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Budgetary Proposals
2014-15

4- Shami Road, Lahore Cantt, Pakistan. UAN: 111-123-586 www. ipr.org.pk

WORKING GROUP

Lead: Dr. Hafiz A. Pasha, *Managing Director IPR, Former Finance Minister*

Members:

1. Mr. Humayun Akhtar Khan, *Chairman IPR, Former Commerce Minister*
2. Mr. Mueen Afzal, *Former Secretary General Finance*
3. Mr. Haroon Akhtar Khan, *Director IPR, Former Senator*
4. Mr. Ashraf M. Hayat, *Executive Director IPR*
5. Ms. Aaiza Khan, *Research Associate IPR*
6. Ms. Mehwish Gul, *Research Associate IPR*

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ACRONYMS

AOP	Association of Persons
CDWP	Central Development Working Party
CNIC	Computerized National Identity Card
CPI	Consumer Price Index
ECNEC	Executive Committee of the National Economic Council
ERP	Effective Rate of Protection
FBR	Federal Board of Revenue
FCF	Federal Consolidated Fund
FRDL	Fiscal Responsibility and Debt Limitation
GDP	Gross Domestic Product
GST	General Sales Tax
IMF	International Monetary Fund
IRS	Internal Revenue Services
ITO	Income Tax Ordinance
KESC	Karachi Electric Supply Company
MOF	Ministry of Finance
MTBs	Market Treasury Bills
NSS	National Saving Schemes
NTN	National Tax Number
PASMIC	Pakistan Steel Mills
PDF	Pakistan Development Fund
PEPCO	Pakistan Electric Power Company
PIA	Pakistan International Airlines
PIBs	Pakistan Investment Bonds
PMLN	Pakistan Muslim League (Nawaz)
PPP	Pakistan People's Party
PSDP	Public Sector Development Program
PSE	Public Sector Enterprise
PTA	Pakistan Telecommunication Authority
SBP	State Bank of Pakistan
SMEs	Small and Medium Enterprises
SPDC	Social Policy and Development Centre
SRO	Statutory Regulatory Order
TDS	Tariff Differential Subsidy
VAT	Value Added Tax
WAPDA	Water and Power Development Authority

Executive Summary

Over the last few years, the public finances of Pakistan have deteriorated. There has been a rapid increase in the fiscal deficit to above 8% of the GDP, due to falling tax-to GDP ratio and rapidly rising current expenditures, especially on power sector subsidies.

- Soon after coming into power, the new government presented its first budget with the target of achieving 26.7% growth in tax revenues, containment of the growth of current expenditure, increasing the size of PSDP by over 55% and a reduction in the fiscal deficit from 8.2% of the GDP (2012-13) to 6.4% of the GDP (2013-14).

- However, major changes have been made in the budget after the signing of agreement with the IMF. The FBR revenue target has been decreased by Rs 130 billion, while the non-tax revenue target increased by Rs 162 billion. PSDP has been cut down by Rs 120 billion. This is expected to bring the federal deficit further down from 6.4% to 5.7%.

- The estimated deficit for the first nine months of 2013-14, calculated by adopting the 'below- the –line' approach, at the federal level is Rs 1025 billion, which is equivalent to 3.9 % of the GDP. Up till now the government seems to be on track to achieve the target, however, traditionally the largest deficit occurs in the last quarter of the fiscal year. Keeping this in view, a simple projection depicts that the annual fiscal deficit of the Federal government in 2013-14 will be close to 7 % of the GDP, especially if a large subvention is made in the next few weeks to retire the circular debt in the power sector. However, inclusive of grants and Provincial cash surpluses the consolidated fiscal deficit could fall below 6% of the GDP in 2013-14.

- The proposals given for the federal budget 2014-15 are based on the expectation that there will be a transition from the stabilization mode to efforts for reviving economy. The people expect some relief. On the contrary, IMF will continue to emphasize on 'fiscal consolidation' till the deficit comes down to 4% of the GDP. Thus a balance has to be maintained by the Government between adopting an expansionary fiscal policy and achieving deficit reduction.

- The budget for 2014-15 is based on a Federal fiscal deficit target of 6.5%. The tax- to - GDP ratio has to be increased by 0.5% of GDP in the next year. For an increase of 20% in the Federal

PSDP , with major investments in the water and power sectors, current expenditure growth will have to restricted to less than 8 %.

- The taxation system of Pakistan has a low revenue yield, an imbalanced incidence by sector (76 % on industry) ,low elasticity and a large number of exemptions and concessions (with the projected cost of Rs 560 billion).

- Tax Proposals for 2014-15: The principal focus of the tax proposals for 2014-15 is on the development of the direct tax regime, in order to make the federal tax system more buoyant and progressive. Within direct taxes, rationalization of tax expenditures in income tax is one of the major proposals given by IPR. A Securities Transaction Tax may be introduced which will enhance the withholding tax on shares/ securities traded, in lieu of capital gains. In addition to this, exemptions of Income tax of trusts and NGOs to remain applicable if the business income is below 50% of the total income, withdrawal of the tax rebate of 2.5% on sales tax (if sales are made only to registered persons), all dividends subject to a standard rate of 10%, are proposed in this report. In addition. The taxation of capital gains on property and a transition from presumptive to minimum withholding tax regime in the case of unearned incomes are also proposed.

- Taxation proposals in indirect taxes incorporate withdrawal of SRO's in import duties and scaling down of import tariffs, sticking to the current VAT system and working towards improving it rather than reverting to a single – stage tax, which has the problem of 'cascading', with tax on tax. Overall, the taxation proposals are expected to yield Rs 200 billion in 2014-15, with almost 55% of additional revenue coming from direct taxes.

- Federal current expenditure is estimated at Rs 3181 billion in 2013-14. 38 % is composed of debt servicing (interest payments on public debt) . In the first nine months of 2013-14, public debt has gone up by Rs. 1.15 trillion. The big increase in the stock of PIBs this year will raise interest payments significantly in 2014-15.

- Given, the situation of security and law and order in Pakistan, the second largest head, defense expenditure, with a share of 20%, has grown annually at a rate of 10% over the last two years. The National Security Policy of Pakistan identifies additional expenditures (establishment of Rapid Response Force) to improve the security situation in Pakistan. As a result, there is a projection of a 10% growth in defense expenditure in 2014-15.

