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CHANGING MODES OF FISCAL FEDERALISM IN PAKISTAN: A CASE OF CENTRE-SINDH FISCAL INTERPLAY

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ABSTRACT

The last 75 years have highlighted the extent to which issues regarding resource distribution in Pakistan have been closely related to the country's chequered history of federal-provincial relations. Repeated interventions have marred these relations regarding various dimensions of provincial autonomy as enshrined in the constitutional frameworks that have been operative since 1947. The complexities involved have paved the way for multiple other issues, including ethnic, political and economic disparities. The Pakistan federation has applied a three-pronged strategy—bureaucratization, centralization and homogenization—to cope with federating units' demands for provincial autonomy, economic decentralization and appropriate representation. Yet, despite its criticality, there has been little attempt to understand and analyze the fundamental question of why Pakistan's economic system has been predominantly centralized, and so why the provinces have been made so dependent on federal fiscal shares, grants-in-aid and subversion instead of evolving the capacity to generate their own revenue mechanism? The paper addresses these-long standing political-fiscal challenges with particular focus on the relationship between the Centre and Sindh.

Keywords: Fiscal Federalism, Economic Decentralization, Provincial Autonomy, NFC Awards, 18^{th} Amendment.

INTRODUCTION

The theme of this paper occupies a central place in the historical reflection on Pakistan, and more generally on South Asian states. Here are excellent reasons why this is so: not only Pakistan has a complex social, cultural, linguistic and economic structure which is reflected in the role that the provinces have played vis-à-vis the federal state. Moreover, the difficult relationship between the centre and provinces has strong roots in the colonial period, in the power relations established by the British in the localities that were partly transmitted to the successor states after 1947. Therefore, current research is a new reflection on this issue, especially as it focuses on the crucial province of Sindh. The research discusses the fiscal aspects of the Centre-Sindh relation, reforms to the system—especially 18th constitutional amendment and the institutional design for inclusive federalism. The basic arguments of the current study are: federalism concept in Pakistan, although suited to the peculiarities of the society, has been applied by the civil-military elites in order to centralize the political system, rather than to emphasize the autonomy of federated units. This fact, in turn, has created a political, economic and administrative crisis between the central government and Sindh. The research, therefore, proposes measures to strengthen the authority of the Constitution with the aim of protecting the autonomy of federated units.

To begin with, Pakistan inherited the British colonial federal system under the 1935 Act of India. The Act, though theoretically, had enhanced provincial autonomy in the political and economic spheres; however, this politico-economic autonomy could not be enjoyed by the provinces in a true sense because of the Second World War and national issues like the “Quit India Movement”, and the struggle for independence of India. The practice of provincial autonomy could not be matured in a true spirit due to circumstances of the time.

After the partition, the British colonial federal system gave birth to the provincialism and economic disparities at the time of the inception of Pakistan, along with ethnic differences and political upheaval that prevented political institutions from expanding and developing. In the early years, the context of centralist economic tendencies, for example, a sales tax collection had been taken from the provinces and given in the regulator of the central government. The geo-strategic circumstances forced to believe that “development expenditure and central-provinces relations were held hostage to the perceived Indian threat” (Siddiqa, 2007) of independence. Further, developed centralist control to exercise power over the distribution of resources and provide for a strong military institution. However, Ian

Talbot opines that few Muslim classes including landowners, bureaucrats and army officers, businessmen, and religious class, wanted to build Pakistan as per their own interests except Bengali Muslims who were struggling to achieve a sovereign East Pakistan state (Talbot, 2012). Talbot's argument is endorsed by a recent research that argues that political and fiscal institutions of Pakistan are highly influenced by interest groups, including traditional elites (landlords and religious), professional elites (warlords and bureaucrats), and business elites (industrialists, real estate tycoons, and media) (Tunio & Nabi, 2021)

Consequently, relations between the federation and federating units in general and with Sindh in particular, have often been troubling. Constant interference over various aspects of provincial autonomy as outlined in the constitutional frameworks in place since 1947 frequently harmed these relationships. The complexities of this relationship paved the way for other multiple issues including ethnic, political, and economic disparities.

