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Dear xxxx

Towards Flat, Low-Rate, Broad and Predictable Taxes

Thank you for sending me the paper by Huzaima Bukhari and Dr Ikramul Haq which has been published by the PRIME Institute (Policy Research Institute of Market Economy) in Pakistan.

As promised, I am writing with my quick thoughts. I have kept this letter brief to avoid going into excessive detail. However, I would be happy to expand upon any of the points, pro bono, if requested as Pakistan is the country of my birth and I would like to see it become better governed and more successful economically.

There is no private information in this letter so you are free to circulate it (in whole but not in part) as widely as you wish.

Background information on myself

You have of course known me for a number of years. However, for the benefit of any other readers, I have included this short background section.

I am now retired and spend most of my time on politics, interfaith relations, writing and broadcasting, and informal pro bono mentoring. Before I retired at the end of 2009, I spent over 30 years as a tax adviser, culminating in 19 years as a tax partner in PricewaterhouseCoopers of the UK. I am a fellow of the Institute of Chartered Accountants in England and Wales, a fellow of the Chartered Institute of Taxation, and an associate member of the Association of Corporate Treasurers. I also have a mathematics degree from Cambridge University. For 12 years I served on the council of the Chartered Institute of Taxation.

I have a long-standing interest in economics as a result of it being a module within my first year studies at university and in my accountancy examinations. Price Waterhouse also sent me on a one-month economics course at Oxford University. Apart from being a tax adviser, my interest in tax policy has led me to be a member of the Institute for Fiscal Studies for over 30 years.

Political environment

I visited the PRIME website yesterday, but only to confirm that the paper is freely available as a download from the website. Accordingly, it is possible that some of my comments below may be addressed elsewhere on the website; I do not know.

The paper does well at pointing out the deficiencies of Pakistan when it comes to tax collection and the deficiencies in the design of the current tax system. However, in reading the paper and considering what to do, one needs to remember some basic principles about politics.

Pakistan has of course been badly governed since independence. The most obvious piece of evidence is that until the most recent general election, no Pakistani elected civilian government had served a full term and then been replaced by another democratically elected government. In between there have been a large number of dictatorships installed by military coups.

The predictable economic consequences have ensued. Pakistan has significantly underperformed better run countries.

As a simple example, when making a political speech last year I contrasted the economic performance of Pakistan and South Korea between 1950 and 2013 to show how much better South Korea has done over the 63 years. The speech is on my website page http://www.mohammedamin.com/Politics/Quality-government-matters.html I have reproduced the Pakistan / South Korea comparison below:

The table below compares South Korea and Pakistan from 1950 to 2013, a period of 63 years.

	GDP per capita	GDP PPP per capita IMF	Compound annual growth rate
	1950	**2013**	
South Korea	$ 876	$ 33,791	6.0%
Pakistan	$ 650	$ 4,574	3.1%
South Korea / Pakistan	1.3	7.4	

The 1950 figures for both countries, of GDP per capita, are taken from the Nationmaster website. As it is the same source for both, the 1950 figures should be comparable between the two countries.

The 2013 figures for both countries, of GDP PPP per capita originate from the IMF (International Monetary Fund) as reproduced on Wikipedia. It is the left hand column on the page. Again as the same source is used for both countries, the 2013 figures should be comparable between the two countries.

The 1950 data is not comparable with the 2013 data. Accordingly, while I have computed annual growth rates, the growth rates are not necessarily true growth rates for these economies. However, the calculations do reliably show the marked difference between the two countries performances, since any differences between the way the 1950 data and the 2013 data is calculated should affect both countries more or less equally.

The data shows that South Korea has grown dramatically faster than Pakistan over these 63 years, 6.0% compared with 3.1%. The result is in 1950 South Koreans had 1.3 times the annual income of Pakistanis, but in 2013 the ratio had become 7.4 times.

When assessing a badly run country such as Pakistan, it is essential to remember that such poor government can only subsist over a long period of time because it serves the interest of a significant number of individuals to have poor government.

For example, in Pakistan having military dictatorships or weak civilian governments is clearly in the interest of the Armed Forces. They are thereby able to maintain the privileges of senior officers and able to ensure that a disproportionate part of the country's resources is devoted to the Armed Forces. Furthermore, having an environment which facilitates widespread corruption combined with very poor tax collection is in the interests of those elites which are closely connected with the government, whether military or civilian.

Accordingly, achieving change will be extremely difficult. It is not enough to put forward good quality intellectually coherent solutions. One also needs to disseminate them widely and to build up very broad-based support which can overcome the vested interests of those who benefit from the current system.

In particular, simplified versions of the proposals in the paper need to be published in a form suitable for general readers, to demonstrate that the overwhelming proportion of the population would be far better off under the reformed system than they are under the present system which exists primarily to serve the interests of the well-connected elites.

