



Policy Brief

# FISCAL FEDERALISM IN A HYBRID STATE: THE CASE OF PAKISTAN

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## **Introduction**

In a state characterized by multifarious centripetal forces, the fact that significant devolution in the form of the 7<sup>th</sup> National Finance Commission Award (henceforth NFC) Award and the 18<sup>th</sup> Amendment has endured for over a decade is no mean feat. Opinion may be divided on whether the worst of the pushbacks against this devolution is behind us or lurks in the near to medium future, the present political and economic crises that engulf Pakistan require political and policy initiatives to preserve the gains from devolution in the last decade.

Specific to the fiscal aspect of the devolution in the immediate aftermath of the 7<sup>th</sup> NFC, most of the early critiques were of a technical and procedural nature, pertaining generally to the incentive structures created by the NFC for provincial revenue generation and about provincial capacity constraints. Over time, the pressure increased. First, it was the IMF that indirectly opposed devolution to the provinces, then opposition from the military came indirectly during the course of the 8<sup>th</sup> and 9<sup>th</sup> NFC deliberations. The (in)famous ‘Bajwa Doctrine’, which directly attributed both the NFC award and the 18<sup>th</sup> Amendment as ‘more dangerous than the six points of Mujib ur Rehman,’”<sup>1</sup> was the most direct and potent challenge to federalism. This gloves-off policy gained further momentum during the tenure of the PTI government in Islamabad as the civil government and its supporters attempted to gloss over their economic policy failings by blaming it on resources being gobbled up by the provinces. But as the economic situation deteriorates, many other voices have provided momentum to the anti-devolution viewpoint.

In the short to medium term, the pressure to revert fiscal resources from provinces to the centre is expected to increase as Pakistan’s macro-economic problems will further deepen. This brief will assess the political and economic probability for such a reversal to happen. It will then suggest policy initiatives that will sustain the gains on fiscal federalism and to further deepen them.

In order to provide historical context, we provide a brief foray into the history of fiscal federalism in Pakistan in Section 1. Section 2 first outlines the gains made through the 7<sup>th</sup> NFC award to fiscal federalism and then assesses different forms of critiques and pushbacks that have come forth in the last decade on fiscal devolution. Section 3 then analyses the political economy of resistance to the pushbacks against fiscal devolution in the last decade and also delves into probabilities on the pushbacks succeeding in the foreseeable future. Section 4 provides policy recommendations.

### **1. Brief History of Fiscal Federalism in Pakistan**

Federalism in the regions constituting Pakistan goes back to the time when the British Government formally colonized India. However, a fully formal structure of fiscal federalism in colonial times came about with the Niemeyer Award in 1937, which in turn was based on the design of federalism created by the Government of India Act 1935 (Khan, 2021). Many of the features of the Niemeyer award have carried on to date. As expected from a colonial state, most of the revenue assignments were centralized; income tax, import and export duties, excise duties,

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<sup>1</sup> Sohail Warraich: ‘Bajwa Doctrine: From Chauvinism to Realism’, *The News International*, March 18, 2018.

earnings from railways, post and telegraph, etc. However, there was also a long list of assignments given to the provinces that included sales tax, agricultural income tax, land revenue, irrigation charges and property tax. While there was a generous set of assignments that were provided to the provincial governments, most of the high revenue yielding taxes remained with the center, with the exception of agricultural income tax. With large landholdings that yielded a substantial surplus, the fact that the colonial state kept the income tax with the provinces which did not have a proper machinery to collect taxes demonstrates that the state was not interested in collecting taxes from a group that provided them political support. Interestingly, in both India and Pakistan, this tax has remained provincial to date and its collection is exceptionally low.

The post-independence state in Pakistan adopted the Government of India Act, 1935 and its subordinate statutes – including the Niemeyer Award – in the initial years. However, fiscal discrimination started fairly early on in the country's existence. Before the annual budget was presented in 1948, the Federal government decided to take over the sales tax in the federal domain from the provinces. While this did not have much of an impact on the finances of West Pakistan, it was an important component of East Pakistan revenues, mainly because East Pakistan charged sales tax on beetle nuts and tea (Islam, 2003). At the time of this re-assignment, it was said that this was a temporary arrangement but later in 1952, this re-assignment was made permanent. Islam (op.cit) states that this move fiscally drained the East Pakistan provincial government, which was otherwise in a sustainable fiscal position.