Rather, to establish inclusive system for federated units, the federation applied three-pronged strategy including bureaucratization, centralization, and homogenization in order to cope with federating units' demands for provincial autonomy, economic decentralization and appropriate representation (Idris, 2007). Therefore, a haphazard and unstructured initial phase continued and gave birth to different other political, constitutional and ethnic issues along with economic disparities. Various political systems ranging from strong military rules to weaker democratic regimes failed to tackle tensions between the federation and federating units of Pakistan. It led to East Pakistan's secession and protest movements in Sindh and Baluchistan against the lack of provincial autonomy provided by Pakistan's federal system. The current study argues that the demand for provincial autonomy, since 1947, more emphatically linked with fiscal decentralization.

Among other conflicting issues, resource distribution crisis between the Centre-provinces *vis-à-vis* inter-provinces exacerbated the issue of public service delivery. Pakistan lagged in creating an effective federal political system and a shared economic management mechanism between the Centre and provinces as per international principles of federalism. Yet, despite its criticality, there has been little attempt to understand and analyze the fundamental question of why

Pakistan's economic system has been predominantly centralized, and so why the provinces have been made so dependent on federal fiscal shares, grants-in-aid and subversion instead of evolving the capacity to generate their own revenue mechanism?

LITERATURE REVIEW

Recently, fiscal federalism, particularly after the 7th NFC award has fascinated scholarly attention. However, literature produced in this field over the last decade is scarce to discuss and analyze the resource distribution problems between the Centre and provinces. It is within the parameters of the available literature, that general economic progress and policies at national and international level are discussed and analyzed. For example, the work of Zaidi *Issues in Pakistan's Economy: A Political Economy* (Zaidi, 2015) provides comprehensive insight on different aspects of the economy in Pakistan. It highlights the general aspects of the country's economy including the process of growth and hurdles in industrial development, an agricultural economy and international factors that provided strength or slowed down the pace of Pakistan's economy. Ishrat Hussain's *The Economy of Modern Sindh: Opportunities Lost and Lessons for the Future* (Hussain, 2019) provides information and analysis of the economic growth and stagnancy in Sindh—a politically conscious province—since independence. With a per capita income that was 55 percent higher than the rest of the nation at the time of independence, the author says that the province has experienced a precipitous decrease less than 17 percent, abandoning the province's economic advancement and provision of public services delivery as a result.

THEORETICAL FRAMEWORK

The theory of fiscal federalism, (Musgrave, 1959) originally developed by Richard Musgrave has been rightly elaborated by Richard Bird: "concerns the division of public-sector functions and finances in a logical way among multiple layers of government" (Bird, 1999). Predominantly, fiscal decentralization includes all financial facets of devolution to regional and local governments. However, positive impact of fiscal decentralization, as envisaged by Usman Mustafa, is that "it increases efficiency, transparency, and accountability with the objectives of economic stability, sustainable growth, and public service provision equitably across people and jurisdictions” (Mustafa, 2011). It provides opportunity to provincial governments to accelerate the economic development of the regions and leaving the national government to fulfill the central level tasks more effectively and efficiently.

Experts point out three essential roles of fiscal decentralization: “stabilization, allocation, and distribution” (Sadiq, 2010). However, in the case of Pakistan, the importance of fiscal decentralization is partly neglected and partly assumed that only the allocation function could be appropriate to fiscal decentralization theory because these three functions are not equitably suitable for all levels of government, however, it is necessary for efficiency that each function is properly attached to the level.

PRE-1971 FISCAL RELATIONS OF CENTRE-SINDH

Before the partition, financial position of the province of Sindh was potentially stabilizing. It can be analysed by two different facts: (i) the financial argument under discussion during the Round Table Conference recommended the Government of India to appoint a committee to report on the financial position of India. That committee also look into the matter of the separation of Sindh and concluded “separated Sindh would start its career with an initial deficit of Rs. 108.45 lakhs (Afzal, 2010), (ii) under the Niemeyer Award (1936-1947) vertical and horizontal sharing of shareable taxes and duties as well as grants-in-aid was recommended under which “10.5 million rupees were recommended for Sindh to improve its financial position” (Sarma, 2010). However, when the financial position of Sindh improved, the grant was used to settle its federal debt.