The other general political point to bear in mind is that any change to tax systems always produces winners and losers. The winners will be a large and diffuse set of individuals, who in many cases may gain very little per capita, and may even be unaware of how much they will gain. Conversely the losers will be acutely conscious of the impact of the change upon them, and in many cases the impact of the change will be very significant. A business which is able to evade taxation as a result of bribing tax administrators will be facing a significant increase in its tax burden even with a relatively low rate of flat rate corporate tax.

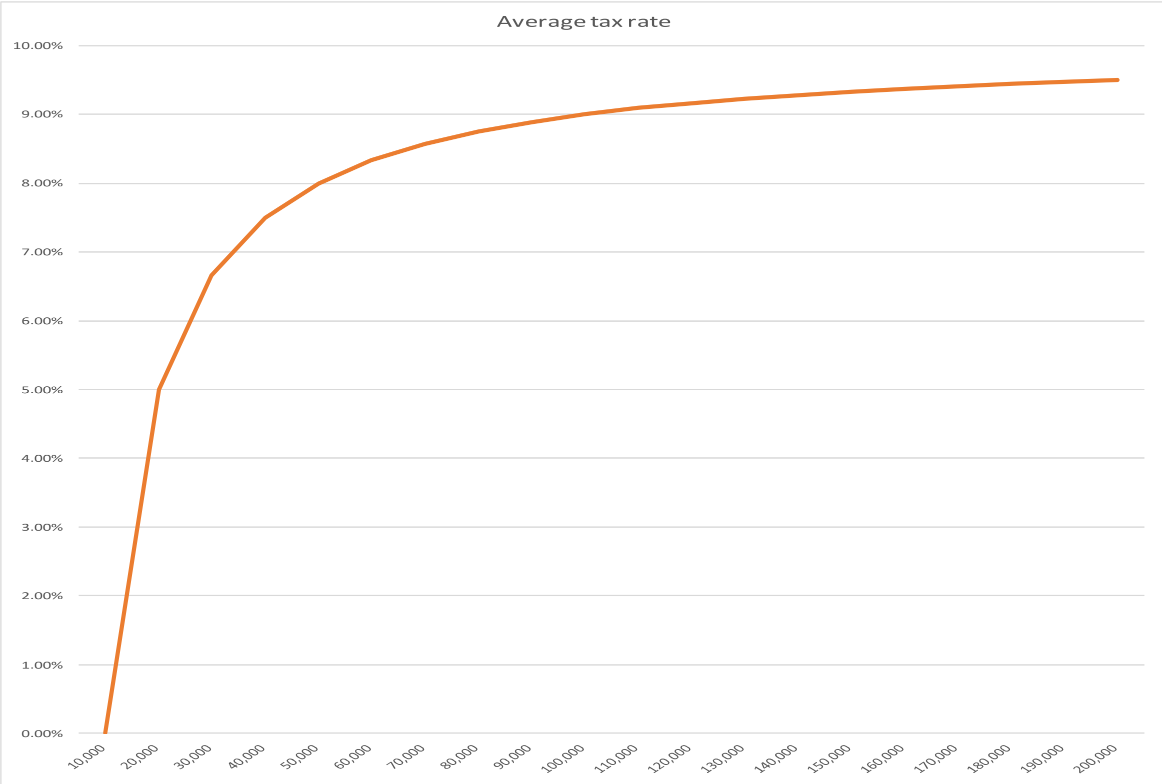
Accordingly, almost all proposals for improved tax systems almost always face significant opposition and in my opinion most attempted reforms, all around the world, tend to fail to be implemented. Even the best ideas often struggle for implementation after decades of advocacy. An example is land value taxation.

Flat rate taxation

Flat rate taxation is a good idea almost everywhere but is particularly appropriate for countries which have limited administrative resources. Its great benefit is that it reduces the scope for arbitrary discretion and also minimises the disincentive effect of the marginal rate of taxation increasing as the taxpayer's income rises.

One point which the paper does not seem to bring out strongly enough is that even with a single rate of flat tax, provided there is an initial allowance of zero-tax income, the flat tax system is progressive. Although the marginal tax rate is constant (at the flat tax rate), the average rate of tax paid steadily increases (asymptotically towards the flat tax rate) as income rises.

If the paper has a second edition, I strongly recommend the inclusion of a small section to bring this out more clearly along with a graph of the type below. Here I have assumed a flat tax rate of 10% and a zero tax exemption on income of 10,000. (I am used to thinking in pounds rather than rupees!)



The two key decisions with a flat rate tax system are of course specifying the initial zero-taxation amount and specifying the rate of tax.

