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# A tax on inherited wealth

Like second marriage, Pakistan's forthcoming recourse to IMF will be a triumph of hope over experience. It is now up to us to mitigate the adverse effects of this unfortunate decision.

Reportedly, a budget strategy paper to be presented to the Cabinet on April 30 will propose additional taxes of Rs 600 billion (1.7% of GDP). This is high, even by IMF standards, and it calls for government to distribute its burden fairly on wealthy and poor citizens. To this end, this article proposes a tax, narrowly targeted on the super-rich, that could yield up to Rs160b (0.4% of GDP) in revenues, taking up a significant share of the burden.

The IMF's own 2002 report on "prolonged use of IMF resources" is damning in its 25 pages of criticism of 30 years of IMF's failures in Pakistan. It should be memorised by our negotiating team. In particular, it finds that IMF staff set unrealistic, punitively high revenue targets (over three times higher than in comparable countries), seriously undermining the programme, the budget and the economy:

"In multi-year arrangements approved since 1993, the average targeted revenue increase over the three-year program period was 2.2 percentage points of GDP in Pakistan, compared to 0.7 points for prolonged users as a whole and 1.3 points for 'temporary' users. Overall and primary fiscal balance targets were also more ambitious in Pakistan than in both 'temporary' and prolonged users' programs on average."

More generally, its 2018 report on "fragile states" (which include Pakistan) also criticises IMF staff for prescribing generic remedies ("using IMF-wide norms") without attending to specific country conditions. Clearly, the "1.7%" demand is an opening gambit. Holding the IMF to its own recommendations, we should negotiate for a tax effort of around 0.7% of GDP.

Irrespective of the tax effort agreed, it is essential to attend not just to tax-yield but to its distributional impact. Especially, in view of the political government's declared aim to seek justice for all. To this end, a tax on inheritance and gifts, in the hands of recipients, is proposed.

By this tax, not only would the scale of unearned wealth be reduced, but recipients would be encouraged to lead more worthy lives by relying on their own talents and energies. This is why the wise among the wealthiest limit the money they leave to their children, motivating them to work and take risks, leading to innovation and entrepreneurship in society.

The proposed integrated transfer tax (ITT) should be placed on wealth inherited at death (over a tax-free threshold), and-to inhibit tax avoidance-on gifts in life (above a zero-rate band), both with specific exemptions and reliefs. These transfers should be treated as income arising from wealth accretion, with tax withheld prior to distribution, under special provisions of the Income Tax Ordinance (under a new Head, Imputed Income).

The concept of 'income from wealth accretion'-an economic concept, that may be unfamiliar to non-economists-requires explanation. While capital and income-think: cow and milk-are notoriously difficult to define or demarcate (Is milk in the udder, cow or milk?), for tax purposes two concepts of income are common: cash and accretion. Under the cash concept, a man earns no income from living in his own house; under the accretion concept, he does (in the amount for which he could rent the house). Similarly, as cash, unrealised capital gains are not taxable income; as accretion, they are.

Most public finance experts favour the accretion concept of income (change in net worth plus consumption). In their classic textbook, Richard and Peggy Musgrave write: "In terms of the accretion concept, the receipt of bequests or gifts constitutes an addition to the economic capacity of the recipient, just as does accretion from other sources. Although [in the US] such transfers are taxed separately under the estate and gift taxes, a good argument can be made for including them in the income tax base of the recipient as well" (Public Finance in Theory and Practice, 5th ed. 1989). There is sound theoretical justification, therefore, to tax these transfers as income, not capital, wealth, or assets.

Whether capital or income makes a better tax base has been long debated. In England, the estate duty (imposed in the 19th century) was replaced in 1975 by the capital transfer tax (charged on both bequests at death and gifts in life), which in turn was replaced in 1986 by the existing inheritance tax. In India, estate duty (7.5%-40%) was abolished in 1985; and the gift tax (30%), after suspension during 1998-2004, was reintroduced as a tax on recipient's income, but with many exemptions (mainly on property) and exceptions. Pakistan also had an Estate Duty (Act, 1950), and a Gift Tax (Act, 1963), but both were abolished permanently in the late 1980s.

