DOTGazette

FBR PAKISTAN

The Federal Budget _ some loud thinking.

"It's clearly a Budget.
It's got a lot of numbers in it."
_ George W Bush.



M Muneer Qureshi
DG(DOT)(DT)

Yes, for the average Pakistani, that is precisely what the Federal [or for that matter, any of the provincial] Budget(s) are - a lot of numbers. Things like the size of 'The Public Sector Development Program,' or the magnitude of 'The Federal Deficit,' or how that [yawning] deficit is proposed to be filled in, do not bother him a great deal. That is not to say of course that this is a good thing. It is not. But given the average Pakistani's multiple distractions and many seemingly intractable problems, his 'apparent' disinterestedness in the Budget is quite understandable. Subconsciously however, he does 'wish' that there would be 'something' in it for him - something 'good' that would give him some relief from the dead weight of his many problems - especially those that entail a monetary outlay. This would be especially true if he were told that a 'Poor Man's Budget' is being announced.

There is indeed a pressing need to 'de-mystify' the budget document. Understanding the Budget should not be seen as 'the art of the occult.' The lack of formal education for many of our citizens is certainly a limiting factor in this regard but still, no justification for ignorance so profound as to render the budget completely meaningless. Indeed it is the job of government to 'educate' the public even when a great chunk of that public is bereft of the benefits of formal education of any significance.

Surprisingly, there are aspects of the Budget that are not properly understood even by those who have had the benefit of formal education. Here probably apathy is more to blame than anything else.

Take for instance, the 'budget deficit.' Many of us cannot recall when last we came across a 'balanced budget' [in Pakistan, that is]. A 'surplus' federal budget is an even greater rarity. For most of us there is something quite sinister about a budget deficit while a balanced budget is seen as an ideal that we have failed to achieve. A surplus budget is viewed as the prerogative of only the most affluent of societies and hence forever out of our reach. The economics behind all this is barely understood even by those who may be categorized as 'literate.'

Much of our conception of the budget has to do with the role we assign it in the economic life of the nation.

Traditionally, the budget has been given, what we may call, a 'governmental housekeeping' role. The federal budget is seen as performing largely the same functions as a family's budget. The government had certain functions to perform which had been assigned to it by society: maintaining order, distributing 'dak', running the courts, providing a monetary system, regulating commerce between the provinces and with foreign countries, maintaining the armed forces. A responsible government will ensure that in carrying out these functions it would live within it's means, a feat of good housekeeping comparable with that of the prudent household. Taxes were levied only to provide the revenue needed for the performance of the services which society required. If special circumstances - most commonly a war- obliged the government to borrow funds, this was to be viewed as an unfortunate but temporary expedient. The sooner the debt was extinguished, the better. To produce a surplus at the end of the fiscal year, which could be put to use to clear the outstanding debt was viewed with special appreciation.

This conception of the budget as a device which disciplined a government to strive systematically to live within it's means, year by year, took such firm hold of the popular imagination that the few professional criticisms leveled against it were scarcely heard.

The ground for professional criticism of this housekeeping conception of the federal budget lay in the limited view which it took of governmental functions. It conceived the government's economic role in the same terms as it would any other economic unit, private or public: private business performed certain economic functions, such as providing goods; households performed other economic functions such as performing labor services, and

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From the Editor's Pen

The July issue of the DOT Gazette, being the 24th issue holds a special significance for the Editorial Board as well as for the readers.

This issue coincides with the completion of two years of continuous publication of this literary effort. The idea of an informative journal detailing the training initiatives and activities of this Directorate General was conceived by our Director General, Mr. M Munir Qureshi. The transformation of this vision into a reality was a feat accomplished by the first editorial board comprising of the probationary officers of the 33rd STP. The editorial board was fortunate to have able guidance from Dr. Hamid Ateeq Sarwar (Additional Director/staff advisor) who had to his credit a long history of association with literary pursuits. The combination of all these positive factors paved the way for the launch of the first issue of DOT Gazette "the August 2006-issue". Officers of the 33rd STP Mr. M. Ijlall Khan (the first Chief Editor), Editor (English) Rafia Illyas Awan and Aisha Dilshad, Editor (Urdu) Asam Aftab and Aamir Ilyas and Azher Jehangir (Design & Layout) deserve special mention for their efforts in materializing this project into a reality.

