



PAKISTAN'S FISCAL FEDERALISM: FROM STALEMATE TO SOLUTION – CHARTING A COOPERATIVE FISCAL FUTURE

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UNDERSTANDING FISCAL FEDERALISM IN PAKISTAN

Article 160 of the 1973 Constitution mandates a National Finance Commission (NFC) every five years to recommend how the “divisible pool” of federal taxes is distributed—vertically between the federation and the provinces, and horizontally among provinces on agreed criteria.

The landmark 7th NFC Award of 2009 (implemented in 2010), together with the 18th Constitutional Amendment (2010), dramatically reshaped

this arrangement. It significantly increased the provincial share of federal tax revenues, raising it from roughly 47.5% to 56% in FY2010–II and to 57.5% from FY2011 onward.

THE NFC AWARD STALEMATE: A 15-YEAR HIATUS

While the 7th NFC Award and the 18th Amendment were hailed as historic steps, they also exposed deep structural challenges. Pakistan has not seen a new NFC Award since 2009/2010, despite the Constitution's clear five-year renewal requirement.

Multiple attempts since 2015 have failed to reach consensus, producing an impasse. Several key issues lie at the heart of this deadlock:

1. Vertical Fiscal Imbalance

The federal government's fiscal position has grown increasingly strained after ceding 57.5% of tax revenues to provinces. The centre still bears responsibility for debt servicing, defence, federal administration, and nationwide infrastructure, but must finance these largely from its 42.5% share. Federal spending has surged while revenues have remained capped, leading to persistent budget deficits financed by borrowing. This vertical imbalance between revenue and expenditure responsibilities is unsustainable in the long run.

2. Provincial Dependencies and Weak Revenue Effort

Provinces, cushioned by guaranteed federal transfers, have displayed little urgency in expanding their own-source revenues. Despite authority over agriculture income tax, property tax, and services sales tax, provincial collections remain stagnant at 0.7–0.8% of GDP. Politically powerful lobbies and limited administrative capacity have kept tax bases narrow. The incentive structure is weak: provinces receive large, unconditional funds regardless of tax effort. This dependency mind-set hinders the development of robust provincial revenue systems and leaves subnational governments reliant on federal transfers for most of their spending.

3. Constitutional and Political Rigidity

The unanimity rule and the constitutional bar on reducing provincial shares have paradoxically locked the system in place. Provinces, content with existing allocations, see little reason to renegotiate. The federal government, burdened with growing expenses and shrinking fiscal space, hesitates to give more. This tug-of-war has created a deadlock. What was once a well-intentioned safeguard to protect devolution has now turned into a rigid structure, making compromise near impossible.

4. Horizontal Inequities and Emerging Needs

The frozen award ignores shifting realities. The merger of FATA into Khyber Pakhtunkhwa (K-P) in 2018 added over 5 million new citizens, yet K-P's share remains the same as in 2010. This is arguably unconstitutional, since population is the main criterion for horizontal distribution. Similarly, Balochistan—with its vast territory and sparse population—continues to receive an allocation many argue does not cover its higher per-capita costs of service delivery. These inequities fuel provincial grievances, but other provinces remain unwilling to surrender part of their share.

5. Political Economy of Deadlock

Politics has further complicated matters. Since 2010, different parties have ruled at the federal and provincial levels, making consensus harder. No party wants to be seen compromising on fiscal rights, particularly in a polarized climate. Frequent government changes and short tenures in Islamabad have also pushed the NFC down the priority list. Successive governments have chosen to carry on with the old formula, sidestepping the Constitution's renewal clause, leaving Pakistan with an arrangement that no longer reflects today's fiscal or political realities.

In summary, the failure to convene a new NFC Award for well over a decade stems from a combination of constitutional rigidity, misaligned incentives, and political deadlock. The outcome has been a stagnant fiscal federal architecture: one that initially empowered provinces but now struggles to adapt to changing conditions or to ensure a sustainable national fiscal balance. The costs of this stalemate are increasingly evident in Pakistan's macroeconomic stress and inter-provincial frictions.

The National Fiscal Pact (NFP) - An Interim Solution under IMF Auspices

With no new NFC Award in sight and fiscal pressures mounting, federal and provincial governments turned to a temporary arrangement. In late 2024, they signed the National Fiscal Pact (NFP) as part of an IMF-backed reform effort. The NFP is a political understanding, not a constitutional replacement, but it provides a short-term framework for stability and burden-sharing. Key Elements of the NFP are:

- **Devolution of Expenditure Responsibilities:** Provinces agreed to take on certain spending functions that were still being funded by the federal government, in line with the 18th Amendment's division of subjects. For instance, development schemes that benefit only a single province will, from FY2025-26 onward, be funded by that provincial government rather than by the federal PSDP. This prevents the center from incurring expenditure on essentially provincial domain projects, thereby reducing federal outlays. An exception mechanism via the Council of Common Interests (CCI) or National Economic Council (NEC) is included for any special cases, ensuring consensus on any federal involvement in local projects. Additionally, the federal government is undertaking a "right-sizing" initiative – cutting or restructuring federal ministries and departments that overlap with provincial functions – to shrink its footprint and expenditure accordingly.
- **Provincial Revenue Mobilization Commitments:** A key feature of the NFP is the provinces' commitment to step up their own revenue collection. For years, taxes under provincial control like those on agriculture, services, and property have remained largely underused. Now, all four provinces committed to reforming Agricultural Income Tax laws by October 2024, aligning them with federal income tax rates. From January 2025, farmers will be taxed like other citizens, a major shift for a sector long shielded from taxation. Provinces also adopted a "negative list" approach for Sales Tax on Services and moved toward harmonized property tax frameworks. Together, these reforms aim to tap under-taxed sectors such as agriculture, services, and real estate.
- **Tax Policy Harmonization:** Through the National Tax Council, federal and provincial governments will coordinate on property taxation, share data, and align agricultural pricing policies. Provinces also agreed to end market interventions such as separate support prices or large procurement drives, which often distort trade and strain budgets.
- **Shared Funding of National Programs (Adjusted in Final Pact):** An initial proposal for provinces share the cost of certain federal programs like the Benazir Income Support Programme (BISP) was softened after

resistance, particularly from Sindh. Instead of mandatory cost-sharing, both sides agreed to coordinate better on social protection to avoid duplication and use resources more efficiently. Still, provinces committed to gradually increase, provinces pledged to scale up their own spending on health and higher education, recognizing these as core responsibilities. The broader idea is that with greater fiscal space post-7th NFC, provinces should take more ownership of key social services, while the federal government limits its role to national-level support where needed. **Fiscal Coordination and Surpluses:** Provinces are encouraged to run surpluses that support federal fiscal targets, investing idle balances in federal securities to provide both returns for provinces and non-inflationary financing for the centre.

A PRACTICAL BUT IMPERFECT STEP

The NFP reflects pragmatic compromise in tough times. It reduces duplication, nudges provinces to take ownership in health, education, and agriculture, and trims federal overreach. Perhaps most importantly, it demonstrates that cooperation across provinces and parties is possible.

Yet concerns remain. Some view the NFP as shaped more by IMF pressure than by genuine domestic consensus. Others worry that it could become a substitute for constitutional reform if allowed to drift beyond its intended role. For this reason, the NFP must be seen not as a destination, but as a stepping stone towards a stronger and fairer NFC Award.

BRIDGING THE GAP

Pakistan's prolonged failure to finalize a new NFC Award is more than a procedural lapse. It reflects deeper structural issues within its fiscal federalism framework. The emergence of the National Fiscal Pact (NFP), though shaped by the urgency of IMF-led reforms, shows that intergovernmental cooperation is possible when the stakes are high. The NFP is not a perfect solution, but it is a timely reminder that Pakistan's existing fiscal arrangement is no longer fit for purpose. It has opened the door for rethinking outdated structures and provided a rare moment of consensus across party lines.

However, this temporary arrangement must not become a substitute for genuine, constitutional reform. Pakistan needs to seize this moment to rebuild the fiscal compact between the center and the provinces, one that upholds the spirit of the 18th Amendment while addressing today's economic realities.

The next NFC Award should be designed not just as a mechanism for dividing resources, but as a renewed social contract anchored in fairness, flexibility, and shared responsibility. To that end, it must resolve vertical imbalances by either assigning additional revenue streams to the federal government or having provinces absorb specific federal expenditures. It should also correct horizontal inequities using updated population data and additional criteria, including climate vulnerability and service delivery costs. Most importantly, the new formula must reward performance by embedding incentive-based transfers, rewarding provinces for revenue effort, governance, and better social outcomes for citizens. To support this shift, Pakistan should establish a permanent, technocratic NFC Secretariat under the Council of Common Interests (CCI), tasked with continuously analyzing fiscal data, preparing policy options, and fostering informed dialogue among stakeholders. Such an institutional body would depoliticize the NFC process, ground it in evidence, and make it a dynamic tool for cooperative fiscal federalism ensuring that both national unity and provincial autonomy are strengthened for generations to come.

On a hopeful note, the challenges of the past 15 years can be overcome by a New Fiscal Pact evolving into a New Fiscal Consensus. A data-driven, incentive-compatible sharing formula one that rewards revenue effort, addresses genuine needs, and promotes solidarity, could transform Pakistan's fiscal federalism from a source of friction into a pillar of national strength.

The time to act is now. With constructive engagement, Pakistan's federal and provincial leaders can ensure that the fiscal framework supports sustainable development, equity, and national cohesion for decades to come.



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