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# TAXATION AND STATE FORMATION IN PAKISTAN:
## THE ROLE OF INSTITUTIONS

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Tax collection by the state reflects the political challenges it faces and the socio-economic conflict in which it exists. Strong centralization has enabled many states to extract high tax revenues from the economy as depicted by high tax-to-GDP ratios. Main stress in the literature has been on the institution formation, and centralisation of political and executive authority, which translate into strong state fiscal capacity. In the context of taxation, these standard approaches fail to account for how state building and state capacity are contingent upon historical conditions, political conflicts and patterns of economic development. This is a significant omission as the state's capacity to tax is not an absolute phenomenon but a relational one. This policy brief is based on a theoretical paper that argues that a state's fiscal capacity can be weak despite having a strong centralised state structure. The paper develops a novel understanding of formal institutions by investigating Pakistan's inability to improve its tax collection despite several reform efforts.

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# INTRODUCTION

Taxation in Pakistan has become a bit of a conundrum. While Pakistan's taxation issues are not unique to it and many developing countries face similar problems, Pakistan's tax collection is low in the context of its own expenditures. This is despite total expenditures as a share of GDP falling from around 30 per cent in 1988–1989 to about 20 per cent in 2016–2017. Following are some of the pressing, current challenges and observations about Pakistan's current taxation landscape, compared to other South Asian economies:

**Revenue Cover:** Within the South Asian region's three largest economies, Pakistan's tax collection falls quite short of its current expenditures as compared to Bangladesh and India *(See Figure 1).*

**Tax to GDP Ratio:** India and Bangladesh have seen a consistent (albeit a sluggish) rise in their tax to GDP ratios, Pakistan has experienced a considerable fluctuation *(See Figure 2).*

**Composition of Taxes:** In recent years the growth in indirect taxation in Pakistan has been contributed by the Sales Tax at the import stage and the customs duties collected by the government. Both of these taxes are easy to collect as they are collected in the country's main port in Karachi *(See Figure 3).*

**FIGURE 1: Revenue Cover**

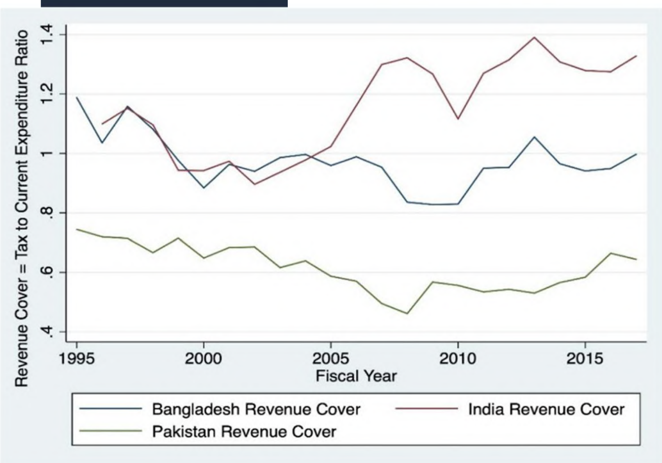



**FIGURE 2: Tax to GDP Ratio**

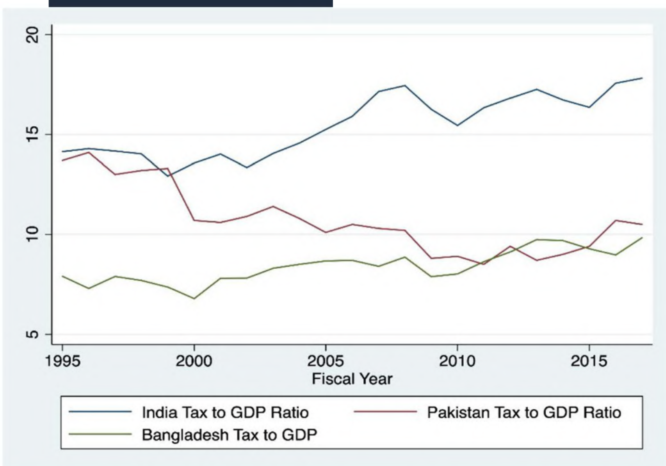
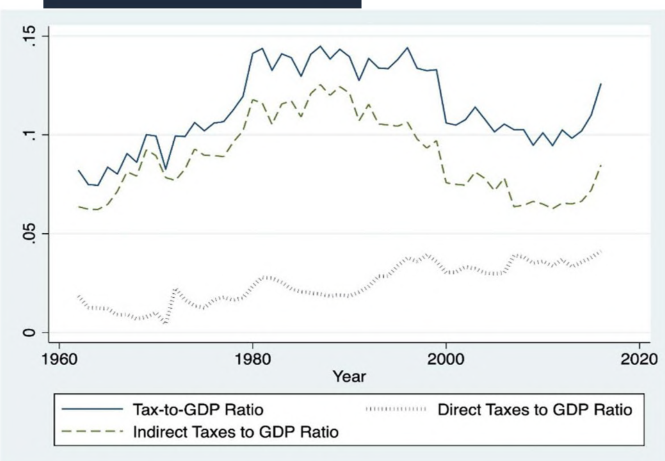