DOT Lahore Campus bid farewell to the officers of 33rd STP in January 2007 who then left for IBA Karachi in order to pursue a degree in Masters in Tax Management. The January 2007 issue (6th issue) of DOT Gazette was the last issue published under the editorship of 33rd STP. The following eighteen (18) issues have been published under the editorship of faculty members with contribution from office of 34th STP to ensure continuity of the whole exercise.

This publication overtime has evolved into a credible resource house of tax related discussions and fiscal issues invading the Pakistan economy. The google search engine on internet recognizes this potential source by making available articles on issues such as Universal Self Assessment Scheme USAS under Income Tax Ordinance, 2001, Fiscal Evasion etc. through DOT's Official web site www.dgtrdt.gov.pk.com

Some other topic covered in the 24 (twenty four) issues included "The Taxation of Agricultural Income in Pakistan", "Taxation of Business Profits", "Direct Taxation of Income in Pakistan, 1947-2006 an overviews", Tax Base Broadening", "Tax Reforms and Mindset Change in Tax Personnel & Taxpayers", "Change Management", "Automating the Taxman's workplace in Pakistan", "Tax Administrative International Best Practices" etc.

In addition book reviews, interviews with senior tax managers in Pakistan, International tax consultants such as Dr. V. Van Kommer (Manager, Government Consultancy, IBFD Holland), Ms Yassie Hodges (Consultant FBR), Mr. Lee M. Niederman (Tax Administration Advisor, U.S Department of Treasury) and economists have also been regularly featured in some of the issues.

In a span of just two years DOT gazette has come to be recognized as a standard journal highlighting the taxation issues confronting the country as well as the strategy implementation underway through reforms at FBR to tackle the economic woes of our times. Chairman FBR Mr. M. Abdullah Yusuf, Member FATE Mr. Kawar Khurshid Butt, Former Member HRM Mr. Muhammad Tallha are some of the names having high praise for this literary contribution by DOT.

In short the horizon of DOT Gazette has not been restricted to only reporting the training activities centered at DOT Campus. In the domain of training the preceding 24 months superceded all past training records of this institution.

In the year 2006-2007 a total number of 3052 FBR personnel were trained through 168 training programs. Out of these, 72 training courses were organized for FBR officer through which a total number of 1671 officer from BS-16 to BS-19 were trained in different disciplines. Similarly a total number of 1381 officials were trained through 96 different training programs specially designed for each category of officials.

In the year 2007-2008 a total number of 2703 FBR personnel were trained through 176 training programs. Out of these, 40 training courses were organized for FBR officer through which a total number of 1203 officers from BS-16 to BS-19 were trained in different disciplines. Similarly a total number of 1500 officials were trained through 96 different training programs. It is worthwhile to mention here that during the current financial year there is renewed focus on training programs for officials to be posted in newly created reform units. DOT organized crash computer training courses at its Lahore campus commencing from December 2007 which went up till April 2008 for officials in BS-7 to BS-16. The purpose of these trainings was to make the support staff computer literate for working productively in automated office environments at LTU's and RTO's. Wishing the readers the very best for the coming financial year.



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similarly, the federal government performed still other economic functions. The federal budget was the largest of all budgets, to be sure but this was a difference in degree and not in kind.

Or was it? Was there something about the government's budget that distinguished it from a regular family budget or the budget of a corporate entity engaged in business? Was there some special function connected with it which gave it a purpose other than the economical provision of particular services? There was indeed, said a school of economists, whose minority voice failed to attract much notice until the late 1930's, when John Maynard Keynes became it's spokesman. Their view gained ascendancy largely as a consequence of the Great Depression, which lingered on until finally dispelled by wartime activity, and memories of which provided the emotional undertow on which full employment policies rode to legislative approvals in post-war Western Europe and North America. The second stage of budgetary history was thereby ushered in.