- The major share in subsidies is the tariff differential subsidy (TDS) to the power sector. IPR anticipates that the subsidy bill next year will be reduced by Rs 60 billion, due to lower cost of furnace oil after the appreciation of the rupee. The fast growing component in current expenditure, grants (13 % of current expenditure) are likely to increase due to the costs of restructuring of PIA and PASMIC prior to privatization in 2014-15 .A salary and pension hike of 10% will increase expenditure by Rs 30 billion.

- Proposals for economy in current expenditure in 2014-15: Reducing the size of federal Government (Divisions and Ministries), zero-based budgeting to determine the contribution of the existing autonomous organizations and rebalancing of the debt portfolio are some proposals presented in this report for achieving greater economy. For greater accountability, following proposals are made; In view of the violation of (FRDL) Act, Federal Government to present a detailed medium- term action plan to come within the limits imposed by the Fiscal Responsibility and Debt Limitation Act (FRDL) to the National Assembly, supplementary grants exceeding the annual voted expenditure should be reported to the Finance Committee of the National Assembly during the year , all discretionary funds to be abolished and greater scrutiny of the defense budget.

- The Federal PSDP has been cut to Rs 420 billion from Rs540 billion after negotiations with IMF. Looking at the level of releases up to mid- April 2014, it is likely that the actual PSDP expenditure by the end of 2013-14 will be Rs350 billion. On the basis of this, it is suggested that the federal PSDP is set at Rs 420 billion in 2014-15. The priority should be given to the water and power sectors, and 50% of the next year's PSDP should be allocated to these sectors as compared to 30% this year. New projects other than in sectors mentioned above should not be undertaken for the time being. The Pakistan Development Fund (PDF) may be brought into the Federal Consolidated Fund and grants received be used for energy investments rather than on transport projects.

CHAPTER 1

THE FEDERAL BUDGET OF 2013-14

The public finances of Pakistan have been in a state of disarray over the last few years. A falling tax-to-GDP ratio and rapidly rising current expenditure, especially on power sector subsidies, have led to a burgeoning of the fiscal deficit. The Federal government has consistently run deficits of over 8% of the GDP during the last two years (see table1.1).This has implied primary deficits of more than 4% of the GDP, which are leading to a rapid increase in public debt. By the end of 2013, the level of public debt had approached Rs. 14.4 trillion, equivalent to 62.7% of the GDP.[1]

1.1. BUDGETARY TARGETS FOR 2013-14

The newly elected government of the PML(N) presented its first budget soon after induction into power on the 12th of June 2013, for the current financial year. This is an ambitious budget which targets for the following:

- **i)** A 26.7% growth in tax revenues, which, if attained will raise the tax-to-GDP ratio from 8.9% of the GDP to 10% of the GDP. Such a large increase has not been seen since the early-90s.
- **ii)** Containment of the growth of current expenditure to, more or less, the projected increase in nominal GDP in 2013-14.
- **iii)** A big jump in the size of the PSDP by over 55%.
- **iv)** A quantum reduction in the fiscal deficit from 8.2% of the GDP in 2012-13 to 6.4% of the GDP in 2013-14.[2]

However, the signing of agreement on access to the Extended Fund Facility of the IMF has led to major changes in key budgetary magnitudes as follows:

- **i)** The FBR revenue target was considered infeasible and has been brought down by Rs.130 billion, from Rs.2475 to Rs.2345 billion.
- **ii)** The target of non-tax revenues has been raised substantially by Rs.162 billion in light of larger inflow from PTA, higher SBP profits and receipts from the 3G auction.

[1] As reported in the Debt Policy Statement of the DPCO.

[2] With a Provincial cash surplus of 23 billion, the combined fiscal deficit is expected to be 6.3% of the GDP.

	2011-12	2012-13	2013-14 (IMF Projections)	2013-14 (First Half)	% of Year
(a)TOTAL REVENUES	**2424**	**2775** (14.4)*	**3488** (25.7)	**1577**	**45**
Tax Revenues	1946	2049 (5.2)	2504 (22.2)	1084	43
Non-Tax Revenues	478	727 (52.1)	984 (35.4)	493	50
Less TRANSFERS TO PROVINCES	**1090**	**1215** (11.5)	**1427** (17.4)	**646**	**45**
NET REVENUES	**1334**	**1560**	**2061**	**931**	**45**
(b)TOTAL EXPENDITURE	**3002**	**3441** (14.6)	**3553** (3.3)	**1626**	**46**
Current Expenditure**	2667	3016 (13.1)	3181 (21.1)	1407	44
PSDP	313	348 (11.1)	420 (20.7)	121	29
Net Lending	22	77 (∞)**	-48 (-∞)**	98	∞**
(c) REVENUE DEFICIT	**-1333** (6.5)***	**-1075** (-4.7)	**-1120** (-4.3)	**-476**	**42**
(d)FISCAL DEFICIT	**-1668** (-8.1)	**-1881** (-8.2)	**-1492** (-5.7)	**-695** (-2.7)	**47**
Memo Item: FBR Revenue	1906	1936 (27.8)	2345 (21.1)	1031	44

Table 1.2 'Below the Line' Estimation of Federal Fiscal Deficit, July-March 2013-14 (Rs.in Billion)	
Borrowing from SBP	**242.2**
Borrowing from Scheduled Banks	**292.7**
PIBs	794.1
Ijara Sukuk Bonds	-124.0
Market Treasury Bills	-377.4
Borrowing from Funds,	
Insurance Companies, Corporates, etc.	221.7
PIBs	249.0
Ijara Sukuk Bonds	-12.6
MTBs	-14.7
National Savings Schemes[b]	150.2
External Financing	118.3
TOTAL	1025.1
% OF GDP	3.9

iii) Current expenditure has been raised by Rs.179 billion, primarily in lieu of higher level of tariff subsidy payments to the power sector.

iv) A big slashing down of the PSDP by Rs.120 billion.

v) Overall, the above measures are expected to bring down the federal deficit further, from 6.4% to 5.7% of the GDP.As such, the IMF is asking in the first year of the Program for a massive fiscal adjustment of 2.5% of the GDP. However, this is due to the retirement of circular debt in last June 2013, which raised the deficit for 2012-13.

1.2. FISCAL DEVELOPMENTS IN 2013-14

1.2.1. First Two Quarters

The Federal government has been successful in stabilizing the fiscal situation in the first half of 2013-14. The deficit has been limited to 2.7% of the GDP, equivalent to 47% of the annual deficit, as shown in Table 1.1.