The government of Sindh rapidly maintained its economic position during almost ten years of its autonomous position in British India. Rather, Sindh was in a position not to get grants-in-aid at the inception of Pakistan. However, during the formative phase of Pakistan, Sindh had been pushed into fiscal crisis. The initial arrangement for the central government made by the province; had over-burdened the finances of Sindh. Moreover, the capital loss of Sindh, mass influx of refugees and an outflow of Hindus also weakened Sindh’s economic position at an early stage of the new entity—Pakistan.

Moreover, different challenges faced by the new nation were instrumental in making changes in the revenue receipt and expenditure. It was believed that once circumstances would be normalized, changes would be revoked. However, neither changes were revoked nor the circumstances were normalized, rather remained a source of contention between the Centre and provinces. For the compulsion of defence requirements and abnormal conditions created by the large influx of refugees, the central government made some changes in the sharing of income, railway budget, and sales tax in the pre-partition colonial award. For example, the railway budged was merged with the central budget; the income tax sharing with provinces was temporarily suspended in 1948-49; sales tax was kept under the regulator of the central government; and obtaining funds through public loans were made prerogative of the centre (Report of the National Finance Commission, 1990). The federating units were looking forward to better economic sharing, or at least, revoke in earlier changes in the Raisman Award of 1952. The Award, however, provided two-thirds of the export duty to East Pakistan on raw jute. On the precedent of the distribution of jute export duty, Punjab and Sindh claimed for a share of the proceeds of the cotton export duty. But the claim was rejected on a ground that "the case of jute in relation to Bengal is quite unique, whereas, export duties are essentially federal in character. A right of the units to the proceeds on the basis of the local origin of the taxed commodity would ultimately be fatal to any rational scheme of federal finance" (Report of the National Finance Commission, 1974). At the same time, other demands from Punjab and Sindh were also declined including: the sales tax should be distributed among the provinces and not to be shared between the centre and provinces, and sharing of the proceeds of export duties on cotton (Jalal, 2014).

The Raisman Award did not go far enough in alleviating the centre-regions' frictions over all important issues of fiscal autonomy, rather it gave a boost to the existing demand of provincial autonomy. Additionally, praetorian supremacy at that time had exacerbated the vacuum between the centre and regions. This vacuum transformed into an ethnic bias towards communities that were overwhelmingly represented in the civil-military bureaucracy. Despite resolving fiscal issues of the provinces, the central government further grilled the East

Pakistan and minority provinces of West Pakistan into the issues of political representation based on population and merger of units' formula, respectively.

The One Unit formula scared the people of Sindh and deprived the province of its autonomous provincial status as well as neglected people of this region in economic spill over. Ishrat Hussain rightly observed that the elite from the Punjab province, instead of creating balance of power between the two wings for the national interest, adopted a confrontational strategy to consolidate their power (Hussain, 2009). The ethno-national movements in Sindh, Balochistan, and NWFP, according to Muhammad Waseem, were evidences of a furious backlash against One Unit (Waseem, 2010). With the establishment of One Unit, Sindhi leaders anticipated control over Sindh's financial and land resources by the civil-military establishment. G. M. Syed had already apprehended it as "colonization of Sindh" at the hands of Punjab (Syed, 1974).

Economic conditions of Pakistan during the Ayub period substantially developed but inequalities had also been increased between the East and West wing and the wealth was concentrated in the hands of twenty-two families. However, Sindhis did not a figure in such families who came to dominate the commercial and industrial sectors of the economy. Like Bengalis, many Sindhis resented these policies and they also accused Ayub's regime of reducing Sindh to an internal colony.

Sindh's socio-economic conditions were vehemently deteriorated. Jobs in industrial and public sector organizations were mostly provided to non-Sindhis. During the period (1955-1970) state power was centralized and the provinces had little financial autonomy with the result that the rural areas of Sindh did not witness much change. Moreover, the dominant role of the civil-military establishment diverted significant resources to the national defence and established command of bureaucracy over projects funding and spending of resources.

