Fiscal federalism in a hybrid state

By **Dr.Asad Sayeed**

In a state characterized by multifarious centripetal forces, the fact that significant devolution in the form of the 7th NFC Award and 18th Amendment has endured for over a decade is no mean feat.

Prior to the 1973 Constitution, overt fiscal discrimination was the norm in Pakistan. One example: when the 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's revenues, mainly because East Pakistan charged sales tax on beetle nuts & tea, which yielded significant revenue. At the time of this re-assignment, the Federal government said this was temporary, but this re-assignment was made permanent in 1952.

This move fiscally drained the East Pakistan provincial government, which was otherwise in a sustainable fiscal position. This sowed the seeds of East Pakistan's fiscal alienation from the centre.

The 1973 Constitution gave fiscal federalism a Constitutional cover through Article 160. Despite this leap, the actual awards did not alter much: vertical shares increased in favour of the provinces but import duties (the highest revenue yielding tax till the early 1990s) were excluded from the divisible pool. The horizontal share was determined solely on basis of population, through which Punjab benefitted the most while the poorest and most under-developed province, Balochistan, received a mere 5%.

The 7th NFC Award of 2010 was path changing. Not only did the vertical share increase, but for the first time fiscal equalization was explicitly addressed: the weight of the population was reduced from 100% to 82% and poverty & revenue effort were included in the formula.

Consequently, Balochistan's share doubled to 10%. The 18th Amendment further deepened federalism by devolving 17 federal ministries and the jurisdiction of provinces on subjects widened.

Provinces have been criticized for a lax revenue effort. The numbers, however, tell a different story: whereas the federal govt's average annual growth in sales tax between 2010 and 2022 has been 14%, that of the provinces has been 23%. In fact, the provinces have attained the target for revenue collection given to them in the 7th NFC by 2017, whereas the Federal govt has failed to do so.

The brief highlights policy recommendations for a sustainable and egalitarian way forward. Firstly, both the provinces and the Federal govt need to improve their tax effort. Traders, agriculturalists and real estate owners/dealers are either not taxed or extremely undertaxed—meaning that roughly 50% of GDP lies outside the tax net in a de facto sense.

Exemptions have put an additional 4% of GDP outside the tax net.

Second, Fiscal equalization requires further deepening because of concentration of poverty in Balochistan, and climate change vulnerability across all provinces. Lastly, the ballooning pension bills of both provinces and the Federal govt are unsustainable and need to be addressed to create fiscal space.