There is, in fact, some short fall in FBR revenues. These have grown by 16% in the period, July to December, 2013, which is significantly lower than the annual growth target of over 21%. But there has been major jump in non-tax revenues due to higher receipts of profits from SBP, from PTA and from PSEs in the form of dividends.

The big success has been in curtailing the increase in current expenditure. Only 44% of the annual projection has been consumed in the first six months. Further, releases have been only 27% of the scaled down PSDP for the year.

The result is a Federal deficit of 2.7% of the GDP in the first half of the year, as opposed to 3% of the GDP in the corresponding period of the previous year. The Provinces have meanwhile generated a cash surplus of 0.6% of the GDP. Therefore, the overall fiscal deficit from July to December 2013 is 2.1% of the GDP. This must be recognized as a significant improvement in the quality of financial management by all five Governments.

1.2.2. Third Quarter

Fiscal operations data for the 3rd Quarter of 2013-14 have not yet been released by the MOF. Therefore, the size of the deficit has been estimated by adopting the 'below-the-line' approach of deriving the borrowing from different sources, as shown in Table 1.2.

The estimated deficit for the first nine months of 2013-14 at the Federal level is Rs.1025 billion, excluding grants, equivalent to 3.9 % of the GDP. This compares with the deficit of 5% of the GDP in the corresponding period of 2012-13.

FBR revenues have grown from July-to-March by 16% and PSDP releases stand at Rs.292 billion as of end-April 2014.This is still only 69% of the annual Program size.

1.2.3. Likely Outcome in 2013-14

The Federal government appears to be on track currently to achieve the fiscal deficit of 5.7% of the GDP. But, traditionally the largest deficit is incurred in the last quarter of the financial year. During this quarter, the deficit has been 35% on average of the deficit for the year in the last five years. A simple projection on this basis implies that the annual fiscal deficit of the Federal government in 2013-14 will be close to 7% of the GDP,

There are actually a number of reasons why the fiscal deficit, excluding grants, could be relatively large in the last quarter of 2013-14, as follows:

- **i.** If FBR is unable to raise the growth rate of tax revenues beyond the current rate then there is likely to be a shortfall of about Rs.90 billion in the attainment of even the reduced target for 2013-14 of Rs.2345 billion.
- **ii.** The auction process of the 3G license was completed on the 23rd of April. The Government is likely to receive a payment from the licenses during the current fiscal year of Rs.55 billion. The expectation was for Rs.120 billion in 2013-14. Therefore, non-tax revenues will have a shortfall of Rs.65 billion on this account.

- **iii.** According to media reports, the circular debt in the power sector has started accumulating rapidly once again and could reach Rs.355 billion by the end of the fiscal year. The big question is whether the Government will intervene fully or partially to retire this debt in the next few weeks. Given that power load shedding gets worse during the summers, there will be pressure to inject liquidity to avoid a further deterioration in supplies of electricity. We assume that about 50% of the debt will be retired by end –June 2014, imposing thereby a further liability of Rs.150 billion or so on the Budget of 2013-14.
- **iv.** It is likely that the Government may try to contain the size of the fiscal deficit by further cut back in allocation to the PSDP. As of end-April, the total release stands at Rs.292 billion, according to the Planning Commission. If this rate is sustained then the total outlay on the PSDP will reach approximately Rs.350 billion, 17% less than even on the reduced size of the PSDP.

Given the above deviations, we project that the Federal fiscal deficit will approach the magnitude of Rs.1821 billion by the end of the fiscal year. This is equivalent to 7% of the GDP, higher by over 1% of the GDP in relation to the target agreed with the IMF.

It is interesting that the fiscal deficit position with grants is likely to be significantly better due to the large ‘gift’ of over Rs.150 billion from a friendly country. This will bring the fiscal deficit down to Rs.1671 billion or 6.4% of the GDP. Further, if the provinces are able to show a cash surplus of 0.6% of the GDP, then the consolidated fiscal deficit with grants will come close to the level agreed with the IMF of 5.5% of the GDP.

It needs to be recognized that even if the consolidated deficit, without grants, remains somewhat above 6% of the GDP, it will still mean a large fiscal adjustment of over 1.8% of the GDP. This effort by the Ministry of Finance must be recognized, although it will come on the back partly of a large cut back in the PSDP and an artificial enhancement in the fiscal deficit last year.

CHAPTER 2

THE FEDERAL BUDGET OF 2014-15

The Federal Budget of 2014-15 will be framed in the backdrop of heightened expectations that it will represent a transition from the stabilization mode to efforts at revival of the economy. This is based on the sizeable increase in foreign exchange reserves which have reduced the vulnerability of the balance of payments, following the gift of $1.5 billion from a friendly country and a successful flotation of the Eurobond of $2 billion.

In addition, the people are legitimately expecting some relief, after a year of high inflation, especially in food prices and in line with election promises of the ruling party, PML(N). As such, the Government will have to ensure that administered prices of wheat, petroleum products, gas, electricity, etc., remain stable. Wherever possible, benefits of a stronger rupee will have to be transferred in the form of lower prices.

However, the IMF will continue to place emphasis on ' fiscal consolidation', till such time as the combined deficit of the Federal and Provincial Governments falls to about 4% of the GDP. Therefore, the Government will have to maintain an intricate balance between contrasting pressures to go for an expansionary fiscal policy and to achieve some deficit reduction. The fundamental question is how can this be done? The subsequent part of this report deals with this difficult issue.

2.1. BUDGETARY PROJECTION FOR 2014-15

As demonstrated in the previous section, the fiscal year, 2013-14, is likely to close with a federal fiscal deficit close to 7% of the GDP, as shown in Table2.1. The Fund will expect a deficit reduction of 1% of the GDP in 2014-15. But, a budget deficit target reduction of 0.5% of the GDP appears more reasonable. It provides for some fiscal space to raise the level of development expenditure. This is also consistent with the thinking that too much austerity will drive the economy to a low level equilibrium. As such, the budgetary projection for 2014-15 is based on a fiscal deficit target of 6.5% of the GDP.

The recommended budget strategy for 2014-15, to ensure that the Federal fiscal deficit does not rise above 6.5% of the GDP, is as follows:

i) The FBR tax-to-GDP ratio is expected to show a modest increase of only 0.2% of the GDP, despite heavy additional taxation, in 2013-14. This ratio will have to be raised by about 0.5%

of the GDP next year, primarily from direct taxes. The proposals for achieving this increase in the tax-to-GDP ratio are presented in Chapter 3.