During the Ayub period, only two fiscal awards for the years 1961 and 1964 were announced. The 1961 award constituted a pool of 50 percent of income tax and corporation tax receipts and 60 percent (previously 50 percent) of sales tax and excises on tea, betel, and tobacco to be divided between the provinces, while 100 percent of export duties on jute and cotton (previously 62.5 percent of Jute duties to East Pakistan alone) was assigned to the province of collection (Wheeler, 1970). Furthermore, the sales tax share was divided 70 percent based on population and 30 percent on incidence, and the remainder of the pool based on population (i.e. 54:46 in favour of the East Pakistan). The capital value tax on immoveable property and the remaining agricultural land duties, however, were specified to units in accordance with their collection (Ahmad, 2007).

The National Finance Commission, constituted in the year 1964 under article 144 of the 1962 Constitution, had its antecedents in the Constitution of 1956, and the provisions of the 1935 Act, regarding the allocation of resources. The allocation was reviewed and modified by the National Finance Commission in 1964-65 to provide a uniform provincial share of 65 percent under all heads, with the allocation between provinces remaining the same, except that export duties were included as 54:46 in the divisible pool. During these two fiscal awards of Ayub Khan Period, the provincial status of Sindh was aborted under One Unit policy.

The development share of Sindh into the West Pakistan unit was at the mercy of the government at the provincial capital of West Pakistan. There were least development projects, grants-in-aid and financial divisible pool proportionate for the areas of Sindh during One Unit period. The central government and West Pakistan province failed to carry out any initiatives or programs that were promised to Sindh at the time of the creation of One Unit.

Ayub Khan’s military government failed to reach an agreement with the provinces of East and West Pakistan on fiscal awards of 1961 and 1964 respectively, resulting in a deadlock between the centre and provinces. The impasse forced the federal government to take *ad hoc* measures (Uddin, July-December 2010). Furthermore, Ayub’s imbalanced socio-economic policies for the federation had accelerated resentment against his economic policies and One Unit government from the East Pakistan and Sindh. The economic policies of Ayub khan not only promoted fiscal centralization, but it also led to a secessionist movement in East Pakistan. Concurrently, political resentment from the area of Sindh which gathered support for the newly established Pakistan Peoples’ Party (PPP) of Zulfiqar Ali Bhutto with the hope that

Bhutto will secure genuine politico-economic and demographic interests of Sindh.

POST-1971 FISCAL RELATIONS OF CENTRE-SINDH

One of the major problem remained in the way of inclusive federalism in Pakistan is “the demand for a more equitable division of resources” (Adeney, 2007) that was also one of the prime demand of East Pakistan. The allocation of resources between the Centre and provinces vis-à-vis provinces concerned as the primary tension. In united Pakistan, revenue and inverse density rather than population served as the foundation for the NFC Award. But with the separation of East Pakistan, the formula for income sharing was altered to allocate the country’s financial resources to the majority province of the remaining Pakistan. Once, Punjab became the most populated province, the population was made the sole basis for the distribution of the NFC award. Hence, the elements of majority-constraining federalism emerged in the smaller provinces of Pakistan (Waseem, Pakistan: A Majority Constraining Federalism, 2015).

Post-1971 Pakistan witnessed new economic policies and an era of economic transition from the pro-private sector strategies of the earlier years to a strange concept of socialism which made Bhutto responsible for the highest rate of inflation and the dismal growth rates for ever seen in Pakistan. ‘The Nationalization Policy’ with regard to economic transitions, Akbar Zaidi believes, turned for Bhutto as ‘bad luck or bad management’ causing the economy to grow below trend rates (Zaidi, 2015).

Beside all internal and external economic and political crises, Bhutto inherited the issue of equitable resource sharing between the centre and provinces which had remained a bone of contention for a long time. Most of the other tensions in Pakistan are attributed to resource allocation. With the separation of East Pakistan, it was apprehended that the contentious issues would be settled down through representative government by giving a consensus constitution. The Constitution of 1973 was adopted by a consensus through the tripartite accord. At this stage, the resource allocation tension between the centre and provinces and the division of resources between the provinces proposed to be resolve through strategic institutional design.

