Constitution and mandated to recommend, at intervals of no more than five years, a formula for dividing federally collected taxes between the Centre and the provinces (Fiscal Federalism in Pakistan, 2026a). Since 1973, only four such Awards have secured full consensus, in 1974, 1991, 1997, and 2009; attempts in 1979, 1984, and 2000 collapsed without agreement (Mustafa, 2011).

Among these, the 7th NFC Award, signed on 30 December 2009 and implemented from the 2010-11 fiscal year, is widely regarded as the most significant reform of Pakistan's intergovernmental fiscal architecture. It increased the provinces' combined share of the divisible pool from 47.5 to 57.5 percent and, for the first time, moved beyond a population-only distribution formula to include poverty, revenue effort, and inverse population density as weighted criteria. For Khyber Pakhtunkhwa (KP), a province that has historically combined high poverty with acute security-related development costs, the Award also introduced a dedicated one percent allocation in recognition of its role as a frontline province in the war on terror. This paper asks a question the existing literature has not fully answered: judged against the core theoretical expectations of fiscal federalism, how well has the 7th NFC Award actually served provincial development in KP? Rather than treating the Award purely as a technical revenue-sharing mechanism, the paper situates it within the broader theory of fiscal federalism and then tests that theory against KP's documented fiscal, social, and developmental outcomes between 2010 and 2026.

2. Theoretical Framework: Fiscal Federalism

Fiscal federalism theory rests on several foundational contributions. Musgrave (1959) first distinguished three functions of government, stabilisation, distribution, and allocation, and argued that the allocation function, which includes the provision of local public goods, is generally best assigned to sub-national governments that are closer to citizens' preferences. Building on this, Tiebout (1956) proposed that when local governments have genuine fiscal autonomy, citizens can effectively choose jurisdictions whose tax and service packages best match their preferences, a mechanism that promotes efficiency in the provision of public goods.

Oates (1972) formalised these insights into the decentralisation theorem, which holds that, absent significant economies of scale or spillover effects, a public good should be provided by the lowest level of government capable of internalising its costs and benefits. Oates (1999) later extended this reasoning to intergovernmental transfers, arguing that federal grants are justified primarily to correct vertical fiscal imbalances, where sub-national governments carry more expenditure responsibility than revenue capacity, and horizontal disparities, where some regions are poorer or costlier to serve than others. Olson (1969) contributed the related principle of fiscal equivalence, which holds that the jurisdiction responsible for a public good should also bear its financing, so that political accountability and financial responsibility remain aligned.

Applied to developing federations, Shah (2007) and Bird and Vaillancourt (1998) note that fiscal decentralisation frequently proceeds unevenly: expenditure responsibilities are devolved to provinces more readily than revenue-raising powers, producing a persistent vertical fiscal gap that must be closed through federal transfers. Where those transfers are allocated using multi-criteria formulas that weight poverty, population density, and revenue effort, rather than population alone, fiscal federalism theory predicts more equitable regional development; where transfers remain population-dominated or are delayed and unpredictable, the theory predicts

continued regional disparity and weak sub-national accountability (Shah, 2007).

This framework generates three expectations against which the 7th NFC Award's impact on KP can be assessed: first, that a multi-criteria formula should narrow, not simply redistribute, developmental gaps between provinces; second, that growing transfers should be accompanied by growing provincial own-source revenue effort, consistent with the principle of fiscal equivalence; and third, that the formula itself should be periodically revised to reflect genuine changes in provincial needs and boundaries, such as the 2018 merger of the former FATA into KP. Sections 6 and 7 test each of these expectations empirically.

3. Constitutional and Historical Background of the NFC

Pakistan's fiscal federalism operates through a two-stage transfer system. Vertically, the federal government transfers a share of the national divisible pool to the provinces as a whole; horizontally, that provincial share is then divided among the four provinces according to a formula recommended by the NFC (Mustafa, 2011). Under the first NFC Award of 1974, negotiated by the government of Zulfikar Ali Bhutto, the vertical split was fixed at 20 percent for the provinces and 80 percent for the Centre, while the horizontal distribution relied solely on population; this gave Punjab 60.25 percent of the provincial share, Sindh 22.50 percent, KP 13.39 percent, and Balochistan only 3.86 percent (Fiscal Federalism in Pakistan, 2026a).