The Raisman Award in 1951 was the first fiscal distribution arrangement in post-Independence. Since Pakistan was still governed by the Government of India Act 1935 when the award was made, one assumes it had constitutional cover but there is no evidence that there was any legally mandated consultative process that was followed for this award. There were two salient features of this award. First, although the vertical share was decided at 50:50, the divisible pool for resource sharing excluded the most buoyant of all taxes, i.e. import duties. This largely remained the case in subsequent awards. As a result, transfers as a share of federal revenues were a mere 12.8% in 1951 and gradually increased to 33.4% in 1970 (Khan, 2021). This goes to show the degree to which Pakistan remained an authoritarian and centralized state.

Second, the horizontal distribution for East and West Pakistan was decided at 45:55 respectively by the Raisman Award (Zaidi, 2015). This is in spite of the fact that the population of East Pakistan was more and that levels of poverty and underdevelopment was greater there. Add to this the fact that their own revenue was severely curtailed when sales tax was centralized in 1948.

After the 1973 Constitution was promulgated, fiscal federalism was not only given constitutional cover, as enunciated in Article 160 of the Constitution, but also a Commission was formed (the National Finance Commission, NFC), with representation from all four provinces. The operationalization of the Commission in 1974 also created an informal norm that the NFC awards will be decided with consensus. In terms of *de jure* institutionalization of federalism, this was a big leap forward.

The first Award post 1973 was agreed upon in 1974. However, no further award came about till 1991, partly because consensus could not be achieved and partly because much of the intervening period was spent under Martial Law (1977-88). However, in spite of the de jure leap in fiscal federalism through the 1973 Constitution, the actual awards did not alter much. While vertical shares increased in favour of the provinces, import duties, that remained the highest revenue yielding tax till the early 1990s, remained outside the divisible pool. Moreover, in the now truncated Pakistan, the horizontal share was determined solely on the basis of population in all awards between 1974 and 2006. As such, the bulk of the resources went to Punjab, which was not only the most populous of provinces but also the most developed. This also meant that the poorest and most under-developed Balochistan province received a mere 5% of resources. The criterion of fiscal equalization – integral to the concept of fiscal federalism – thus remained elusive in Pakistan’s quasi-authoritarian federal architecture.

## **2. The Path Changing 7<sup>th</sup> NFC and its Critics**

The 7<sup>th</sup> NFC Award of 2010 was a radical departure from the past in deepening fiscal federalism in Pakistan. It increased the share of provinces (with all federal taxes included in the divisible pool) from 46% to 58.5%. Moreover, the General Sales Tax (GST) on Services, hitherto collected by the federal government,<sup>2</sup> was devolved to the provinces. Most salient was the incorporation of Article 160 (3a) through the 18<sup>th</sup> Amendment mandated that the vertical share cannot be reduced in subsequent awards. Cookman (2010) correctly predicted that this will become the main bone of contention between the federal government and the provinces going forward.

Not only did the vertical share increase, but for the first time, fiscal equalization was explicitly addressed in the Award. The weight of population was reduced from 100% to 82% and poverty, the inverse-population ratio (to cater for the geographical expanse of the province) and revenue effort were included in the horizontal distribution formula. Balochistan, the poorest and the most infrastructure deprived province, saw a doubling in its share of resources but also a guarantee that their revenue growth will be ensured even if federal government tax collection is below target.

The 7<sup>th</sup> NFC was predicated on certain targets, the achievement of which were critical to its medium and long term sustainability. One of these targets was that by the end of tenure of the 7<sup>th</sup> NFC, i.e. 2015 the tax-GDP ratio should increase from 9% at the time to 15% of GDP. At a disaggregated level, the target was for federal government revenue to go up to 13.75% of GDP and provincial revenue to increase up to 1.25% of GDP. As we will see later, the (non)achievement of these targets have become the main bone of contention in the resistance to fiscal devolution.