**FIGURE 3: Composition of Taxes**




Over the course of more than 70 years of history, Pakistan's issues of poor tax collection have persisted, despite several reform efforts that were motivated from different quarters (See Table 1).

**Table 1: Impetus for Tax Reforms**

| Early Years: | Later Years: |
|---|---|
| • poor financial position of the central government<br>• desire to industrialise the newly independent country | • international financial institutions<br>• various structural adjustment programmes<br>• other loan agreements |

Even then, tax reforms in Pakistan have not delivered lasting results in the form of long-term improvement in tax revenues. The wealthy routinely avoid and evade taxes, while the state, despite its centralized tax machinery, and strong enforcement powers, has been unable to bring them into the tax net. Neither military nor civilian governments have managed to fix this chronic problem in revenue collection.

## About the Research

This policy brief is based on a theoretical research paper that answers the following question:

**Why, given its extremely centralised structure and a seeming willingness to pass policy reforms, is the Pakistani state unable to significantly raise its tax revenue?**

The research attempts to understand issues of state capacity and tax collection in a post-colonial state like Pakistan.

By employing a Gramscian approach (See Table 2) to state formation and economic and political developments in post-independence Pakistan, and developing a novel theoretical framework, the research tries to explain Pakistan's perennial weak tax collection problem.

The research relies on constitutional negotiations using debates from Pakistan's first Constituent Assembly that met from 1947 to 1956 and several other hitherto unused Government of Pakistan archives to make its case.

**Table 2: Gramscian Framework**

| Ideas | Explanation and Application |
|---|---|
| Passive Revolution (State Formation) | State formation from above, for maintaining and restoring class dominance and neutralizing subaltern resistance. |
| Hegemony (Intellectual, political and moral leadership for deriving consent) | A way to solicit consent from the public for the ruling elite's policy decisions. Gramsci believed that this was operationalised through the formation of a 'historic bloc'. |
| Historic bloc (Alliances) | A cross-class alliance that allows the ruling elite to rule over a society and manage its economy.<br>In Pakistan's case, this comprises the civil military bureaucracy and landed political elite.<br>The capitalist class had little to no role to play as it was largely absent in the nascent state. |

# Foundations of Taxation System: Economic Imperatives and Fiscal Challenges of the Early State

- Pakistan inherited an ***overwhelmingly agrarian economy*** from British India in 1947.

- The leadership of the ***main political parties*** comprised the landed elite or gentry in both wings of the country and dominated the provincial and central legislatures.

- A major task facing the government was to ***modernise the country's economy*** and provide it with an industrial base, while balancing the many social and ethnic groups whose support was vital for a smooth functioning of the state.

- The modernisers from the colonial period occupied the ***central governemnt***, particularly its ***bureaucratic institutions*** and the ***military***. The military, as an institution, also saw the benefits of a modern economy. With crucial support from the military, the bureaucracy wanted to modernise the economy rapidly and required investment capital for the same.

- However, both these institutions stood in ***contrast*** to the main political parties; i.e. this policy ***'desire'*** and the ***reality*** facing the government contained two main ***contradictions.***

    - First, the political regimes in the early years of Pakistan history, a period from 1947–1971, only had ***unelected governments***[1] in place at all tiers of the state. All these regimes required political legitimacy that they obtained from the landed elite that dominated the legislatures as mentioned earlier.

    - Second, the desire to modernise the economy required ***capital investments*** from the state as private capitalists were virtually absent. The attempt to raise capital could rely either on:
        - Taxing the landed elite (*this was politically unviable*)
        - Centralising the state's revenue streams (*this was met with resistance*)

- These contradictions limited political regimes' capacity to modernize the economy or generate long-term domestic revenues, pushing them instead to depend on ***external funding for development***.