Subsequent Awards in 1991 and 1997 adjusted the vertical ratio between the Centre and the provinces, and the 1997 Award notably expanded the divisible pool to include nearly all federal taxes, but the horizontal formula continued to rely on population alone until 2009 (Fiscal Federalism in Pakistan, 2026a). Attempts to reach consensus in 1979, 1984, and 2000 failed outright, and the 2006 Distribution of Revenues and Grants-in-Aid Order was issued as a stopgap measure rather than a full Award. Clause 3(B) of Article 160 requires the federal and provincial finance ministers to review implementation of the Award biannually and report to parliament and the provincial

assemblies, a requirement that has not, in practice, prevented the 7th NFC Award from remaining unrevised for sixteen years (Daily Parliament Times, 2026).

The 7th NFC Award was negotiated alongside the 18th Constitutional Amendment of 2010, which devolved several federal ministries and subjects to the provinces. Together, these two reforms are generally treated as the most consequential redesign of Pakistan's federal structure since 1973 (Government of Khyber Pakhtunkhwa Directorate General of Information and Public Relations [DGIPR KP], 2025).

4. Literature Review

4.1 Fiscal Federalism and the 7th NFC Award

A growing body of Pakistani scholarship evaluates the 7th NFC Award through an explicitly fiscal-federalism lens. Using an intergovernmental structure as its conceptual framework, one qualitative study finds that while the Award improved provincial shares of the divisible pool, it simultaneously left the federal government struggling to meet its own expenditure needs in subsequent years, producing a persistent vertical fiscal imbalance within the federation (Journal of Politics and International Studies, 2024). A related review traces the Award's historical development and constitutional framework, concluding that although it advanced provincial autonomy, heavy continued reliance on federal transfers has curbed the growth of strong provincial tax regimes and weakened downward accountability to citizens (An Analytical Review of Pakistan's NFC Award, 2026).

Mustafa (2011), writing shortly after the Award's implementation for the Pakistan Institute of Development Economics, similarly concluded that the 7th NFC Award was a genuine step forward for fiscal federalism, but cautioned that future Awards would need to incorporate environmental and climate criteria, and that federal ministries would need to reorient toward policy formulation while provinces built the administrative capacity to absorb new service-delivery responsibilities.

4.2 Provincial Development Outcomes

A second strand of literature examines whether increased NFC transfers actually translate into stronger provincial development outcomes. Evidence from a study covering NFC allocations from 2001 to 2021 finds that provinces with higher poverty-driven allocations, including KP and Balochistan, do tend to direct a larger share of resources toward education and health, consistent with public-choice expectations, but that significant disparities in fund utilisation persist, with Punjab consistently outperforming KP and Sindh in effective spending (Journal of Asian Development Studies, 2025). A case study focused on Balochistan similarly cautions that increased fiscal transfers alone do not guarantee improved living conditions where local governance structures, such as tribal patronage networks, limit the trickle-down of development spending to ordinary citizens (Daily Parliament Times, 2026).

4.3 Poverty and the Merged Districts

A further body of work focuses specifically on the former FATA districts that merged into KP in 2018. Using Alkire-Foster multidimensional poverty methodology applied to household survey data, researchers find that poverty in the merged districts is far higher than in KP's settled districts, driven by deprivation in female education, sanitation, and housing quality (Journal of Asian Development Studies, 2024). This literature underlines that province-wide fiscal averages can conceal severe intra-provincial disparities that a purely provincial-level NFC formula cannot, by design, address.

5. Objectives and Methodology

5.1 Objectives

- To situate the 7th NFC Award within the broader theory of fiscal federalism, drawing on the work of Musgrave, Tiebout, Oates, and Olson.
- To assess the Award's impact on KP's fiscal capacity and on key provincial development indicators, including education, health, and poverty.
- To evaluate the Award's performance against the theoretical expectations of a multi-criteria, needs-responsive federal transfer system.

- To identify the structural gaps, particularly regarding the 2018 merger of the former FATA, that limit the Award's contribution to provincial development.
- To propose theory-informed recommendations for a future 8th NFC Award.

5.2 Methodology

This study uses a descriptive-analytical, qualitative research design combining a theoretical review of fiscal federalism literature with an empirical secondary-data analysis of KP's fiscal and developmental outcomes. Data were drawn from official government sources, including the Federal and Khyber Pakhtunkhwa Budget in Brief documents, the Pakistan Economic Survey 2024-25, World Bank project reports, and peer-reviewed and policy-institute research, supplemented by verified reporting from established Pakistani news outlets covering fiscal developments through mid-2026. Because the NFC dispute involving KP is an actively evolving policy issue, recent, dated sources were used deliberately alongside classical fiscal-federalism theory and Pakistan-specific academic literature to ensure the analysis is both theoretically grounded and empirically current.