PROSPERITY MADE TO ORDER

The second-stage school of economic theorists looked on the budget as performing not just one function proper federal housekeeping - but two. The second function was to preserve the economic health of the nation as a whole. It was the government's duty, said this group, to see that the nation remained prosperous, a duty no less important than maintaining law and order and maintaining courts and other such time-honored governmental services. The nation's economic health was the business of the government because no other agent or institution could serve as doctor.

The doctor's instruments were not only monetary policy - making money cheaper to use in depressions so that businesses and households would use more of it, hopefully returning the nation to prosperity; the instrument kit of the federal government as economic doctor included it's budget as well. In times of depression, it could spend more than it took in, thereby directly putting people and plants to productive use. It did not have to wait for businesses and households to become optimistic enough to borrow money at lower rates of interest. It could put money in their pockets directly by cutting it's tax cake, or it could itself spend on a variety of projects, or it could increase the amount of money it transferred to people who could be counted on to spend it. All these ways would put the government budget in the red, but it would increase the nations economic activity. It would put people and plants to work whose services would otherwise be irretrievably lost.

All very well, said more traditional economists, but how long could this go on? How many times could the medicine be repeated? If the government persisted in deficit spending, it's debt would double, it's credit would crumble, and it would find no buyers for it's buyers. Fiscal responsibility could not be evaded. The balanced budget was not a luxury to be dispensed with under pressure but a necessity of a solvent government.

BUSINESS 'CYCLES' & REMEDIAL ACTION BY GOVERNMENT

The 'discovery' of 'business cycles' - alternating phases of 'boom' and 'bust' [depression] provided another 'solution' to the problem of exercising 'fiscal responsibility' solely through the medium of a 'balanced budget.' The upward phase of the 'business cycle' brought in it's wake inflationary pressure and the governmental prescription for that was to take in more then it spent and use budget surpluses to restore economic normality. On the other hand, in the downward phase of the cycle, 'depressed' prices and economic activity are the problem and the prescription for this malady is the opposite - spend more than the government takes in and use budget deficits to bring the economy back to normal. It was thus not really necessary to 'balance' the budget annually on a continuing basis. Rather, it made much more sense to balance it over the period of the business cycle. Annual balancing was an error since it ignored the cyclical rhythm of the nation's health. Outgo and income could be matched over an appropriate span of years, in which the minuses of some were wiped out by the pluses of others.

This 'solution' too however was not really an answer. For one thing, the nation's needs seemed to expand with time, so that the federal budget tended to rise in good years as well as bad. For another, the 'cycle' was really a myth especially in terms of it's regularity.' And then there were many 'cycles' - inventory cycles, building cycles, short cycles, long waves etc etc. Which one of these to adopt as a reference point for initiating 'corrective action' was hugely problematic. Some other 'explanation' had to be found and with it a different policy prescription.

"PLANNED" BUDGET DEFICITS

A policy of regular budget surpluses in good times matched by budget deficits in bad times so that the one cancelled the other over the full phase of a business cycle though attractive as a theoretical proposition was not really a viable 'answer' to the 'problem.' For one thing, what precisely was a 'good year' - when the budget may be kept in 'balance' or even in 'surplus?' Casual observation and hearsay could obviously not be relied on to initiate 'corrective measures' in an 'ad-hoc' manner. And then, what was to be the 'scale' of these corrective measures? Again one needed a much more rigorous set of criteria to determine precisely 'how much' corrective action was called for to appropriately deal with a problem properly quantified on a given scale.

After mulling over the problem, economists found that 'full employment' came close to what one could reasonably expect in a 'good year.' But full employment did not usually mean 100 percent employment of every able bodied (adult) man and woman making up the nation's labor force. An English economist, A.W Philips, ran a correlation of unemployment and price levels in England as far back as 1861 and found that when unemployment dropped below 2.5 percent of the labor force, prices rose. Similar statistical studies showed that the ' Philips effect' operated in the United states as well, though not in exactly the same manner - the upward pressure on prices came earlier than in England.

Given these parameters the implication was that if we wanted to avoid unemployment and inflation we could do so only in terms of a marginal trade off of one for the other. At what degree of 'full employment' would the upward pressure on prices still be tolerable? A compromise point could be selected on the 'Philips curve' - say a 3 percent rate of unemployment accompanied by a 2

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percent rise in prices, or a 4 percent rate of unemployment with perhaps only a slight price creep.