The NFC Award was accompanied by the 18<sup>th</sup> Amendment, which as mentioned earlier abolished the concurrent list. This meant that 17 ministries in the centre stood devolved to the

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<sup>2</sup> The 1973 Constitution had delineated the GST on services as a provincial tax. However, the provinces had agreed that the FBR will collect this tax on behalf of the provinces and then transfer it back to each province, after deducting a 5% collection charge.

provinces and consequently the jurisdiction of the provinces on subjects widened considerably. This deepening of federalism was viewed with skepticism by many. Below we will distinguish across the critiques on technical and economic grounds from those that can be categorized as those of a hybrid nature and in the realm of political-economic pressures.

### *2.1. Economic and Institutional Critiques of Fiscal Devolution*

The most common refrain post fiscal devolution was that the provinces did not have the capacity to absorb the resources devolved to them and fulfill the functions assigned to them under the 18<sup>th</sup> Amendment (Husain, 2012, Sherani, 2011). However, Shah (2012), based on the experience of China and Brazil says that ‘technical capacity is secondary to political commitment, bureaucratic incentives and results based accountability.’ Nabi and Shaikh (2010) argue that the large vertical share going to the provinces has created a disincentive for the provinces to enhance their own fiscal effort, particularly in taxing agricultural and property income. Shah (2012) also argues that devolving the GST on services will create ‘significant roadblocks to national level tax reforms.’ He also states that devolution has the potential to create restrictions on the mobility of persons and goods across the country.

Capacity of governmental entities is difficult to measure. Given that social development is one area where provincial governments have predominant jurisdiction, it will be useful to gauge the capacity issue through this variable. The most prominent and consequential social sector responsibilities for provincial governments are health and education. Allocations for education increased from 1.88% to 2.1% of GDP and for health from .56% to 0.92% of GDP in the decade post devolution compared to the decade preceding it. Outcomes have varied across provinces, but the aggregate data show improvements in both education and health. There have been improvements in school enrollment rates across provinces, especially in female education. In health, both infant and maternal mortality have witnessed improvements and the number of women giving birth in the presence of trained medical practitioners have doubled in the last decade.<sup>3</sup>

As it was to be expected, improvements in social development in general and development as a whole has varied across provinces. Punjab has invested heavily in infrastructure and seen significant improvements in education outcomes, investments in primary and tertiary health facilities in Sindh have been prominent and KP has attained near universal health insurance for its citizens. Skeptics can of course argue that these improvements would have occurred without devolution also. Regardless of that counterfactual, the fact of the matter is that developmental outcomes have continued to demonstrate a positive trajectory post devolution. This also indicates that capacity improvements have taken place, albeit differentially, across provinces.

Another variable through which capacity at the federal level can be gauged is through provincial revenue effort. With the provinces now collecting the GST on services, this was a critical test of their capacity for tax collection. With Sindh taking the lead immediately in 2011, by 2016 all

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<sup>3</sup> Data compiled by author from Pakistan Demographic and Health Survey (various issues), Pakistan Maternal Mortality Survey (2019), Pakistan Integrated Household Survey (various issues) and Ministry of Finance, Fiscal Operations (various issues).

provinces were collecting the GST on services themselves. For this purpose, they created their own revenue boards. Tax collection on this particular revenue assignment saw a marked increase. For instance, the last year before GST on services was devolved to the provinces, the federal government transferred Rs. 14 Billion to the Sindh government and in the first year (2011-12) that the Sindh Government itself collected this tax, it was Rs. 23.9 Billion. The story has been the same across all provinces. Whereas the federal government's average annual growth in sales taxes between 2010 and 2022 has been 14.1% that of the provinces on GST on services has been 23%. This clearly goes to show that capacity is endogenous to responsibility.

It is also important to note that mainly because of the GST on services, the provincial governments attained the target for revenue collection given to them in the 7<sup>th</sup> NFC by 2017, whereas the Federal government has not kept its side of the bargain.