6. Key Provisions of the 7th NFC Award and Their Fiscal-Federalist Logic

6.1 Vertical Distribution: Correcting the Fiscal Gap

Consistent with Oates's (1999) argument that federal transfers should correct vertical fiscal imbalances, the 7th NFC Award made five principal changes to the vertical distribution of resources between the federal government and the provinces as a whole. First, the FBR's tax collection charges were reduced from 5 percent to 1 percent, enlarging the size of the overall divisible pool. Second, one percent of the net divisible pool was earmarked exclusively for KP in recognition of the province's role as a frontline area in the war on terror; in 2010-11 alone this amounted to an additional Rs15 billion. Third, the provincial share of the divisible pool rose from 46.25 percent to 56 percent in 2010-11 and then to 57.5 percent for the remainder of the Award period, while the federal government's share fell correspondingly.

Fourth, Balochistan was guaranteed a minimum transfer of Rs83 billion regardless of its formula-based share. Fifth, General Sales Tax (GST) on services was reclassified as a provincial tax to be transferred through a straight-transfer mechanism rather than through the divisible pool.

6.2 Horizontal Distribution: Toward a Multi-Criteria Formula

For the first time since 1973, the 7th NFC Award distributed resources among the four provinces using more than population alone, a shift that partially aligns Pakistan's practice with the multi-criteria approach that fiscal federalism theory generally favours (Shah, 2007). Table 1 sets out the weighted formula agreed in 2009.

Table 1
Weighting Factors in the Horizontal Distribution Formula, 7th NFC Award (2009)

Factor	Weight (%)	Fiscal-Federalist Rationale
Population	82.0	Standard indicator of service-delivery burden
Poverty / Backwardness	10.3	Corrects horizontal disparity (Oates, 1999)
Revenue Collection / Generation	5.0	Rewards own-source effort (Olson, 1969)
Inverse Population Density	2.7	Compensates high-cost-to-serve areas

Source: Sustainable Development Policy Institute (2026); Wikipedia (2026a).

Compared with theoretical expectations, the persistence of an 82 percent population weight means the 7th NFC Award remains far closer to the population-only formulas of 1974-1997 than to the more balanced multi-criteria systems used in comparator federations such as India, where the Finance Commission weights per-capita income

distance, area, tax effort, and fiscal discipline alongside population (Shah, 2007). Applying Pakistan's formula produced the fixed provincial shares of the divisible pool shown in Table 2 and Figure 1, which have remained unchanged since 2010 despite the significant demographic and administrative changes discussed in Section 7.

Table 2
Horizontal Distribution of the Divisible Pool by Province

Province	Share of Provincial Pool (%)
Punjab	51.74
Sindh	24.55
Khyber Pakhtunkhwa	14.62
Balochistan	9.09

Source: Wikipedia (2026a); The Express Tribune (2026b).

