

PAKISTAN'S FISCAL FEDERALISM AT A CROSSROADS: HOW THE FY27 BUDGET QUIETLY REWRITES THE FEDERAL-PROVINCIAL CONTRACT

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Writing an article in Business Recorder 'Is It Time to End the Cycle of Endless Consolidation?' on 11th August 2025, I argued the following: "The depressing social and economic outturns during FY23-FY25 should serve as a wake-up, the next FY27 budget must not be yet another missed opportunity. The time for halfway measures is long gone. Pakistan's political leadership must decide whether they wish to continue administering the same palliative year after – or whether they are finally prepared to confront the structural roots of the fiscal trap that has held the economy back for far too long."

Unfortunately, the FY27 federal budget does more than mobilize and allocate resources; it marks a profound shift in the country's fiscal federalism. On paper, the constitutional architecture remains intact: Articles 160–161 continue to govern the National Finance Commission (NFC), provinces retain their guaranteed share of the divisible pool, and the 18th Amendment's protections remain untouched. But in practice, the FY27 budget introduces two measures that fundamentally alter the flow of resources between the federation and the provinces: (1) IMF-mandated provincial budget surpluses, and (2) nearly Rs 1 trillion in provincial grants to the federal government. Together, these measures reverse the logic of the NFC. Instead of the federation transferring resources to provinces, the provinces are now expected to transfer resources back to the federation. This is not a formal collapse of the constitutional framework, but it is a deep hollowing-out of its substance.

The Constitutional Logic: A One-Way Flow of Resources

Pakistan's fiscal federalism rests on three pillars: Division of taxation powers (Articles 141–142, Fourth Schedule), NFC Award (Article 160), and Provincial autonomy (18th Amendment). The NFC is the operational heart of this system. It ensures that federally collected taxes—income tax, sales tax on goods, customs duties, and excise—flow from the federation to the provinces. After the 7th NFC Award of 2010, provinces receive 57.5% of the divisible pool, the largest share in Pakistan's history. The 18th Amendment further strengthened this arrangement by prohibiting any reduction in the provincial share. This architecture was designed to correct Pakistan's long-standing vertical imbalance: the federal government controls the most buoyant taxes, while provinces bear large expenditure responsibilities. The NFC therefore functions as a constitutional equaliser.

FY27 Budget: A Quiet Reversal of the Constitutional Flow

The FY27 budget introduces two unprecedented measures: (1). Provincial Surpluses of Rs 1.794 trillion. The federal government's fiscal deficit is projected at Rs 7.02 trillion, but the overall deficit is shown as Rs 5.23 trillion. The difference—Rs 1.794 trillion—is the provincial surplus that the federation has committed to the IMF. This surplus is not a provincial policy choice. It is a federal commitment, negotiated with the IMF and then imposed

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on provinces. In effect, provinces are being asked to compress their spending to help the federation meet its primary fiscal surplus target of 2% of GDP (or Rs2.83 trillion). (2). Provincial Grants to the Federation of nearly Rs 1 trillion. Provinces are now expected to transfer around Rs 1 trillion back to the federal government as grants. The funds are being provided under Article 164 to fulfill strategic national requirements rather than a constitutional amendment to the NFC Award itself. The provincial ADP cuts reflect a federal-provincial fiscal consolidation driven by defence spending needs and IMF programme conditionalities for FY 2026-27.

To accommodate this grant, the provinces heavily slashed their respective Annual Development Programmes (ADPs). The three-year transfer agreement stipulates that the full realization of the provincial grant remains dependent on the FBR successfully hitting its collection target for the fiscal year. Punjab and Sindh are absorbing over 80% of the overall cut in provincial ADPs.