While provincial revenue effort on services GST has been commendable, their performance on traditional assignments such as taxes on agricultural income and property have been dismal. This gives credence to Nabi and Shaikh's (op.cit) contention that devolution did not build in incentives for provinces to ramp up their effort for the aforementioned revenue assignments, which can contribute in improving progressivity as well as horizontal equity to the aggregate national tax effort.

Since 2015, the IMF has demanded that provinces voluntarily revert their surpluses to the Federal government. While provinces nominally agreed to this demand, they devised tacit arrangements with the federal government to circumvent this condition. However, for the first time in July 2022, the IMF has asked the provinces to sign an agreement that binds them to revert Rs. 750 Billion (1% of GDP) to the federal government. Whether the provinces will abide by this agreement – at a time when flood related expenditures will mean both lower revenues and higher expenditure – remains to be seen. As Pakistan's fiscal situation deteriorates, there has been a de facto pushback of sorts that has been agreed upon by the IMF and the provincial governments in the form of taxation on petroleum through the Petroleum Levy (which is a purely federal tax) rather than through the General Sales Tax (GST), which is shared with the provinces. The sheer enormity of the present economic crisis has meant that the provinces have not explicitly contested these pushbacks.

## *2.2. The Hybrid Pushback*

As mentioned earlier, the Bajwa Doctrine was the most serious hybrid pushback against the 7<sup>th</sup> NFC and the 18<sup>th</sup> Amendment. However, because of the insertion of Article 160 (3a) through the 18<sup>th</sup> amendment, there were no formal channels to reverse the 7<sup>th</sup> NFC formula by the Federal government. In subsequent NFC meetings – during the 9<sup>th</sup> and 10<sup>th</sup> NFC – the Federal Governments of both PML (N) and PTI attempted to convince the provinces to voluntarily concede a part of their shares to the Federal Government on various pretexts.<sup>4</sup> However, they received strong pushback from the provinces. And most importantly this pushback was not

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<sup>4</sup> These pretexts included provision of security for CPEC projects, expenditures on Azad Jammu & Kashmir, Gilgit-Baltistan, to pick up losses of state-owned enterprises and expenditures required for post-merger FATA.

limited to the smaller provinces, but by Punjab also.<sup>5</sup> During the PTI government, informal pressure was brought on the provinces through various channels on provincial governments as well as individual members of the NFC.<sup>6</sup> These pressures were successfully resisted before the turn of events that led to the denouement of the PTI government.

### **3. Resistance to the Pushback Against Fiscal Devolution**

The pushback to fiscal devolution – and for that matter administrative devolution as a result of the 18<sup>th</sup> Amendment – for the most part has been resisted successfully by most sections of the political class as well as provincial governments over the last decade. Understanding the nature of this resistance to the push back will also provide us clues to the probability of its success or otherwise in the foreseeable future.

Given the fiscal crisis of the state, it is likely that there will be attempts on reversing gains to fiscal federalism secured through the 7<sup>th</sup> NFC Award. It is possible, though unlikely, that this can be done legally given the Constitutional firewall created by Article 160 (3a). In the event that such a move is initiated, it will trigger resistance across the elites of smaller provinces and possibly also by provincial politicians and bureaucrats of the Punjab. Moreover, the equal representation of provinces in the Senate will mean that any attempt to amend the Constitution will fail in all likelihood.

So far, however, resistance to the pushbacks have been created by the provincial level political and bureaucratic elites that have brought to bear their organizational, political and financial influence to resist the rolling back of gains made through the 7<sup>th</sup> NFC.

The provincial level politicians are the first tier of resistance. They combine organizational ability and the capacity to mobilize around symbols of ethno-nationalism. Moreover, they occupy a crucial position so far as the formal and constitutional architecture of the state is concerned. By holding the reins of executive power at the provincial level, they have been direct beneficiaries of the increase in the flow of funds to the province. They can also wield effective resistance by blocking pro-centrist legislation through the Senate. Their posture within the formal halls of power will be strengthened by mobilization outside on a crucial right being snatched away from them. Moreover, their street mobilization potential along ethno-nationalist lines is likely to be cross-partisan and create a new form of resistance that the federal government will have to contend with.