Table 2.1: PROJECTIONS OF KEY MAGNITUDES IN THE FEDERAL BUDGET OF 2014-15 (Rs. In Billion)

	2013-14 (Likely Outcome)	2014-15 (Projection)	Growth Rate (%)
TOTAL REVENUES	**3333**	**3714**	**11.4**
Tax Revenues	2414	2875[a]	19.0
Non-Tax Revenues	919	864[b]	-6.0
Less TRANSFERS TO PROVINCES	**1375**	**1639**	**19.2**
NET REVENUES	**1958**	**2075**	**6.0**
TOTAL EXPENDITURE	**3779**	**4000**	**6.1**
Current Expenditure	3181	3430	8.1
PSDP	350	420[d]	20.0
Net lending	248	150[e]	-39.5
REVENUE DEFICIT	**-1223 (-4.7)**	**-1355 (-4.6)**[f]	**-2.7**
FISCAL DEFICIT	**-1821 (7.0)**	**-1925 (-6.5)**	**-3.3**
Memo Items: FBR Revenue	2255	2700[a]	19.7

[a] implies an increase of 0.5% in the tax-to- GDP ratio

[b] exclusion of once-and for all revenues in 2013-14 plus revenues from the Gas Levy of 0.4% of GDP

[c] arrived at as a residual to ensure fiscal deficit reduction of 0.5% of the GDP

[d] to enable some recovery to the targeted level of 2013-14

[e] for retirement of circular debt of the Power Sector

[f] based on a projected GDP in 2014-15 of Rs.29625 billion, with growth rate of 5.5% and inflation at 8%.

ii) The scope for achieving a significant increase in non-tax revenues is limited by the artificially high base of 2013-14, consisting of once-and for- all revenues like the transfer of funds from the PTA, income from sale of 3-G licenses and large grants. However, revenues of about

0.4% of the GDP will accrue for the full year from the Gas Levy. As such a small decrease of 6% is anticipated in non-tax revenues.

iii) An increase in the Federal PSDP of 20% or so is required to provide some 'multiplier' effect on the economy and to create some fiscal space for major investments in the water and power sectors. The development priorities that ought to be pursued are highlighted in Chapter 5.

iv) Some provision will have to be made for further retirement of circular debt in the power sector of at least Rs.150 billion in the Budget of 2014-15.

v) Current expenditure growth will have to be restricted to less than 8% if the target deficit of 6.5% of the GDP is to be achieved. The economy measures required are listed in Chapter 4.

Based on the above, the projected key magnitudes for the Budget are presented in Table 2.1.In addition; a number of fiscal incentives are identified to promote investment, employment and exports in the economy in Chapter 3.

CHAPTER 3

TAX REVENUES

This Chapter first reviews the principal features of the federal tax system of Pakistan. This is followed by analysis of the performance of FBR during the current fiscal year. Section 3 then presents proposals for the Budget of 2014-15, with primary emphasis on development of direct taxes.

3.1. THE FEDERAL TAX SYSTEM

The federal tax-to-GDP ratio has been steadily declining from the peak of 10.5% attained in 2006-07 to 8.9% in 2012-13. It is likely to rise to 9.1% of the GDP in 2013-14. A decline of 0.6% of the GDP has occurred in direct taxes and 0.8% of the GDP in indirect taxes.

The share of direct taxes stood at 38% in 2012-13. The largest tax is the GST, with a share of over 48%. The remaining two taxes, customs duty and central excise duty, contribute 14%.

Pakistan today has one of the lowest tax-to-GDP ratios in Asia. It is lower than Bangladesh at 10%, India at over 16%, Sri Lanka at 12%, Malaysia at 14%, Thailand at 18%, Philippines at 12% and Turkey at over 21%.

The sectoral incidence of taxes is very imbalanced in Pakistan. Industry contributes over 76% of the revenues, while the shares of services and agriculture are 21% and 3% respectively. As far as the burden of the federal taxes on households is concerned, the estimate by FBR is that it is mildly progressive. While this reflects the rise in burden of direct taxes with household income, the worrying finding is the regressive incidence of indirect taxes.

The fall in the tax-to-GDP ratio implies the lack of buoyancy of the tax system. According to SPDC (2013), the elasticity of the tax system is as low as 0.85. That is, in the absence of taxation proposals, tax revenues rise by 8.5% for every 10% increase in the nominal GDP. Clearly, there is need to enhance the built in elasticity of the tax system.

Government estimates, presented in Pakistan Economic Survey, are that the tax expenditure in the federal tax regime is Rs.185 billion, or 0.9% of the GDP. This is the revenue foregone due to exemptions and concessions, as embodied in the tax laws and SROs. More recent and comprehensive coverage of tax expenditures by the World Bank [2013] reveals that the magnitude is substantially larger at Rs.402 billion in 2011-12, equivalent to almost 2% of the GDP.

The largest share in tax expenditure is of the GST of 37%, followed by income tax and customs duty each of 31%. However, even the World Bank estimate appears to be on the low side, especially in the income tax. Full allowance has not been made for the exemptions and concessions embedded in the Second Schedule of the Income Tax ordinance, 2001. Our estimates of tax expenditure in income tax in 2013-14 are presented in Table 3.1.These aggregate to Rs.261 billion, equivalent to 1% of the GDP.

3.2. FBR PERFORMANCE IN 2013-14

The previous year, 2012-13, witnessed a debacle in FBR revenues. Gross revenues remained, more or less, unchanged at the level of 2011-12. Net revenues showed a growth of 3%, due primarily to the holding back of refunds. This was due, first, to frequent changes in leadership and, second, to concessions granted by the PPP government as it moved into the pre-election mode.

FBR's performance in the first nine months of 2013-14 has been distinctly better, as shown in Table 3.2. Revenues have shown growth of 16.5%, facilitated in particular by the rapid growth in GST of 20%. The growth is primarily due to the series of taxation proposals announced in the Finance Bill, 2013-14. The major proposals are listed in Chart 3.1.

The Major factors contributing to the improved performance are, first, the rise in the standard GST rate from 16 % to 17% and, second, the expansion of and enhancement in rates of withholding taxes. It appears that the measures designed to check tax evasion and increase the number of tax payers have largely failed.