- The "developmental passive revolution" of the early years further exacerbated the ***income and regional inequalities*** and created a ***bourgeoisie heavily dependent on state support through tax breaks and incentives.***

> ***This dependency made it difficult for regimes to build genuine hegemony or form a historic bloc (in Gramsci's sense) that could drive coherent taxation and revenue reforms.***

## Foundations of Taxation System: The First Constitution and Fiscal Woes

While a detailed account of events leading to the formulation of the constitution can be found in Section 5 of the paper, following are some of the main developments to be kept in mind while tracing the history of institution formation in Pakistan:

- In Pakistan's early years, ***taxing agricultural income*** could have provided a huge boost to government revenues.

[1] These successive governments were either directly led by the military (1958–1971) or tacitly supported by the military (1952–1958).

- Yet the Constitution continued with the ***colonial-era divide*** between agricultural and non-agricultural income, leaving agricultural taxation solely to the provinces.

- With ***landlords dominating politics at both the centre and provinces,*** any meaningful attempt to tax agriculture was not successful, despite bureaucratic recommendations to the contrary.

- Going forward, problems persisted because the ***central government's imperatives were at odds with the concerns of the provincial governments***. Consequently, there were prolonged delays and resistance over holding the meeting of the National Finance Commission and the central government and the finance ministry succeeded in side-lining their constitutional obligation.

- Pakistan's ***fiscal woes*** further exacerbated the larger crisis faced by the state. The power struggle between Pakistan's political, military, and bureaucratic elites led to the abrogation of the 1956 Constitution and the imposition of martial law in 1958. The Taxation Enquiry Committee's report, submitted in 1959, was taken up by the new military regime, which only announced the first National Finance Award two years later in 1961.

## Key Arguments

- ***Institutions are embedded in social, historical and political contexts***. Their success depends on their explicit mandate but also on the balance of power that the ruling block enjoys vis-à-vis other contenders of power.

- The state can form explicit rules but still face many challenges in their implementation, especially when ***challenges originate from beyond the sphere of formal rule making***.

- Institutions, therefore, should be seen not just as rule-makers, but as ***bridges that mediate between state and society***.

- Understanding a country's tax performance, thus, requires looking at how this ***state–society relationship has evolved over time***, as well as the ***evolution of taxation institutions in its historical and political context***.

# Key Arguments

- The conflict over resource distribution is understood not simply through conflict over rule-making but also through the everyday evolution of the state.

    - The historic bloc in Pakistan didn't act in unison with a single policy objective. Instead, there was a great deal of disagreement within the bloc on the direction that state development should take. The conflict arose because of a tension between class and institutional interests.

        - The class interests of the landed gentry at the time wanted financially autonomous provinces so as to entrench its political and economic base through a federal state with financially autonomous constituting units.

        - The institutional interests of the civil–military bureaucracy wanted a highly centralised state, rapidly modernise the economy and move away from its agricultural base.

The paper argues that this conflict also shaped the tax policy and institutions in the newly independent country as well, as manifested in the mechanism of distribution of state finances between the federal and provincial governments. The NFC was meant to create a fair formula, but what was written in the Constitution mostly clashed with day-to-day political realities. Resource distribution, therefore, reflects not just rule-making but the evolving practices of the state.

# Policy Insights

Applying the Gramscian framework to the events in the early history of Pakistan helps understand the emergence and development of formal economic and legal institutions, state formation and the political economy of state-society relations, and offers insights on policy formulation:

- From a Gramscian lens, the passive revolution in Pakistan took the form of ***establishing a heavily centralised state over the society from above, while the hegemony or consent required for its formation was absent***.

- Several years of politics on deciding a constitutional structure and the state's inability to decide between distribution of power and resources between the centre and the provinces left the ***central government with very little legitimacy with the regional elites and general citizenry for taxation purposes***.

## Policy Insights

- The National Finance Commission is an extremely important institution in this context. An equitable and just mechanism to do so would have created an environment where cooperation from a regional elite (especially in a multi-ethnic state) would have been forthcoming to help the central government collect taxes effectively. However, the 1961 National Finance Commission and the subsequent award was ordained under a military government that relied more on ***coercion for order rather than cooperation***.

- This had dire consequences: On the fiscal front, ***it destroyed the environment in which Pakistan could have made institutions that could favour tax collection, both federally and provincially***.

- The state has also been unable to arrive at a political settlement with the society that would give it the ***necessary consents from its citizens for taxing them effectively***.

While this research and policy brief has provided a nuanced view of institutions and how they operate, rather than merely identifying them as necessary pre-requisite for economic growth or effective governance in the context of Pakistan, the insights have wider application to other developing countries as well.

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