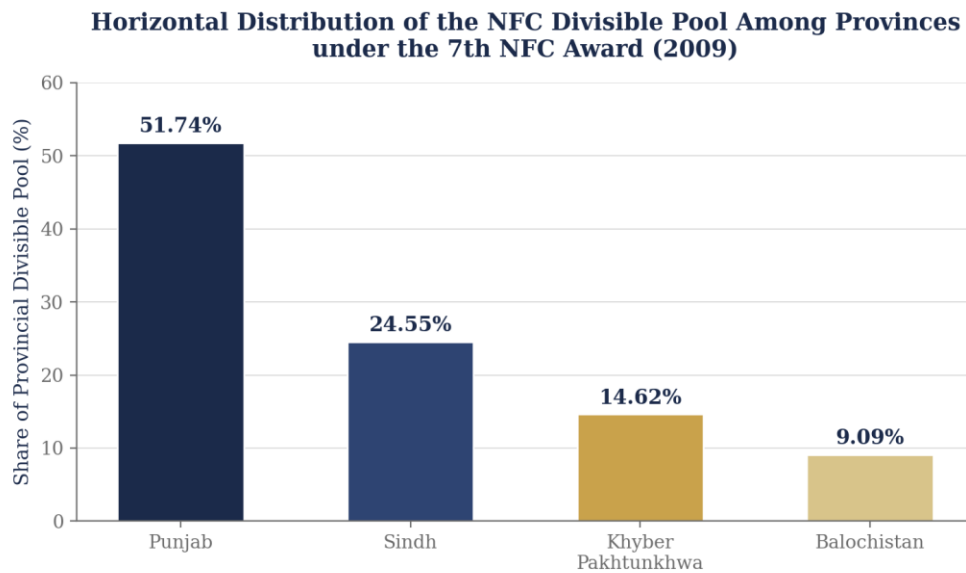


Figure 1. Horizontal distribution of the NFC divisible pool among provinces under the 7th NFC Award (2009).

Source: Author's construction based on Wikipedia (2026a) and The Express Tribune (2026b).

7. Impact on Provincial Development in Khyber Pakhtunkhwa

7.1 Growth in Fiscal Capacity

The most direct, and most consistent with fiscal-federalist expectations, effect of the 7th NFC Award has been a substantial rise in the nominal fiscal capacity available to KP. In the Award's first year of implementation, 2010-11, KP's total transfers under the divisible pool and related

straight transfers amounted to roughly Rs151.2 billion. By the 2024-25 fiscal year, KP's receivables, including the one percent war-on-terror allocation, had risen to approximately Rs1.22 trillion, and the federal budget for 2025-26 proposed a further increase to Rs1,342 billion, an addition of Rs207 billion over the previous year (Dawn, 2024; Dunya News, 2025). Table 3 and Figure 2 summarise this growth using only verified, documented figures.

Table 3
Growth of Federal Fiscal Transfers to Khyber Pakhtunkhwa

Fiscal Year	Total Transfers to KP (Rs Billion)	Source
2010-11 (NFC baseline)	151.2	7th NFC Award estimates
2024-25 (Actual/Budgeted)	1,220.0	Dawn (2024)
2025-26 (Budgeted)	1,342.0	Dunya News (2025)

Source: Author's compilation from Dawn (2024) and Dunya News (2025).

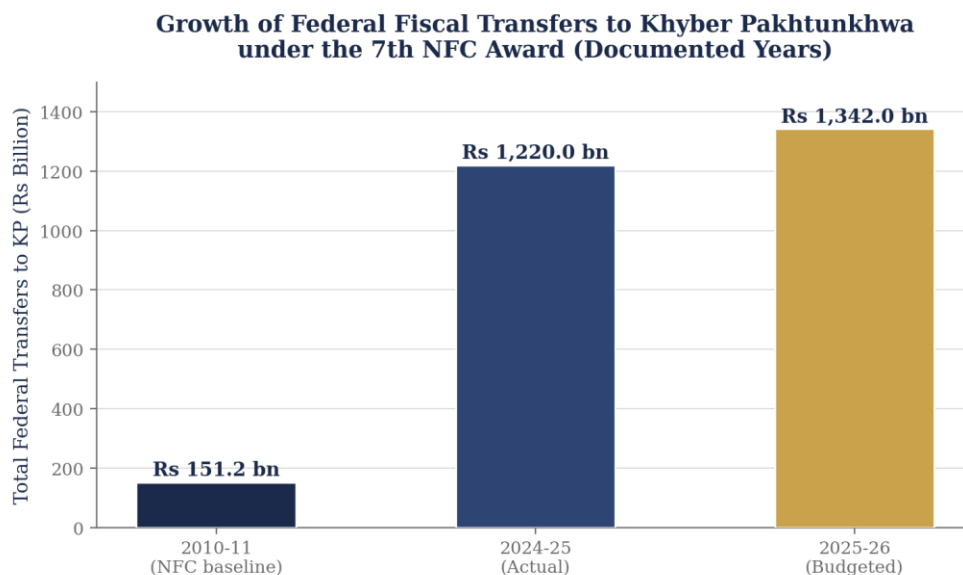


Figure 2. Growth of federal fiscal transfers to Khyber Pakhtunkhwa under the 7th NFC Award (documented years only).

Source: Author's construction based on Dawn (2024) and Dunya News (2025).

Judged purely by this metric, the Award appears to have delivered exactly what fiscal federalism theory would predict from a corrected vertical imbalance: a large, sustained increase in the resources available to a historically under-financed province. However, as Olson's (1969) fiscal-equivalence principle would predict, sustainable provincial development requires that growing transfers be matched by growing local revenue effort and administrative capacity, a requirement examined in Section 7.6.