Balance the budget? Of course, but what budget? The answer which is now being given is the full employment budget. At levels short of full employment this means balancing not an actual but a hypothetical budget, the budget as it would be if we were operating at potential GNP. This is not a matter of running in the red in a vague hope that this will do the economy some good, as the bloodletting of earlier days was expected to restore a patient's health. It is the incurring of deficits in an amount which is guided by calculations of potential GNP, which in turn is based on computations of the level of acceptable compromise between unemployment and price increases.

As recurring budget deficits add to the national debt there is a perception that such a national debt creates a burden on future generations for the self gratification of the present. Aside from failing to grasp that present gratification was not the object, but only the removal of a budget barrier to future economic progress, those of this persuasion persisted in believing that future generations would somehow have to pay off that larger debt to someone else. This is certainly true in the case of the proportion of the national debt held abroad. Other than that however, future generations will not have to pay someone else but only themselves. All will pay taxes to the government in varying amounts, and some will receive interest from the government on the bonds which they hold. Some will pay more and receive less than others, proportionately, and vice versa, but what is involved is a redistribution of the income at that time and not a transfer among the generations.

The discussion supra should clear some of the popular misconceptions about budget deficits in general. However one cannot help but observe that much of the economics that has been formulated would appear to be more applicable to a 'developed economy' like the United States or Britain and less so to a 'developing economy' like ours. Budget deficits in developed countries are taken in stride because the economic managers are confident that given the size and depth of the formal economy that dwarf's the size and depth of the informal sector the residual capability of the economy to eventually generate resources sufficient to offset the consequences of budget deficits is hugely significant. This of course is not so in a developing economy like Pakistan where the informal sector may be anywhere between 35 - 60 percent of the GDP - if not more. Then again huge expenditure on 'unproductive' areas, like Defense, means that if the budget deficit caters to such areas disproportionately it is of no help to the economy. The ability of government to mobilize revenues in developing countries is also severely restricted. Not that there is not enough 'income' to yield the required tax. As pointed out, a large chunk of the economy is placed in the informal sector generating significant 'income.' But such income is largely out of reach of the federal authorities. Tax administrations in third world countries generally lack the expertise required to deal effectively with the burgeoning informal economy. To make matters worse, the formal economy too makes no meaningful contribution to the federal exchequer as the woefully inadequate tax to GDP ratios bear out so vividly - only 10 percent in the case of Pakistan, when it ought to be in the region of 18 - 25 percent at least. As pointed out, 'ad nauseam,' only 2.2 percent of the population of 165 - 170 million is registered as taxpayers. This of course translates into an exceedingly narrow tax base.

Given executive will, revenues can and should be increased dramatically. The 'problem areas' are well known. The anomalies identified. With strong executive support a revamped, modernized and well trained, I.T. savvy tax administration must deal with the problem 'head on.' There are no short cuts. Effective legislation to plug the loop holes has to be a starting point. Once this is achieved, progressive expansion of the tax base should follow and in it's wake, significantly increased revenues and an escalation in the tax to GDP ratio.

Besides the ramifications of recurring budget deficits what everyone needs to understand is that the key to a 'dream' budget is adequate resources, which in our particular context, would be, mosly tax revenue. All said and done, a 'dream' budget for me would be that which can steer the economy towards full employment. One budget will not do that in Pakistan's case. But if resources enough [ie taxes] are forthcoming then we will be headed towards full employment and successive 'dream' budgets mobilizing adequate revenues can take the economy towards full employment - or very close to that objective.

The people of Pakistan will only get what they desire when they are willing to 'pay' for the things that they yearn for. This 'payment' is through taxes. Handouts from foreign sources will never succeed in making the economy self sufficient. And there is only so much that the country can mobilize through contracting loans abroad and the dead weight of such loans is already daunting.

In a lighter vien.