3.3. TAXATION PROPOSALS FOR 2014-15

We focus here on the so-called 'big moves", which will not only represent major structural reforms but will also contribute significantly to additional revenues. The primary focus is on the development of the direct tax regime, so as to make federal tax system more buoyant and progressive

Table 3.1

Estimated Tax Expenditure in Income Tax
(Tax Base of 2013-14)

No.	Description	Estimated Tax Expenditure (Billion Rs)
A.	EXEMPTIONS	110.1
1.	Tax Holiday(Life Time) to Independent Power Producers	60.7
2.	Under recovery of Capital Gains on Securities	32.7
3.	Exemption to Profit from Behbood Savings Certificates and Pensioner's Benefit Account	12.4
4.	Exemption of Business Income of Certain Trusts, Welfare Organizations, etc.	2.6
5	Exemption of Profit from Euro/Sukuk Bonds	1.7
B.	TAX DEDUCTIONS/ ALLOWANCES	98.3
1.	Accelerated(Initial) Depreciation Allowance	41.0
2.	Investment Allowance to Personal Tax Payers	10.4
3.	Tax Deductions on Provisioning by Banks	27.2
4.	Tax Deduction on WWF & WPPF Payments	13.1
5.	Tax Credit on P:ension Fund/Provident Fund Contributions	4.0
6.	Tax Deduction on Charitable Contributions	2.6
C.	CONCESSIONARY TAX RATES	37.7
1.	Concessionary Rate on Sales Tax	6.1
2.	Concessionary Rate on Export of Services	2.7
3.	Concessionary Rate on Export of Goods	18.1
4.	Concessionary Rate on Supplies	3.4
5.	Concessionary Rate on Teachers	1.9
6.	Concessionary Rate on Dividends	5.7
D	OTHERS	14.5
1.	Other regional/Sector/enterprise exemptions	14.5
	TOTAL TAX EXPENDITURE	260
	Percentage of GDP	1.2
	Source: Estimated	

Chart3.1
Major Taxation Proposals in Finance Bill of 2013-14

Enhancement in Tax Rates

- Enhancement in standard rate of GST from 16 % to 17 %.
- Enhancement in income tax rates on individuals and AOPs
- Enhancement of existing withholding tax rates
- Enhancement in minimum tax companies from 0.5 % to 1 % of turnover

Broadening of the Tax Base

- Serving of notices to non-filers under Section 144 of the ITO
- Extension in the Withholding Tax Regime
- Expansion of list of items chargeable to GST on retail price.

Withdrawal of Concessions

- Rate of initial depreciation allowance reduced from 50% to 25 %
- Partial withdrawal of income tax concession to teachers
- Substitution of zero-rating with exemption

Measures to tackle Evasion

- Access to Bank Accounts
- Withholding taxes on unregistered persons
- Limit to exemption of agricultural income
- Compulsory filing of return by salaried tax payers
- Mandatory filling of wealth statement by all return filers
- Greater use of NTN/CNIC in transactions

Other Measures

- Introduction of capacity tax in the beverages sector
- Simplification of the excise duty structure on cigarettes

Source: Finance Bill, 2013-14

Table 3.2

Performance of FBR Revenues **(Rs. In Billion)**

	July-March 2012-13	2013-14	Growth Rate(%)	July-June 2013-14 (IMF Program)	Likely Shortfall
Direct Taxes	505	590	16.8	892	21
General Sales Tax	596	717	20.3	1014	23
Customs Duty	170	165	-3.0	287	43
Central Excise Duty	81	99	22.2	152	3
TOTAL	**1352**	**1575**	**16.5**	**2345**	**90**

3.3.1. Taxation Proposals in Direct Taxes

Proposal No.1: Rationalization of Tax Expenditure in Income Tax

Table 3.1 has presented the major tax expenditures in the income tax and their costs in terms of revenue foregone. The following tax expenditures are recommended for withdrawal in the Finance Bill of 2014-15.

- **Under taxation of Capital Gains on Securities:** This will involve enhancement in the withholding tax on shares/securities traded in the stock exchanges, in lieu of capital gains. The proposal is to introduce a **Securities Transaction Tax**, of the type that exists already in India. The suggested rate is 0.5% of the traded value of a share. Suitable arrangements will have to be made by FBR to ensure that this tax is fully collected.
- **Exemption of Income of Certain Trusts, NGOs, etc** : This will only become applicable if the business income exceeds 50% of the total income(including charitable contributions). The taxable business income may be taxed at the reduced rate of 20%.
- **Tax Deduction on Provisioning of Banks:** This provision is contained in the Seventh Schedule of the ITO. The proposal is to restrict this benefit only to bad loans to SMEs, agriculture and exports.
- **Tax Deduction on Pensions:** Pension contributions already enjoy tax deductibility. The present system of also exempting pension income, in effect, provides a double benefit. As such, the second benefit is proposed to be withdrawn, especially in the case of retired corporate executives, for annual pension income in excess of Rs.750, 000.

- **Concessionary Rate of Sales Tax:** There is a tax rebate of 2.5 % if sales are made only to registered persons. This is proposed to be withdrawn, as some buyers may be genuine small tax payers.
- **Concessionary Rate on Dividends:** All dividends may be subject to the standard rate of 10%.
- **Concessionary Rate on Teachers**: The partial concession currently available may be withdrawn.

Proposal No.2: Transition from Presumptive to Withholding Tax Regime

Currently, different forms of unearned capital income are taxed as separate blocks of income. The proposal is to make a transition from scheduler to comprehensive income taxation. As such we recommend the withdrawal of the presumptive and final tax of 10% on the following:-

- Dividends
- Interest from bank deposits
- Profit on government securities
- Prize bonds

This may be replaced by a minimum withholding tax of 10%, which will make the tax system more progressive and also raise additional revenues.

Proposal No.3: Taxation of Capital Gains on Property

We are of the view that capital gains on property is more in the nature of income and should be within the fiscal powers of the Federal government. However, the focus should be on taxation of real, net nominal gains.

Overall, the above three sets of proposals will signal the more towards progressive taxation, especially through broadening of tax to more effectively cover capital gains and unearned incomes .

Proposal 4: Measures to compel non-filers of returns to file returns

Owners of property above a minimum size are expected to file income tax returns. However, this is frequently not the case. FBR has sent notices to a large number of non-filers, but the response has been very poor.

As one punitive step, property owners who are required to file returns may not be allowed to sell or transfer their property if they are unable to present the last three years income tax returns at the time of registration of the transaction.

3.3.2. Taxation Proposals in Indirect Taxes

The ‘big move’ expected this year is the large-scale withdrawal of SROs, providing for special exemptions or concessions, in import duties and the GST. This is in the form of a Structural Benchmark in the IMF Program, to be implemented by June 2014.