Once the initial zero-taxation amount has been set, reducing it is politically challenging as that will cause an increase in the tax paid by all taxpayers, with the greatest proportional impact being upon poorer taxpayers whose income is just above the zero-taxation amount. Obviously, raising the zero-taxation amount will be very popular!

With regard to the rate of tax, once it has been set, it should be noted that any reduction in the rate of tax will confer much larger absolute benefits upon richer taxpayers than upon poorer taxpayers. Accordingly, any tax rate reductions risk populist accusations that the government is unduly favouring the rich.

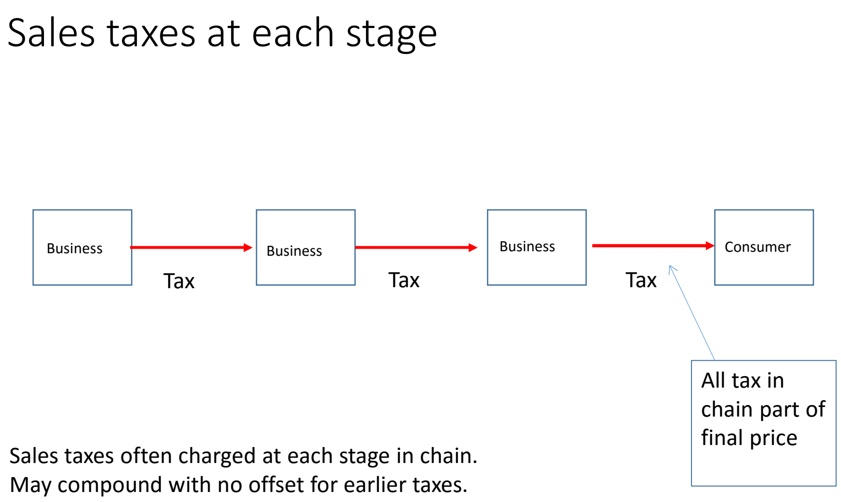
The other point to bear in mind is that while in most countries the introduction of a flat rate tax system would be popular with high earners as it would typically reduce their tax liabilities, in a country where there is widespread tax evasion by high income earners, the introduction of even a low flat rate tax (with mechanisms for it to be collected effectively) will represent a significant increase in the tax paid by high earners. Accordingly, I would expect significant political difficulties getting the idea accepted unless one succeeds in getting widespread support from middle-income earners who are already paying significant amounts of tax under the present system and who would see a tax reduction with flat rate tax.

Sales tax

The paper quite properly points out the many problems caused by a complex sales tax system, both with regard to raising revenue and with regard to facilitating commercial activities.

However, I found this chapter of the paper particularly unsatisfactory. The reason is that it does not distinguish sufficiently clearly between sales tax and value-added tax (sometimes also called goods and services tax.)

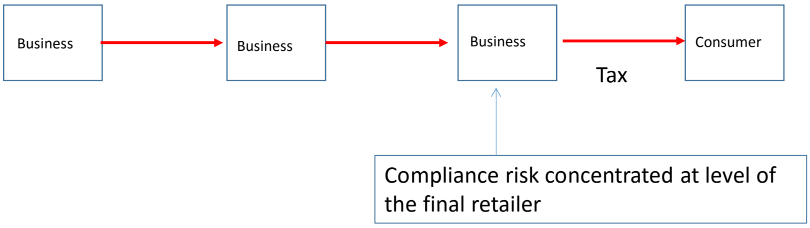
A sales tax that is applied each time the goods concerned are sold as the disadvantage of cascading the tax as illustrated by the diagram below.



In the above example, tax is added on at each stage increasing the price paid by the final consumer. For the intermediary businesses, the sales tax on the goods purchased simply becomes part of the cost of goods sold and should be recovered by increasing their selling prices.

One obvious way to avoid the cascading effect is to only charge sales tax on the final sale to the consumer, illustrated in the diagram below.