The 1973 Constitution not only defines the financial distribution of resources between/among different tiers of government in both vertical and horizontal spheres under Article 160 to 171, it also provides institutional set-up to resolve complex issues of fiscal federalism. The Constitution makes the centre very powerful in almost all aspects. As far as the financial relations are concerned, the bulk of revenue is collected by the central government while the collection work had to be done by the provinces, which have little or very limited taxing powers (Bhattacharya, 2010). However, Anwar Shah is of the view that the principles of fiscal federalism are concerned with the design of fiscal constitutions—that is, how taxing, spending, and regulatory functions are allocated among governments and how inter-provinces transfers are structured. These arrangements are of the fundamental importance to the efficient and equitable provisions of public services (Shah, 2006).

The 1st NFC award (1974) by Z. A. Bhutto government reorganized the essential need for preserving the financial soundness and strength of the Centre. Under this award, the divisible pool contained fewer taxes including sales tax, income tax and export duty (Mustafa, 2011). However, it also appreciated the imperatives of making the provinces financially viable units. The National Finance Commission unanimously recommended that out of the net proceeds of the divisible taxes and duties, 80 percent should be allocated to the provinces and 20 percent should be left with the federal government on vertical line (Report of the National Finance Commission, 1974), whereas population was determined as basic formula. Hence, Punjab's share from 56.25 percent in 1970 award increased to 60.25 percent in 1974. This vertical percentage continued till 1990 award whereas it further changed in 1996 award as 37.5 percent for the provinces and 62.5 percent for the federal government (Report of the National Finance Commission, 1990). However, the vertical ratio was proposed to be revised to 65:35 by the 1985 Commission which could finalize its recommendations (Report of the National Finance Commission, 1990). The Commission allocated horizontal share of provinces in the divisible pool as per percentage of their respective population including Punjab 60.25 percent, Sindh 22.50 percent, KP 13.39 percent, and Baluchistan 3.86 percent (Report of the National Finance Commission, 1974).

Furthermore, the 1st NFC Award after enforcement of the 1973 Constitution, in order to accommodate two smaller provinces of KP and Baluchistan, provided additional assistance in the form of fixed subvention. In this concern, KP and Baluchistan received 100 and 50 million rupees respectively (Report of the National Finance Commission, 1974). However, population was being made the sole principle for resources distribution among provinces which made three provinces except Punjab suffered a lot, Sindh the most. Hence, fiscal issue was turned as an 'ethnic' issue because grievances subsequently articulated against the province of the Punjab in general and Punjabis in particular.

Under the new NFC set-up of 1974, provinces were forced to remain dependent on the Centre for their revenues and never geared again to arrange their own revenue generation system. For example, the federal government had the power to holdback/delay release of funds and could exert considerable influence on how funds were spent. Secondly, a lot of non-divisible pool fiscal transfers were discretionary in nature and not formula based (Idris, 2007).

According to Katherine Adeney, "the issue of the percentage shares of each province took on extra salience. Baluchistan demanded that a percentage of resources be allocated according to backwardness and land mass; KP demanded that a certain amount be allocated for backwardness, and Sindh demanded that a certain amount should be allocated according to revenue generation" (Adeney, 2007).

After the 1st NFC Award, the next one was due in the year 1979 but was delayed for almost 12 years. However, the 1979 NFC Award, *ad hoc* in nature, enlarged the size of divisible pool by adding additional items i.e. excise duty on tobacco and tobacco manufacturers. But, recommendations of the Commission could not be finalized. Similarly, the NFC Award of 1985, again *ad hoc* in nature, added excise duty on tobacco and tobacco manufacturers in the divisible pool. Moreover, the Commission recommended distribution of local funds between the provinces and local bodies and any other financial matter referred to the Commission by the President. The Commissions' recommendations could not be finalized though it had done some useful work and had nearly reached a consensus.