Table 1: Provincial ADP Cuts: FY 2026-27 vs FY 2025-26

Province	ADP FY 2025-26 (Rs bn)	ADP FY 2026-27 (Rs bn)	Change (Rs bn)	Change (%)
Punjab	1,240	752	▼488	▼39.4%
Sindh	1,018	720	▼298	▼29.3%
KPK	608	524	▼84	▼13.8%
Balochistan	279	206	▼73	▼26.2%
Total (4 provinces)	3,145	2,202	▼943	▼30.0%

This is a structural inversion of the NFC's purpose. The constitutional design envisages unconditional, formula-based transfers from the federation to provinces—not conditional, IMF-driven reverse flows. These measures do not violate the letter of Article 160, but they undermine its spirit. The federation honours the NFC numerically, then reclaims fiscal space through extra-constitutional mechanisms. The IMF's role in enabling—and in many ways incentivising—this quiet unravelling of Pakistan's fiscal federalism deserves far more scrutiny than it currently receives.

The Federal Fiscal Crisis Driving This Shift

To understand why this reversal is happening, one must examine the federal fiscal position. Net federal revenues in FY27 is estimated at Rs 11.751 trillion (or 8.2% of GDP) and debt servicing (FY27) is estimated at Rs 8.054 trillion, which is 68.5% of net federal revenues. This means that for every 100 rupees the federal government retains after NFC transfers, 69 rupees go straight to interest payments. The remaining 31 rupees must cover defence, pensions, subsidies, civil administration, and development spending. Excluding debt servicing but adding PSDP, the estimated budgetary expenditure is Rs 18.6 trillion. The primary fiscal gap of the federal government is estimated at Rs 6.85 trillion. The federal government is short by nearly Rs 7 trillion after debt servicing. Without compression of provincial budgets, debt servicing to net federal revenues would exceed 100%. This is the structural insolvency at the heart of Pakistan's fiscal crisis.

From FY10 to FY27, federal primary expenditure has exceeded net federal revenue every single year. The gap widened sharply after FY20 due to high interest rates, rupee depreciation, and rising defence and pension obligations. By FY23–FY26, debt servicing exceeded 100% of net federal revenue—an unprecedented situation for a sovereign state. FY27's apparent improvement—reducing the ratio to 68%—is not the result of stronger federal revenues or lower interest costs. It is the result of provincial fiscal compression and reverse transfers.

The FY27 federal budget lays bare the government's spending priorities with unusual clarity. Defence outlays are set to surge by 17.6%, reaching Rs 3 trillion, while pensions—driven by the relentless rise in both civil and military retirement costs—climb another 11% to Rs 1.169 trillion. Civil government expenditure grows by 10%, touching Rs 1.071 trillion. Even as the state trumpets fiscal restraint, debt servicing remains an immovable mountain at Rs 8.054 trillion, only 1.86% lower than last year. Subsidies, meanwhile, face an 8% cut

to Rs 1.091 trillion, and the PSDP is effectively frozen at Rs 1 trillion, signaling a development agenda stuck in neutral.

Recognizing Pakistan’s budget execution practices as a structural fault line in its fiscal governance, the IMF’s Third Review of the Extended Fund Facility (May 2026) reiterated a core requirement: all non-budgeted or above-appropriation expenditures must receive ex-ante parliamentary approval. This demand was not new. The IMF’s Governance and Corruption Diagnostic Assessment (November 2025) had already flagged Pakistan’s chronic reliance on supplementary grants—often approved after the fact—as a mechanism that effectively regularizes overspending with minimal scrutiny, particularly when the National Assembly’s attention shifts toward the next year’s budget.

Despite the Supreme Court’s interpretation of Article 84 in 2013, which clearly requires ex-ante legislative approval for supplementary expenditures, the government has argued that the practical realities of Pakistan’s fiscal operations make frequent in-year adjustments unavoidable. The Diagnostic Assessment nonetheless credited the authorities for curtailing the use of supplementary grants under the ongoing EFF, noting that no supplementary grants were approved in FY24 or FY25.

That narrative has now been overtaken by events. During the current budget session, the National Assembly approved a combined supplementary package for FY25 and FY26 amounting to Rs 15.297 trillion in debt-servicing obligations alone, including an unprecedented Rs 12.6 trillion domestic debt repayment in FY26 alone. This represents the largest debt-repayment supplementary approval in Pakistan’s history, driven by record rollover requirements, elevated interest rates, maturity bunching, and the reclassification of obligations into the current fiscal year.