Sales tax on consumer sale only

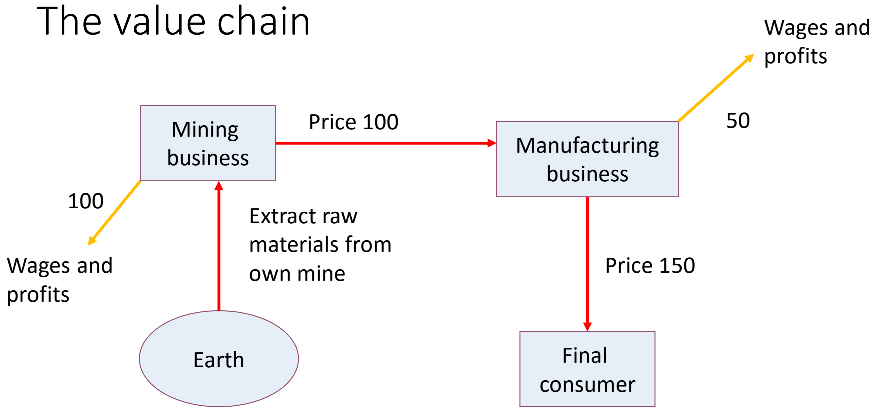


However, while this avoids the cascading effect of the sales tax, it creates a serious compliance risk. Only the final business in the chain, which is selling to a final consumer, would charge sales tax. That will typically be the smallest business (for example, a small retail store selling goods for cash) where in practice compliance risks are highest. Accordingly, this approach risks increasing the amount of sales tax evasion.

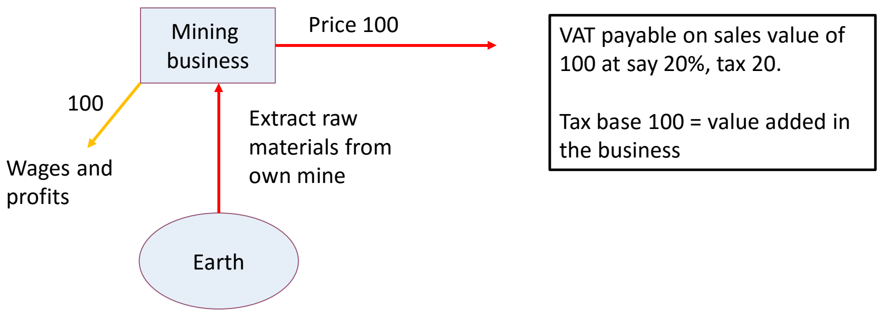
Value-added tax (VAT) has the great merit of avoiding the cascading effect that arises when a sales tax is charged at each stage but without magnifying the compliance risk. It achieves this by charging value-added tax at each stage but with a credit mechanism to avoid compounding the tax charged. It also has the benefit that most implementations of VAT do not charge tax on goods exported to foreign purchasers.

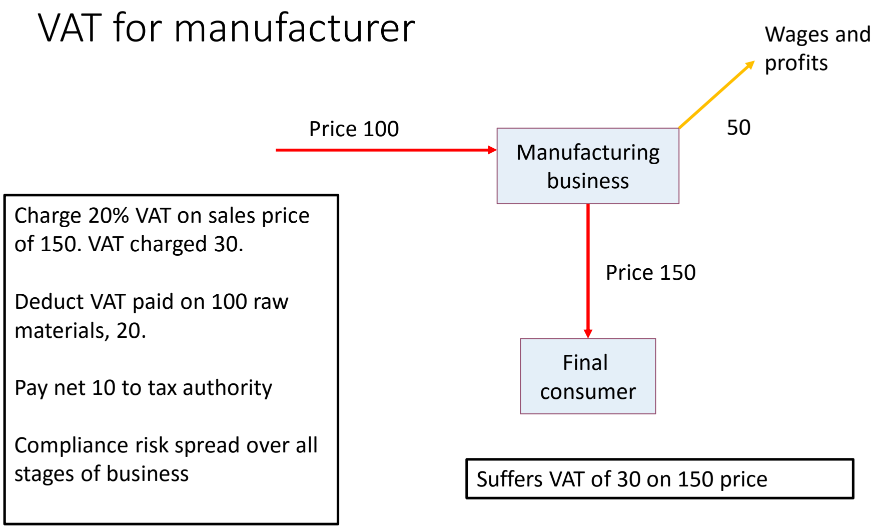
The following diagrams illustrate how VAT would be operated in a simplified business chain.

The value chain



VAT for miner





As will be seen from the above example, all of the VAT of 30 is borne by the final consumer but the compliance risk is not concentrated in the last business selling to the final consumer.

Furthermore, the operation of VAT can serve to increase the quality of tax compliance as businesses need to keep proper records in order to recover the VAT that they suffer on their purchases of goods for resale and the VAT they suffer on their overheads.

Pakistan's federal structure need not be an impediment to the operation of VAT.

The European Union has managed to require each individual sovereign member to operate VAT in a harmonised way but without pooling the taxes collected and without requiring fiscal barriers to the movement of goods between countries. I strongly recommend that the authors spend time looking at the operation of VAT within the EU as the tax was pioneered by the EU and the EU is the world's largest economy to have implemented VAT.

Single-rate customs duty regime

National tax agency

National tax tribunal

The proposals in these chapters seem very sensible and I have no particular comments to add.

The key point is that significant impediments can be expected to be put in the way of reform since the present tax regime benefits many parties who have a vested interest in preserving the status quo.

Yours sincerely

Mohammed Amin