7.2 Impact on the Education Sector

Increased fiscal space under the 7th NFC Award allowed KP to expand its education budget considerably in the years following 2010. By 2022-23, KP was one of only two provinces, alongside Sindh, whose education budget allocation met the internationally recommended benchmark of committing around 20 percent of the total provincial budget to education (Pakistan Institute of Education [PIE] & Institute of Social and Policy Sciences [I-SAPS], 2023). In absolute terms, KP allocated approximately Rs275 billion to education in 2022-23, though this represented a 21 percent decrease from the previous year's

allocation, reflecting the vulnerability of social-sector budgets to broader fiscal pressures even when the underlying NFC transfer keeps growing. The same source finds that a substantial share of KP's non-salary education budget has historically gone unspent, pointing to execution and planning weaknesses that constrain the developmental returns on the province's enlarged fiscal envelope. The cumulative effect of increased, if uneven, education spending is reflected in KP's literacy rate, which stands at approximately 51 percent, making it the third most literate province in Pakistan (Government of Khyber Pakhtunkhwa, 2024). This average, however, conceals very large gaps between settled districts and the merged districts of the former FATA, where female education indicators remain critically low, a disparity discussed further in Section 7.5.

7.3 Impact on the Health Sector

KP's health expenditure also rose in the years following the 7th NFC Award. According to the Pakistan Economic Survey 2024-25, KP's combined current and development health expenditure increased from approximately Rs55.7 billion in 2018-19 to approximately Rs77.0 billion

by 2020-21, an increase of roughly 38 percent in two years, even as Pakistan's overall public health expenditure remained low relative to GDP, at

under 1.5 percent nationally throughout the period (Government of Pakistan, Finance Division, 2025). Table 4 presents this trend.

Table 4
Khyber Pakhtunkhwa: Public Health Expenditure, Selected Years

Fiscal Year	Current Expenditure (Rs Million)	Development Expenditure (Rs Million)	Total (Rs Million)
2018-19	46,995	8,675	55,670
2020-21	56,179	20,778	76,957

Source: Government of Pakistan, Finance Division (2025), Pakistan Economic Survey 2024-25, Chapter 11.

Despite this growth, health outcomes in KP remain constrained. Infant and under-five mortality rates stood at approximately 35 and 39 deaths per 1,000 live births respectively, and the province's total fertility rate of 4.4 births per woman remains above the national average of 3.9, particularly in the merged districts, where access to reproductive, maternal, newborn, and child health services is weakest (World Bank, 2023).

vehicle through which the province funds infrastructure, health, education, and merged-district projects. The KP budget for 2026-27, with a total outlay of Rs2.17 trillion, allocated Rs524.3 billion to the ADP, prioritising infrastructure at 44 percent, social sectors including health and education at 19 percent, and governance at 13 percent, with tribal and merged districts receiving Rs92.9 billion under a dedicated Accelerated Implementation Programme (Business Recorder, 2026b). Figure 3 illustrates this sectoral breakdown.

7.4 Provincial Development Budgets and Sectoral Priorities

Growing NFC transfers have also expanded KP's Annual Development Programme (ADP), the

Sectoral Allocation of KP's Annual Development Programme, FY2026-27

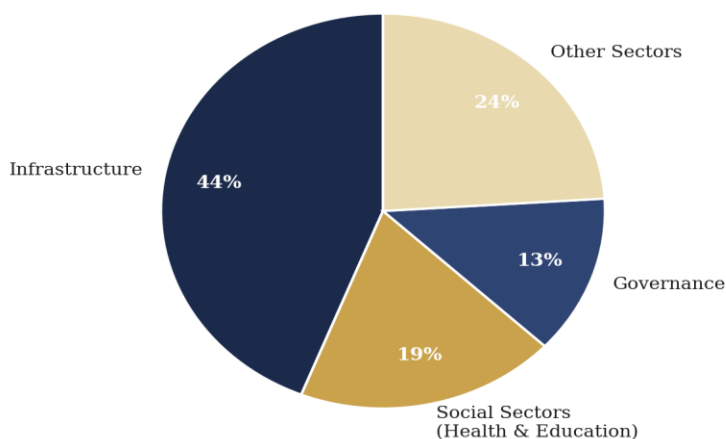


Figure 3. Sectoral allocation of KP's Annual Development Programme, FY2026-27.