" The budget is like a mythical bean bag. Congress votes mythical beans into it, then reaches in and tries to pull real ones out.".
_ Will Rogers

"The only way you can do that [decrease taxes, balance the budget, and increase military spending] is with mirrors..."
_ John B. Anderson

"The defense budget is more than a piggy bank for people who want to get busy beating swords into pork barrels."
_ George H. W. Bush

"As fighting in Iraq intensifies, President Bush delivered his supplemental war budget to Congress. The money will cover 30 days of fighting, then we'll be sent one war every other month until we cancel our subscription."
_ Craig Kilborn

" A billion here, a billion there – sooner or laterit adds up to real money."
_ Senator Everett Dirksen

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WORKSHOP ON INTERNATIONAL TAX AVOIDANCE & EVASION

HELD IN MEXICO CITY, MEXICO FROM 2nd 6th JUNE, 2008

The Organization of Economic Cooperation & Development (OECD) held a 5-days workshop on International Tax Avoidance & Evasion in Mexico from 2nd -6th June 2008. The delegation from Pakistan included Mr. Shahid Bashir, Director DOT, Mr. Faiz Illahi Memon, Additional Commissioner of Income Tax, RTO Karachi and Mr. Shabih-ul-Aijaz, Deputy Commissioner of Income Tax (LTU Lahore).

The focus of this workshop was to examine some common techniques used by enterprises and individuals to evade and avoid taxes. The emphasis was on tax avoidance and evasion in international transactions and cross border situations. The workshop specially dealt with avoidance and evasion using "Tax Haven" jurisdictions, preferential tax regimes, transfer pricing techniques, thin capitalization, cross border leasing arrangements, hybrid structures and other financial market innovations.

The forum also provided an opportunity to the participants to look at common responses introduced by government in the domestic laws, international and national tax treaties to counter international tax avoidance and evasion. The common responses discussed in the workshop were as under:

- Improving access to bank and other information.
- General antiavoidance/ anti-abuse rules
- Controlled foreign company and foreign investment fund legislation
- The arm's length principle
- Rules addressing treaty shopping
- Thin capitalization rules
- Rules to deal with certain financial market innovations, and
- Effective international exchange of information.

The panel of experts addressing the workshop included Mr. Karsten Fluchter, Event Leader (OECD, Ms.Maria Garcia, Program Manager (Internal Revenue Service, Ecuador), Mr. Carlos Serrano, Coordinator (Spain) and Mr. Jorge Libreros Calderon (Mexico).

List of countries participating in the workshop included Argentina, Chile, Ecuador, Guatemala, Panama, Venezuela, Morocco, Jamaica, Pakistan and Mexico. Director DOT, Mr. Shahid Bashir in his presentation discussed in detail tax evasion and avoidance provisions introduced in Pakistan through the Income Tax Ordinance, 2001. He explained to the participations



Pakistani delegates at the workshop

that the legislative frame-work applicable in Pakistan until the year 2002 did not include provisions to ensure proper incidence of taxation on non-resident and foreign controlled entities. With the introduction of Income Tax Ordinance, 2001 provisions relating to transfer pricing, arm's length transaction, thin capitalization and the concept of permanent establishment (PE) were made part of local taxation legislation. He further explained the role of double taxation treaties entered with 54 countries by the Pakistan Government to encourage international trade and commerce.

Mr. Shahid Bashir also highlighted the infrastructure and function of the Directorate General Training & Research [Direct Taxes], Lahore in providing quality training to the workforce of Federal Board of Revenue , Pakistan. He invited the participants to utilize the training infrastructure and facilities available at DOT for organizing inter-country taxation seminars and workshops. He specially invited the organizer of the event i.e. OECD to DOT for exploring avenues for future international seminars.

This seminar was a great success in bringing together members OECD countries for constructive debate and discussions on important issues such as international tax avoidance and evasion. It also gave the Pakistani delegation an opportunity to present to the participants an over-view of large scale reforms underway at FBR for improving the tax collection machinery of the country.