Import Duties

The major Chapters of the Harmonized System which enjoy the largest tax breaks due to SROs are mostly either intermediate or capital goods, with the exception of automobiles which fall largely in the consumer good category. The impact of SROs, consequently, is an enhancement in effective rates of protection (ERPs) to domestic industry. For example, the ERP of the automotive sector is as high as 116%, according to Pasha (2012), due largely to SROs.

While many of the SROs represent the lobbying efforts of influential industrial groups, an indiscriminate and large-scale withdrawal could constitute a big ‘negative shock’ and lead to some displacement of domestic industry.

Therefore, two basic principles need to be observed in the rationalization of import duty SROs as follows:

Principle 1 No withdrawal of SROs on basic food items falling in Chapters 1 to 23.

Principle 2 Cascading down the statutory rate of import duties as follows:

	Rate of Import Duty (%)
Raw Materials	5
Machinery	5
Intermediate Goods	15
Finished Goods	25

Simultaneous withdrawal of SROs and scaling down of import tariffs will enable industry to absorb the big move, while leading to a simpler and more transparent import tariff regime.

GST

There is currently a debate as to the type of sales tax regime which best suits the country. The GST is levied, more or less, in the VAT made with multiple stages of taxation along the value chain and with input tax invoicing at each stage.

The growing disillusionment with the GST is due primarily to two reasons. First, there is a perception of over-invoicing of inputs, arising from the so-called ‘flying invoices’ problem. Second, industry has been complaining vociferously about delays in the payment of refunds. This has arisen particularly at times when FBR is under pressure to achieve targets.

The alternative that has been suggested is the reversion to a single-stage scales tax, without input tax invoicing. This is the kind of tax which existed in Pakistan prior to the promulgation of the 1990 Sales Tax Act. As such, the GST will be levied on the value of sales/production and not on the value added. The general perception is that this will lead to a quantum reduction in the standard tax rate, on the same tax bases as at present, without jeopardizing revenues. It will also imply a simpler tax system.

Pakistan has been one of the pioneers in the implementation of a VAT system in developing countries. It will be unfortunate if this system is abandoned now. In our view the strategy should be to work towards improving the existing system rather than go back to a single-stage tax.

The biggest drawback of the single-stage tax system is that it will lead to a cascading of the tax burden, that is, a tax on tax. If the nominal rate is 5% then due to cascading the effective tax rate could be as high as 8%.

Steps that need to be undertaken to improve the working of the existing GST are as follows:

(i) The development of the CREST software has led to a reduction in over invoicing of inputs. In addition, the capacity to audit sales tax returns is, more or less, non-existent in FBR currently. Such capacity should be built up quickly to facilitate a move towards composite audit (of income tax and GST simultaneously). This was the basic logic behind the setting up of IRS.

(ii) Refunds must be honored expeditiously. Small refunds of opts, say, Rs.1 million may be paid immediately. In the case of larger refunds, the policy may be to pay 60% immediately after the filing of a claim and the remaining

40% following assessment. Earlier a special Refund Cell had been established in the office of the Chairman, FBR. This ought to be reactivated.

We turn next to the withdrawal of sales tax SROs. The incidence of SROs at the import stage by chapter of the Harmonized System is given in Box 3.The principal imports benefiting from SROs are capital goods (41%) and intermediate goods (38%). Bulk of the sales tax paid on these goods will be tax invoiced away as inputs into domestic production. Therefore, while the removal of these SROs may remove distortions, it will not contribute as much to additional revenues as is generally anticipated. SROs in the domestic component of the GST are limited. Excluding items in the Sixth Schedule, there is a case for withdrawal of SROs.

3.4. FISCAL INCENTIVES

As measures to support the revival process of the economy and to promote investment, exports and employment, the following fiscal incentives are proposed:

3.4.1 Income Tax

- As proposed in the Finance Bill of 2013-14, reduction in the corporate income tax rate by 1% each year to 30% finally. As such, the rate for 2014-15 will be 33 %. Scheduled banks have been excluded from this benefit. It is proposed that they may also be included, subject to the condition that 25% or more of incremental advances during a year are to micro finance, SMEs and agriculture combined.
- Increase in the tax credit for balancing and modernization from 10% to 20%.
- Ten year tax holiday for power sector. The initial depreciation allowance has been reduced from 50% to 25 % in the Finance Bill of 2013-14., It is proposed that from the second year onwards the rate of depreciation admissible may be increased from 10% to 15%.
- Bring down the rate of withholding tax in telecommunications from 15 % to 10%.

3.4.2 GST

- Raise the threshold level in GST from turnover of Rs.5 million to Rs.7.5 million, in line with past inflation.
- Allow input tax invoicing of machinery in line with the accelerated depreciation allowance in income tax.

3.5 REVENUE FROM TAXATION PROPOSALS

The proposed revenue target for FBR in 2014-15 is Rs.2700 billion representing a growth rate of 20%. With normal growth, FBR revenues are likely to reach Rs.2500 billion. Therefore, taxation proposals are required which could yield Rs.200 billion in 2014-15.

Estimates of potential revenues from the taxation proposals identified above are given in Table 3.3. Almost 55 % of the additional revenues accrue from proposals in direct taxes. This will make the tax system more progressive and convey the right signals to the people.

TABLE 3.3

Revenues from Taxation Proposals in 2014-15(Rs. In Billion)

Proposal	Revenue
Income Tax	**110**
• **Withdrawal of Tax Expenditures**	**70**
• **Capital Gains Tax on Property and Shares**	**20**
• **Transition from Presumptive to Withholding Tax**	**10**
• **Revenues from current non-filers**	**10**
Customs Duties	
• **Net effect of withdrawal of SROs and Sealing down of Import Tariffs.**	**40**
GST	
• **Withdrawal of SROs**	**50**
Improvements in Tax Administration*	**30**
TOTAL ADDITIONAL REVENUE	**230**
Impact of Fiscal Incentives	**-30**
NET REVENUE FROM TAXATION PROPOSALS	**200**

*Including strengthening of audit capacity in GST, higher percentage (5%) of income tax returns audited, development of 'data warehouse' for assessment purposes, etc.

CHAPTER 4

FEDERAL CURRENT EXPENDITURE

This Chapter looks at the pressures on current expenditure in the forthcoming year and the extent to which there is scope for exercising economy in this expenditure.

The breakup of Federal current expenditure is given in Table 4.1. The largest component is interest payments on public debt, with a likely share of 38% in 2013-14. Next in size is defense expenditure with a share of 20%. The fast growing component is grants, which account for 13% of current expenditure. The level of subsidies is variable, with peak in 2011-12. Currently, subsidies are pre-empting 15% of the current budget. Finally, the costs of civil administration, pensions and operations of services at the federal level take up 14% of current expenditure.