Source: Author's construction based on Business Recorder (2026b).

Notably, this ADP allocation represented a 14 percent decline from the revised estimates of the previous year, illustrating a pattern consistent with the fiscal-federalism literature's warning that, where provincial own-source revenue remains weak, development spending, rather than protected current expenditure such as salaries and pensions, tends to absorb fiscal shocks first when transfers fall short of budgeted levels (Bird & Vaillancourt, 1998).

7.5 The Merged Districts: A Test of the Formula's Responsiveness

The single clearest test of whether the 7th NFC Award meets fiscal federalism's third theoretical expectation, that formulas be revised as provincial needs and boundaries change, concerns the 2018 merger of the former Federally Administered Tribal Areas into KP under the 25th Constitutional Amendment. The merger added an estimated five million people and seven districts, Bajaur, Khyber, Kurram, Mohmand, North Waziristan, Orakzai, and South Waziristan, to KP's population without a corresponding update to the NFC formula's population and poverty variables (World Bank, 2024). Because Article 160(6) of the Constitution requires that formula shares be revised to reflect such changes, KP's provincial government argues that the continued application of the unrevised 7th NFC Award constitutes a constitutional violation (The Nation, 2026).

KP officials estimate that this omission, combined with a shortfall in the federal government's

promised transitional grant for the merged districts, has cost the province approximately Rs2.177 trillion at 2024-25 prices. Of this, roughly Rs964 billion reflects NFC shares diverted to other provinces because the merged districts were excluded from the formula, and roughly Rs1.2 trillion reflects the gap between the Rs2.2 trillion transitional grant recommended by the Sartaj Aziz Committee for the merged districts and the roughly Rs1 trillion actually disbursed (The Nation, 2026). These provincial figures, though provided by a party to the dispute rather than an independent auditor, are broadly consistent with the pattern documented in the World Bank and academic literature showing that the merged districts remain severely under-resourced relative to settled KP; poverty in these districts, measured through Alkire-Foster multidimensional methodology, exceeds 85 percent in Bajaur and Mohmand and 80 percent in South Waziristan (Journal of Asian Development Studies, 2024).

7.6 Poverty, Human Development, and the Limits of Fiscal Transfers

The 7th NFC Award coincided with a period of significant poverty reduction in KP. The province's poverty headcount ratio fell from 73.8 percent in FY2002 to 27 percent in FY2014, the largest decline recorded among Pakistan's provinces over that period, before rising again to 29.5 percent in FY2019 amid renewed economic and security pressures (World Bank, 2023). Figure 4 illustrates this trajectory.

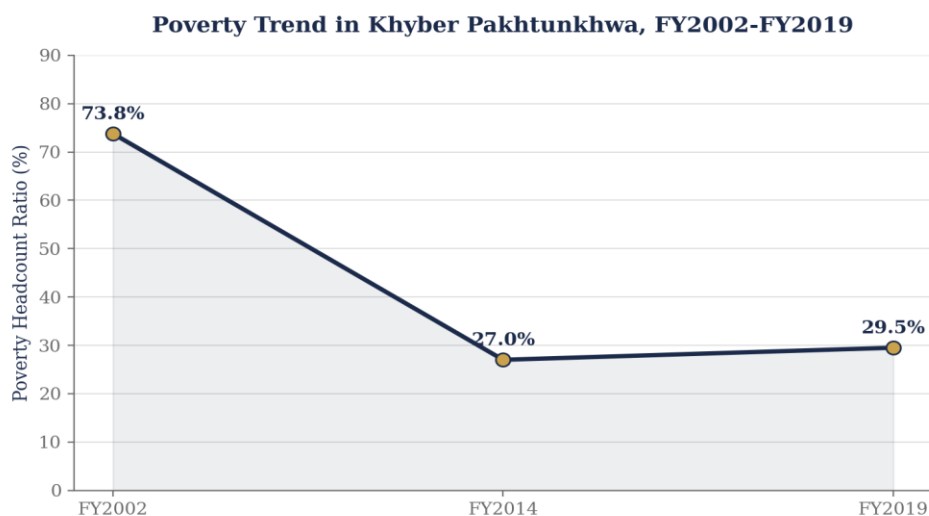


Figure 4. Poverty headcount ratio in Khyber Pakhtunkhwa, FY2002-FY2019.