Pakistani delegates with Instructors


Mr. Shahid Bashir Addressing the participants

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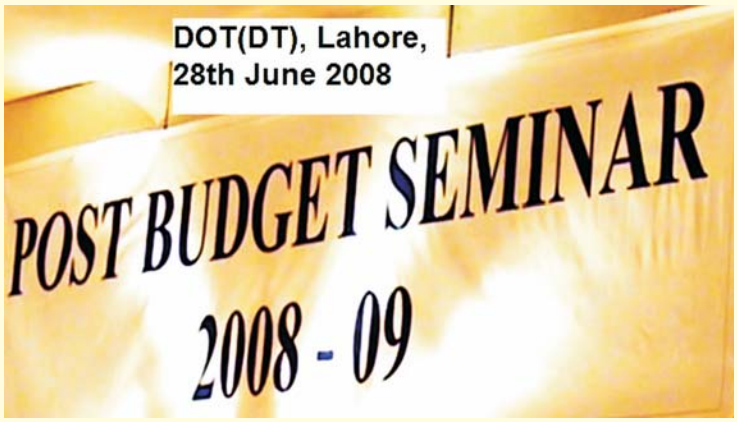



















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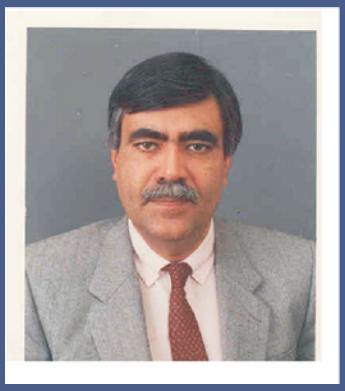
Profile of an Unusual Taxpayer

A skeptic once defined a taxpayer as one who works for the government without having to appear for the Civil Service Examination. Again, according to popular perception, public functionaries lead luxurious lives at the expense of the "poor taxpayers". It is in this background that Mr. Masud's story is unusual and interesting.

Mr. Javed Masud joined the Civil Service (Income Tax Group) in 1970 as a Grade-17 officer with starting salary of Rs.450, per month. He continued to serve the government for 25 years and his terminal salary at the time of seeking premature retirement in 1995 was around Rs.15,000, per month. Assuming that his average monthly emoluments throughout his period of service were around Rs.8,000 (a generous assumption), the total emoluments received by him from government during his entire service do not exceed Rs.2.5 m.

After obtaining premature retirement, Mr. Masud became the chief executive of a private company (Pakistan Credit Rating Agency Limited) and worked in that capacity till the end of 2007. During this period, the total direct income tax paid by him to the government amounts to Rs.14.5m*. This means that what Mr. Masud received from the government in 25 years, he paid back almost 6 times as much to the government. In other words, not only did he devote the best years of his life to the government without any compensation, he has paid a substantial amount merely for the privilege of carrying the honorific title of a 'retired government servant'.

Here is a person belonging to our service who should make us all proud and should be considered as role model for the taxpaying public.



Mr. Javed Masud graduated from Government College, Lahore and obtained his Master's Degree in Economics from Punjab University in 1967. He remained an average student throughout this period. However, the only point of distinction was perhaps his varied interests: dramatics, debating and sports. He was a member of Government College Tennis Team in 1962-63 and captain of the Punjab University Squash Team in 1967. During his period of government service, he got the opportunity to study abroad and obtained Master's Degree in Finance & Economics from Boston University in 1977 (passing with distinction).

While his stay in the Income Tax Department covered only the initial three years of service, he acquired a very diverse and enriching experience by serving in different economic ministries of the Federal Government (Finance, Planning, Production). He also served on the faculty of Civil Service Academy for three years. Mr. Masud held a diplomatic assignment for four years as a Consul General / Commercial Counsellor in South Korea. Given his strong background in Finance, he was also deputed to a DFI (Bankers Equity Limited) for four years as SEVP in the regional office in Lahore. Mr. Masud's last assignment in government was Member of the erstwhile Corporate Law Authority (a Grade-21 position).

Mr. Masud has also distinguished himself through his various publications and papers published and presented, both locally and internationally. From time to time, he also worked as an international consultant with organizations like the World Bank and IFC. He has been invited as a guest speaker at various local training institutes including the NDC, the Administrative Staff College and NIPA, Lahore.

Mr. Masud is currently leading a blissful retired life but remains a Civil Society activist. He is also the Chairman of IGI Finex Securities Limited, member of the Board of Advisors for the Centre for Public Policy & Governance (F.C. College, Lahore). He continues to be a member of the Punjab Finance Commission.