The second tier of provincial elites that has been a beneficiary of deepening fiscal federalism is the provincial bureaucracy. They have been beneficiaries of the increase in the size of the provincial budgets and their expanded influence because of functional devolution through the 18<sup>th</sup> amendment. The more assertive in terms of resistance will be bureaucrats belonging to the provincial cadre. While the federal bureaucrats, belong to the Pakistan Administrative Services (PAS) and serving in, as well as belonging to the smaller provinces, may also resist, however,

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<sup>5</sup> Information provided by respondents during the course of the fieldwork.

<sup>6</sup> As member from Sindh on the NFC (2019-present), the author has himself experienced these pressures.

their incentive to do so will be circumscribed by the fact that their own career prospects are controlled directly by Islamabad.

The provincial bureaucracy, known as the PCS bureaucrats, have the strength of numbers even if not the level of influence that the PAS bureaucrat does. They consist of the teachers, health department officials, revenue and irrigation officials, etc. They are also the first point of the interface of the state with citizens. Their career prospects are also linked with the provincial executive and the provincial legislature. As such, their organizational capacity and ability to create a coalition with the provincial political elites can have a significant impact on any resistance that the provincial politicians wish to launch. This group will also include retired provincial bureaucrats who are recipients of generous pensions from the provincial government.

In the course of our field research, we also assessed that the provincial elites were also engaging the military in rent-sharing arrangements. Several development projects across provinces have been contracted out to military run entities, such as the Frontier Works Organization (FWO) and the National Logistics Cell (NLC). Moreover, through Public-Private Partnership policies adopted by provinces, important management and consulting contracts are given to military subsidiaries. The nature and extent of this strategy will vary across provinces but provincial level engagement at this level implies that some level of rent-sharing from incremental resources coming to provinces from the federal government is ploughed back informally to organizations and individuals linked to the military. Whether this can be categorized as resistance by provincial governments or hybridity mutating at a different level will depend on the extent and prevalence of this strategy across provinces.

#### **4. Conclusion and Way Forward**

Pakistan's implicit fiscal compact over the last decade has been based on consuming beyond what it earns to the tune of 6% of GDP. This also includes a persistent imbalance in foreign exchange consumption and earnings to the tune of 2-3% of GDP. The fiscal compact was to borrow your way out of this situation through drawing on savings through the banking system at home and through garnering geo-political rents to pay for the persistent gap in the foreign exchange balance of payments. As events in the last few years have demonstrated, the latter has virtually dried up and the former has created a choke-hold on growth in the economy. The increasing imprint of hybridity will mean that the demand for resources from the non-elected state will intensify in the near future. The following policy initiatives are thus imperative;

- Both the provinces and the Federal government need to ramp up their tax effort. Apart from the fact that the existing tax regime is vertically inequitable (high share of indirect to direct taxation), horizontal inequity is becoming increasingly contested. Traders, agriculturists and owners and dealers in real estate are either not taxed or taxed way below their potential. This means that roughly 50% of GDP lies outside the tax net in a de facto sense. Moreover, tax policy has put roughly 4% of GDP outside of the tax net through exemptions and subsidies. The main onus on ramping up the tax effort, however,



remains with the Federal Government that has consistently reneged on the commitments made in the 7<sup>th</sup> NFC.

- Fiscal equalization also requires further deepening. The case of the merger of FATA with KP, the concentration of poverty in Balochistan and the concentration of climate change related vulnerabilities in Sindh, Balochistan and KP requires moving ahead on a new horizontal distribution formula.
- The pension bill, both of the Federal government and the provinces has increased by a significant magnitude in the period since the 7<sup>th</sup> NFC, which threatens to further reduce fiscal space at both tiers of government. It is thus imperative that this matter is addressed under the leadership of the Federal government.
- In order to create greater legitimacy for fiscal deepening, provincial governments need to institutionalize local governments on a sustainable basis. Part of this exercise will be to create credible provincial finance commissions so that resources to the third tier of government are allocated transparently.

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