Source: Author's construction based on World Bank (2023).

This provincial average again conceals stark internal disparities that a province-level NFC formula cannot, by design, correct. Nearly half of KP's approximately 40 million residents, and about three-quarters of the roughly five million residents of the merged districts, live in multidimensional poverty, which accounts for deprivation in education, health, and living standards rather than income alone (World Bank, 2023). This finding is consistent with the fiscal-federalism literature's broader observation that transfers targeted at the provincial level are a necessary but insufficient condition for equitable sub-provincial development (Bird & Vaillancourt, 1998).

8. Critical Assessment: Fiscal Federalism Theory Versus Practice

8.1 A Population-Dominant Formula and Structural Inequity

Critics argue that the 82 percent population weight retained in the 7th NFC Award effectively imports Punjab's historical demographic advantage, itself a product of decades of prior investment and infrastructure, into a recurring fiscal entitlement, while allocating comparatively little weight to indicators of need such as poverty and under-development (The Express Tribune, 2026b). For 2024-25, this formula translated into transfers of roughly Rs3.7 trillion to Punjab

compared with a substantially smaller absolute amount for KP despite the latter's higher poverty rate and security burden. This outcome sits uneasily with Oates's (1999) argument that transfers should correct, not reproduce, horizontal disparities between regions.

8.2 Weak Own-Source Revenue and the Fiscal Equivalence Gap

Despite improvements linked to World Bank-supported reforms, KP continues to rely on federal transfers for the overwhelming majority of its budget, a pattern that departs from Olson's (1969) fiscal-equivalence principle. Provincial revenue collection, even after more than doubling between FY2019 and FY2022, remained under USD 220 million against a provincial budget measured in trillions of rupees (World Bank, 2024). Agricultural income tax collection, an area repeatedly flagged by the International Monetary Fund as under-exploited, remained close to Rs3 billion in the 2026-27 budget, a negligible figure relative to the province's overall revenue needs (Business Recorder, 2026a).

8.3 Delayed and Withheld Transfers

Beyond the formula itself, KP has repeatedly reported shortfalls between its constitutional NFC entitlement and what it actually receives, undermining the predictability that fiscal

federalism theory treats as essential for sound provincial planning. In August 2023, the province sought release of Rs628 billion in overdue funds, including unpaid hydel profits and Accelerated Development Programme commitments for the merged districts (Pakistan Today, 2023). By January 2026, KP's Chief Minister reported a further shortfall of Rs54.4 billion against the province's Rs658.4 billion entitlement from the federal divisible pool for the 2025-26 fiscal year, describing the gap as a material breach that had disrupted budget execution, particularly in the merged districts (The Express Tribune, 2026a).

8.4 Intra-Provincial Disparities

District-level Human Development Index data compiled from the Pakistan Bureau of Statistics and UNDP sources show wide variation within KP itself, with urbanised districts in the Peshawar valley performing far better than remote and merged districts such as Kohistan, Torghar, and the former FATA region (Sustainable Development Policy Institute [SDPI], 2025). Because the NFC formula operates only at the provincial level, it provides no direct mechanism to correct these internal imbalances; responsibility for addressing them falls to KP's own Provincial Finance Commission, whose formula-based allocations to districts remain, in the literature's assessment, similarly uneven (SDPI, 2025).

8.5 The 2026 Legal Challenge

The cumulative effect of these grievances led the KP government, in 2026, to shortlist law firms to challenge the 7th NFC Award before Pakistan's Federal Constitutional Court, seeking to have the Award's continued application, without revision for the merged districts, declared unconstitutional under Article 160(6) (The Nation, 2026). This represents an unprecedented escalation of a dispute that, until then, had largely played out through budget negotiations and public statements rather than litigation, and it illustrates how the absence of a periodic formula review, one of fiscal federalism theory's core prescriptions, can ultimately push intergovernmental disputes into the courts.