We discuss the outlook for each component of expenditure below.

4.1. DEBT SERVICING:

Interest payments are a function of the size and composition of public debt. As can be seen Table 4.2, the following recent trends can be observed:

I. Due to the underlying large primary deficit, public debt has increased by Rs 1.15 trillion in the first nine months of 2013-14. In fact, the rise would have been larger but for the fall of Rs 292 billion in the month of March, due to the sharp appreciation in the value of the Rupee, which led to reduction in the stock of external debt in local currency terms.

II. The debt stands at Rs 15.2 trillion as of the 31st of March 2014. The component of domestic debt is Rs 10.7 trillion, with a share in total public debt of over 70%.

III. Within domestic debt, the largest share of almost 50% is of short-term debt, primarily in the form of market treasury bills (MTBs). Next in importance is permanent debt, consisting mostly of Pakistan Investment Bonds (PIBs), with a share of 29%. PIBs have a maturity period ranging from three to twenty years. The remaining part of domestic debt consists largely of inflows into National Savings Schemes (NSS).

Table 4.1 CURRENT EXPENDITURE OF THE FEDERAL GOVERNMENT			
	2011-12	**2012-13**	**2013-14 (IMF Projection)**
CURRENT EXPENDITURE	**2611**	**2647**	**3181**
Interest Payments	889	991 (11.5)	1208 (21.9)
Defense	507	541 (6.7)	637 (17.7)
Subsidies	556	305	479
Grants	291	368	412
Others	368	442	445

IV. There has been a dramatic change in the composition of borrowings in the month of March 2014. Almost Rs 535 billion of PIBs have been floated during the month while the stock of MTBs has fallen by Rs 514 Billion. This will lessen the problem of rolling over of debt. But PIBs are relatively costly with the return starting from 12% for a three year bond to 13% for a twenty year bond.

The recent change in composition of borrowings has implications for costs of debt servicing next year. The stock of PIBs has increased already by Rs. 1.0 trillion in 2013-14. This already implies an enhancement in interest payments next year of over Rs 120 billion. On this basis, we estimate that the outlay on the head of debt servicing will rise by at least Rs 200 billion in 2014-15.

The wisdom of switching from MTBs to PIBs at this time can be questioned. As mentioned earlier, the positive side is a reduction in the rolling over problem of debt and a decline in inflationary borrowing from the SBP. But, if interest rates are likely to come down, as the rate of inflation falls especially due to the appreciation of the Rupee, this was probably not the right time to get ‘locked’ into PIBs.

Table 4.2 STOCK OF FEDERAL DEBT (As of Feb 2014)				(Rs. In Billion)
	End June 2013	**End Feb 2013**	**End March 2013**	**Δ**
PERMANENT DEBT	**2147.5**	**2630.1**	**3122.7**	**948.2**
PIBs	1321.6	1829.8	2365.0	1043.4
Prize Bonds	389.6	425.9	430.9	41.3
Ijara Sukuk Bonds	459.2	370.2	322.6	-136.6
Others	4.5	4.2	4.2	-0.3
UNFUNDED DEBT	**2146.5**	**2248.6**	**2272.8**	**126.3**
NSS	2006.3	2103.4	2122.8	116.5
Others	140.2	145.2	150.0	9.3
SHORT TERM DEBT	**5195.4**	**5803.2**	**5289.0**	**93.6**
MTBs	2920.2	2769.9	2759.0	-161.2
MTBs for Replenishment of Cash	2275.2	2757.3	2530.0	254.8
TOTAL DOMESTIC DEBT	**9520.9**	**10686.6**	**10684.6**	**1163.7**
TOTAL EXTERNAL DEBT	**4479.5**	**4755.6**	**4466.4**	**-13.1**
TOTAL DEBT	**14000.4 (61.1)**	**15442.2**	**15150.6 (60.0)**	**1150.2**
Source: SBP				

4.2 DEFENSE EXPENDITURE

As highlighted earlier, the second largest head of expenditure is defense expenditure. Actually, the total security-related expenditure is about 43% higher if military pensions and expenditure on quasi-military forces and police is included, as shown Table 4.3.

Given the state of security and law and order in the country, these expenditures must have priority. They have grown annually at the rate of 10% over the last two years. The new National Security Policy calls for some additional expenditures, including the establishment of a Rapid Response Force.

Therefore, the growth of expenditure on defense services is projected at 12% in 2014-15. It could be even higher if security conditions deteriorate.

4.3 SUBSIDIES

The major share of subsidies is pre-empted by the tariff differential subsidy (TBS) to the power sector (WAPDA/PEPCO and KESC). This share of subsidies is estimated at over 91% in the budget estimates for 2013-14. It is likely that allocation next year to the TDS will be lower for two reasons. First, additional revenues will be realized by the DISCOs/ KESC because of the full-year impact of the rise in domestic tariffs. Second, the large appreciation of the rupee will mean that the cost of importing furnace oil could be lower by about Rs.60 billion. But against this there will some increase in costs of consumption of natural gas by the power generation units following the imposition of a higher rate of the Gas Infrastructure Development Cess.

Overall, we expect that the subsidy bill will be lower in 2014-15 by about Rs.39 billion. No provision is made for any further increase in power tariffs in 2014-15. Accordingly, the level for subsidies in 2014-15 is projected at Rs.440 billion.

Table 4.3
Security-Related Expenditure at Federal Level
2013-14 Budget Estimate (Rs.in Billion)

DEFENCE SERVICES	**637.0**
MILITARY PENSIONS	**132.7**
ADMINISTRATION	**5.3**
Defense Division	1.3
Interior Division	3.4
Defense Production Division	0.6
QUASI-MILITARY FORCE	**54.6**
Frontier Constabulary	6.2
Pakistan Rangers	14.5
Civil Armed Force	32.4
Pakistan Coast Guards	1.5
PUBLIC ORDER & SAFETY*	**78.5**
TOTAL	908.1
SHARE OF TOTAL CURRENT	29
EXPENDITURE(% of GDP)	3.5
* mostly police	

4.4. GRANTS

Grants of various types are made to different entities. The first group is Provincial governments, with grants estimated at Rs.50 billion. The largest grant is to the Government of Khyber-Pakhtunkhwa of Rs.25 billion, in the form of arrears on profits from hydro-electricity. This comes to an end in 2014-15 and the Government of Khyber-Pakhtunkhwa may insist on recomputation of hydro-electricity profits at a significantly higher level.