The democratic government in 1990 agreed to retain 1974 formula at fixed ratio of 80:20 between the federation and federating units notwithstanding the enlarged pool and addition of straight transfers. The 1990 NFC divisible pool represents a major portion of resources to be distributed. Federal divisible taxes consist of income tax and corporate tax, export duty on cotton, sales tax, excise duty on tobacco and tobacco manufacturers and sugar. The budget estimates for 1991-92 have been taken as benchmark.

The NFC Award of 1996-1997 has been considered as a step-forward towards consensus on resource distribution between the federation and federating units. In this Award, the divisible pool was enlarged by adding custom duties, wealth tax and capital value tax. The vertical ratio was fixed as 62.5:37.5 between the federation and provinces. Hence, Sindh contributed 65 percent, Punjab 25 percent, KP 7 percent, and Baluchistan 3 percent of the country’s tax revenues; however, Sindh received 9 percent of the redistributed revenues, Punjab 25 percent, KP 6 percent and Baluchistan 2 percent while the rest went to the central government (Shah Z. A.). Furthermore, 700 million annual grant for Sindh for five years, and 1000 million for Punjab for three years had also been provided under this award, whereas in account of subvention, KP and Baluchistan 200 and 100 million respectively provided for the period of three years. It is noteworthy that with the enlargement of divisible pool, the 37.5 percent share of provinces was much higher than the 80 percent in previous NFC Awards. However, in the NFC Award of 1996, objections over revenue resources allocation on the basis of population were slightly acknowledged. On the basis of economic deprivation, Sindh was the first that demanded the inclusion of more elements in the distribution criterion i.e. national tax revenue is distributed among provinces on the basis of incidence of collection.

The 6th NFC was constituted by the then military government of General Pervaiz Musharraf. The Commission remained unsuccessful to announce financial Award. The long intervals between Awards and the Commission’s failure to announce the Award happened during the military regime. It is also worth noting that the four Commissions that did not announce the Awards were constituted during military regimes (1979, 1985, 2001, and 2006). The interference could be that democratic regimes provided a more conducive environment for reaching a compromise solution at a forum where conflicting interests are represented. However, this also highlights the fact that the present structure of NFC on its own is not favourable to reaching a solution that can stand on merits (Musleh-ud-Din, 2012).

Keeping in view that the NFC designed resource allocation mechanism on the basis of population in Pakistan, many of the problems are related to the strength of the Punjab—the size of its population and over-representation in army and bureaucracy.

The multiple criterion demand, put forward by Sindh, Balochistan and KP, during the 7th NFC Award, initially created a deadlock over the issue of the distribution criteria because Punjab's interest was in population criteria. Sindh also wanted substantial share for revenue (sales tax services collection). Ultimately, elements like backwardness/poverty, area, and revenue generation (tax collection) were included. Major factors which brought changes through negotiations in the 7th NFC Award were: (a) each province got substantially more than what it would receive under the previous formula, (b) the weight of population share was not drastically reduced, just reduced from 100-82 percent, (c) federal share in the divisible pool was reduced from 53% to 43%, (d) given the previous failures, both federal and provincial governments were under pressure to end the deadlock, and (e) revision of distribution formula was part of the ruling coalition at the federal level, (f) sales tax on services recognized as a provincial subject, and collected (g) provinces were allowed to tax the agriculture and real estate sectors (Musleh-ud-Din, 2012).

CONCLUSION

It is fair to say that the concept of fiscal federalism was never applied in its true sense and spirit. It was partly due to the absence of a clear demarcating line between the federal and provincial subjects, partly because of the relationship between the ruling party at the Centre and the ruling parties in the provinces, and mainly because of hide and seek between civilian governments and military regimes. Mostly, decisions were taken on an *adhoc* basis either to silence the angry politicians in the provinces or to appease the disgruntled partners. Fiscal federalism crisis in Pakistan are deep-rooted. The state institutions along with international economic forms need to root out all structured and unstructured problems and plan out new policies and better structure to develop strong fiscal relations between the Centre and provinces.

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