9. Towards an 8th NFC Award: Reconciling Theory and Practice

Although the Constitution envisages a new NFC Award at least every five years, no successor to the 7th Award had been concluded as of mid-2026, sixteen years after it was signed. Analysts attribute this stalemate to competing provincial interests, particularly Punjab and Sindh's reluctance to accept a smaller share of an enlarged pool, and to the federal government's own fiscal pressures under its International Monetary Fund programme, which has instead sought to freeze or renegotiate provincial surpluses outside the formal NFC process (Business Recorder, 2026a; SDPI, 2026). In its 2026-27 budget, KP formally requested a dedicated three percent share of the divisible pool specifically to address the merged districts' socio-economic convergence with the rest of the province, separate from its existing 14.62 percent formula share (Business Recorder, 2026b). The IMF's own conditionality has added a further layer of complexity: its 2026 review documents call on provinces, including KP, to strengthen enforcement of GST on services and accelerate collection of agricultural income tax, effectively asking under-resourced provincial administrations to raise more revenue at the same time that transfers from the Centre are being contested (Business Recorder, 2026a). Consistent with the fiscal federalism literature's emphasis on periodic, evidence-based formula revision (Mustafa, 2011; Shah, 2007), any future 8th NFC Award will need to reconcile these competing pressures: protecting the fiscal gains smaller provinces secured in 2009, updating the formula to reflect the FATA merger and demographic change since the 2017 and 2023 censuses, and responding to federal demands for greater provincial revenue effort.

10. Conclusion

Viewed through the lens of fiscal federalism theory, the 7th NFC Award represents a genuine, if incomplete, move toward the ideal of a needs-responsive intergovernmental transfer system. It corrected part of Pakistan's vertical fiscal imbalance, introduced poverty and revenue-effort criteria alongside population for the first time since 1973, and delivered a verifiable, roughly

ninefold nominal increase in the resources available to Khyber Pakhtunkhwa between 2010-11 and 2025-26, supporting real gains in education spending, health expenditure, and poverty reduction through the mid-2010s. Measured against this study's three theoretical benchmarks, however, the Award's contribution to provincial development remains only partially realised. Its formula still assigns 82 percent of its weight to population, echoing rather than fully departing from the pre-2009 approach; it has never been revised to reflect the 2018 merger of the former FATA into KP, in tension with the constitutional requirement in Article 160(6); and KP's own-source revenue base remains far too small to satisfy the fiscal-equivalence standard that sustainable provincial autonomy requires. These unresolved tensions culminated, in 2026, in the KP government's decision to challenge the Award's continued application before Pakistan's Federal Constitutional Court. Sixteen years after it was signed, the 7th NFC Award illustrates both what a more equitable federal formula can achieve for provincial development and the risks of allowing such a formula to remain frozen while the country, and the province it is meant to serve, continue to change.

11. Recommendations

- **Constitutional compliance and formula revision:** The federal government should initiate a formal review of the NFC formula under Article 160(6) to incorporate the population, poverty, and revenue data of KP's merged districts, resolving the core legal grievance behind KP's 2026 court challenge.
- **Rebalancing the formula toward need:** Consistent with Oates's (1999) horizontal-equity rationale for transfers, future Awards should reduce the population weight below 82 percent and increase the combined weight of poverty, revenue effort, and density, bringing Pakistan's formula closer to multi-criteria systems used in comparator federations such as India.
- **Strengthening own-source revenue:** In line with Olson's (1969) fiscal-equivalence principle, KP should build on the gains achieved under the Revenue Mobilisation and Public

Resource Management Project by further expanding agricultural income tax collection, urban property tax coverage, and GST-on-services enforcement, reducing its near-total dependence on federal transfers.

- **Timely and transparent disbursement:** Mechanisms should be established to ensure that KP's monthly NFC transfers match its constitutional entitlement in real time, with independent, published reconciliation of any shortfalls to prevent recurring disputes such as the Rs54.4 billion gap reported in early 2026.
- **Protecting merged-district allocations:** The Accelerated Implementation Programme and related merged-district budgets should be ring-fenced from broader development-spending cuts, given the exceptionally high poverty and deprivation levels documented in these districts.
- **A dynamic, periodically reviewed formula:** Future NFC Awards should include a built-in mechanism for automatic, data-driven revision at each five-year interval, rather than relying on ad hoc political negotiation, and should incorporate climate and environmental vulnerability as an explicit weighted factor, as recommended by Mustafa (2011).
- **Strengthening the Council of Common Interest:** The CCI should be resourced and empowered to mediate NFC-related disputes on an ongoing basis, reducing the need for provinces to resort to constitutional litigation.
- **District-level equity within KP:** The provincial government should strengthen its own Provincial Finance Commission formula to more explicitly target underdeveloped districts, since a fairer federal NFC Award alone cannot correct disparities that operate at the sub-provincial level.

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