Table 2: Consolidated Supplementary Grants Approved by National Assembly on 24th June 2026

Category	FY25 (Rs bn)	FY26 (Rs bn)	Combined (Rs bn)
Non-interest Supplementary Grants	554.327	481.666	1,035.993
Debt-servicing Supplementary Grants	2,644.485	12,653.000	15,297.485
Grant Total	3,198.812	13,134.666	16,333.478

Alongside this, the Assembly also endorsed Rs 1.036 trillion in regular and technical supplementary grants for FY25 and FY26. These budgetary overspending span a wide array of ministries and sectors—from security institutions and civil administration to development outlays, climate and disaster management, and special bodies such as the NDMA and SIFC.²

Taken together, these approvals of supplementary grants by the National Assembly underscore the long-standing tension between Pakistan’s constitutional fiscal framework, IMF-mandated fiscal discipline, and the operational realities of a state navigating high debt, volatile macroeconomic conditions, and persistent institutional weaknesses.

Yet beneath the surface of these headline numbers lies a more troubling continuity. Despite back-to-back IMF stabilization programmes, Pakistan’s fiscal machinery continues to exhibit two stubborn traits: systemic budget overruns and built-in growth across nearly every spending head. With these structural habits entrenched, the fiscal arithmetic becomes painfully predictable. The federal government’s expanding appetite for spending is fed not by genuine fiscal discipline and economic growth but by squeezing more tax revenues in the formal economy, piling on more borrowing, and forcing provinces into deeper fiscal compression. The architecture may remain constitutional on paper, but the practice reveals a centre increasingly dependent on extraordinary measures to finance ordinary governance.

² For details of Ministry-wise supplementary grants, see *Business Record*, dated 25th June 2026, <https://www.brecorder.com/news/40427225/74-demands-for-regular-and-technical-supplementary-grants-na-approves-federal-charged-expenditure>

What This Means for Pakistan's Federalism

The FY27 budget does not formally amend the Constitution, but it reconfigures fiscal federalism in practice. The federation is no longer the primary provider of resources to provinces; instead, it is increasingly dependent on provinces to meet its fiscal targets. This shift has three major implications: (1) De facto recentralisation: Pakistan is moving from cooperative federalism to hierarchical federalism, where the federation negotiates with the IMF and then instructs provinces to deliver fiscal outcomes, (2) Erosion of provincial autonomy: Provinces cannot meaningfully plan development, social protection, or service delivery when their fiscal space is pre-committed to federal targets, and (3) Hollowing-out of the NFC: The NFC remains intact on paper, but its redistributive function is neutralised through provincial surpluses and reverse grants.

Conclusion: A Moment of Reckoning

Pakistan's fiscal federalism stands at a decisive inflection point. The FY27 budget does not formally dismantle the constitutional architecture, but it hollows it out with quiet precision. A structurally insolvent federation has inverted the constitutional flow of resources, compelling provinces to underwrite federal fiscal solvency. What was designed as a system of cooperative federalism to provide human rights, security and equitable economic opportunities in the 1973 Constitution is now being bent into a mechanism for extracting provincial surpluses to plug federal deficits to deliver deteriorating governance and falling economic outcomes for the people of Pakistan.

This trajectory is untenable. Without a fundamental rethinking of federal taxation, debt management, and — most critically — a radical rationalization of federal constitutional responsibilities accompanied by sustained and wide-ranging medium-term ruthless expenditure cuts, Pakistan risks drifting into a model

that is federal in name but unitary in practice. The federation is edging toward a role indistinguishable from a debt-collection authority, reliant on predatory taxation and chronic compression of development spending — a path neither the Constitution nor the political system was built to bear. And in this slow unravelling of Pakistan's fiscal federalism, the IMF's enabling role remains an uncomfortable but unavoidable part of the story.

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