Other grants are made to loss making state enterprises and utilities like the railways. This amount is likely to rise substantially in 2014-15 as grants will need to be made also to PIA and PASMIC, for restructuring prior to privatization. In addition, grants of Rs.36 billion combined are being made to the Governments of Azad Jammu and Kashmir and Gilgit-Baltistan. Therefore, it is unlikely that the outlay can be brought down in 2014-15.

4.5. OTHERS

This head consists primarily of costs of civil administration, pensions and provision of services at the Federal level. The primary factor causing escalation in the expenditure under this head is the annual increase in pay and / or allowances granted by the Federal Government. During the last five years, there have been announcements every year of increases, of varying amounts. In real terms there has been an increase of 78% in the pay of government employees.

There is pressure already for another increase, to be announced with the Budget for 2014-15. It is expected that it will be 10%, somewhat higher than the rise in the CPI in 2013-14. This will add Rs.30 billion to the expenditure.

Table 4.4
PROJECTION OF CURRENT EXPENDITURE in 2014-15
(Rs.in billion)

	2013-14 (Likely outcome)	2014-15 (Projection)
Interest Payments	1208	1400 (16.6)
Defense	637	714 (12.0)
Subsidies	479	440 (-8.1)
Grants	412	415 (0.7)
Others	445	461 (3.6)
TOTAL CURRENT EXPENDITURE	**3181**	**3430 (7.8)**

Overall, based on the above, projection of the likely level of current expenditure is given in Table 4.4. In aggregate terms, federal current expenditure is estimated at Rs.3430 billion in 2014-15, representing a growth of 8% over the level likely to be attained in 2013-14.

4.6. PROPOSALS FOR ECONOMY AND ACCOUNTABILITY

The following proposals are presented for achieving greater economy in federal expenditure.

Reducing The Size: The Federal Government today has 38 Divisions and 27 Ministries. While the size is within constitutional limits, it seems too large following the devolution of functions envisaged in the 18th Amendment.

Some Ministries accordingly do not have a justification for presence at the Federal Level. This includes the following:

- Ministry of Education and Training.
- Ministry of National Health Services.
- Ministry of National Food Security.

In addition many Ministries could be merged together as follows:

- Ministry of Defense Production and Textiles with Ministry of Industries and Production.
- Railways with the Ministry of Communications.
- Ministry of Fuel and Natural Resources with Ministry of Water and Power

Also, in his previous tenure, the Prime Minister was keen to rationalize the number of embassies of Pakistan abroad.

Zero-Based Budgeting: There are over one hundred autonomous organizations and attached departments in Islamabad. In many cases it is not clear what their contribution is. As such, a zero-based budgeting exercise needs to be undertaken to determine the case for their continued existence.

Rebalancing of the Debt Portfolio:, almost 90% of the domestic borrowing up to March 2014 has been in the form of PIBs at relatively high rates of return. In 2014-15.There should be better balance among borrowings of different maturity.

Financial Accountability: The following measures are suggested to enhance accountability especially to the Parliament:

i. In view of the violation of the Fiscal Responsibility and Debt Limitation (FRDL) Act in 2012-13 and the likelihood of continued violation in 2013-14, the Federal Government must present a detailed medium-term action plan to come within the limits imposed by the FRDL to the National Assembly.

ii. Supplementary grants in particular heads which exceed the annual voted expenditure during a year by 15% or more should be reported to the Finance Committee of the National Assembly during the course of the year.

iii. All discretionary funds to be abolished (present Government has already taken steps in this regard).

iv. The Federal **Right of Information Act** must include provision for the setting up of a high powered (powers of a Civil Court) Federal Information Commission.

v. More detailed security of the defense budget.

CHAPTER 5

THE PSDP

The PSDP has been the biggest casualty in the process of fiscal stabilization. For example, the year, 2013-14, started with a federal PSDP allocation of Rs.540 billion. This was cut to Rs 420 billion during negotiation with the IMF for a new Program. The level of releases up to mid-April 2014 indicates that we will end up with actual expenditure on projects of Rs.350 billion. This implies a shortfall in relation of the original target of over 35%.

The consequence is that today the Federal PSDP stands at only about 1.3% of the GDP. Given the large and growing infrastructure deficit, especially in water and power, this will have to be raised to over 3% of the GDP in coming years.

5.1. Review of 2013-14 PSDP

The original PSDP for 2013-14 had focused on five priority sectors, as shown in Table 5.1. The share of the power sector was 19%, followed by 12% to highways, 11% to the water sector, 6% to the railway and 3% for higher education. The five sectors combined accounted for just over half of the PSDP. This share was reduced by the provision of a lump sum amount of Rs.115 billion for New Development Initiatives.

Table 5.1
Allocation and Releases by Priority Sectors in PSDP 2013-14
(Rs.in Billion)

	Allocation	Releases up to mid-April 2014	Share (%)
Power	103.7 (19.2)	84.4	81.3
Water	57.8 (10.7)	39.9	69.0
Highways	63.0 (11.7)	38.2	60.6
Railways	31.0 (5.7)	18.9	61.0
Higher Education(HEC)	18.5 (3.4)	14.4	77.8
TOTAL OF ABOVE	**274.0 (50.7)**	**194.9 (12.0)**	

Turning to the releases, in the presence of a restricted amount, the Government has preserved the priority for the power sector, but allocations to the water sector, highways and the railway have suffered disproportionately.

5.2. Recommendations

It has been suggested above that the Federal PSDP should be set at Rs 420 billion in 2014-15. This is actually the level agreed with IMF for the current year. The following recommendations are made for 2014-15:

Priority to Water and Power Sectors: The water and power sectors combined received 30% of the original PSDP for the current year. Given the high priority of these sectors, it is imperative that 50% of next year's PSDP be allocated to these sectors. The emphasis should be on quick completion of mature on- going projects, especially projects for expanding and improving the electricity transmission and distribution system and small hydel projects.

Moratorium on New Projects: CDWP/ECNEC may impose a moratorium on new projects, except those in the water and power sectors.

Operations of the PDF: The Pakistan Development Fund (PDF), which has received the gift of $1.5 billion from a friendly country, may not be operated outside the Federal Consolidated Fund (FCF). Priority with this fund may be on power sector investments, rather than on projects in the transport sector. The projects may be subject to the normal approval process of CDWP/ECNEC.