Estate duties give rise to tax-avoidance gifts. "Ideally," therefore, the Musgraves write, "gift and estate taxes should be integrated into a single transfer tax." Such taxes exist in numerous countries and a rich body of international tax law and practice can be adapted to our conditions quickly to draw up a detailed design. By way of a thumb-nail sketch-adapted loosely from the U.K. inheritance tax-the proposed integrated transfer tax (ITT) would be levied in most cases at death, but also on certain designated lifetime transfers that are presumed to be in anticipation of death. In both cases, title would not be transferred without tax payment.

On death, the ITT would be charged at 40% on the value above the tax-free threshold (proposed at Rs100m, compared to Rs60m equivalent in UK), after excluding exempt assets (like a family residence) and deducting specified reliefs (like on charitable bequests). The tax would apply equally to discretionary and mandatory shares under Islamic wills. Payment would be due six months after death. Most estates would have sufficient liquid (or liquidatable) assets to satisfy the full tax which may be due, but an option could be provided to pay in 10 annual instalments.

In life, the ITT would be charged at 20% on all gifts that are over Rs10m per year, per recipient, with an aggregate lifetime limit of Rs100m-over which the 40% rate would apply. These would include transfers to discretionary trusts, to closely-held companies, or other tax avoidance vehicles. They would also be provided exemptions (like gifts to spouses and children) and reliefs (on zakat, charitable donations, etc.). Triggered by title change, transfer of benami assets would be automatically covered.

Among many other possible variations, ignored for simplicity, the minimum-tax threshold could be lowered to Rs50m, the proposed tax rates could be graduated (from 20%-40%), gifts during the last 7-10 years of life be counted in the tax-free threshold, etc.

Although justifiable on equity grounds alone, how much would the tax yield? In the absence of any estimates of the stock or distribution of wealth (which can be constructed from FBR's tax return data) only speculative estimates are possible. Each year, from an estimated 1.3m deaths, around 200,000 estates are inherited. Of these, if the richest 1% (2,000 persons) who die each year leave behind, on average, an estate of Rs500m each, then their combined taxable value, net of the tax-free threshold, would be Rs800b. Allowing 50% for collection shortfalls, the proposed ITT, if paid in full, would yield Rs160b (which is over 65% of excise tax receipts, or over 10% of total direct tax receipts, or 0.4% of GDP). This excludes both additional yield from the estates of those just below the top percentile, and from gifts. Clearly, the tax deserves a closer look.

Among other details, there would be a need to make separate provisions for property located in, and outside Pakistan; and for cases in which the deceased was, or was not, domiciled in Pakistan (during say the last ten years of life), and in each case, whether the spouse (and heirs) are, or are not, domiciled in Pakistan. Persons domiciled in Pakistan would be taxed on their worldwide estate; those not, on their properties located in Pakistan.

Equally, the ITT should be compatible with our tax treaties that cover estate taxes (the US, the UK, and the UAE, among others). In principle, assets subject to dual taxation should be taxed at the lower rate in treaty jurisdictions, and unilateral rules should apply in non-treaty jurisdictions. These and other details can be worked out in final design.

Finally, as a tax on deemed income arising from transfer, the ITT would be a tax on income, a matter within the federal government's competence to legislate on, under the Constitution. As a tax on income, it would neither be an estate duty, nor a wealth tax, nor a capital value tax. As such, transfers of both immovable property and agricultural land would attract ITT, achieving a long-sought expansion of the tax base.

In Jordan, last year, the IMF programme led to riots, the government fell, and a former World Banker was sworn-in as the new prime minister. In the previous year, mass demonstrations against IMF programmes took place in Argentina, Egypt, Haiti, Sri Lanka and Tunisia, among others. To avoid this in Pakistan in 2019, IMF staff must learn from their mistakes and be more sensitive to the distributional impact of their financial programme.

An inheritance tax is, in principle, a perfect tax. It is fair, progressive, egalitarian and narrowly targeted at the wealthiest citizens. It would be paid by those with guns and guards and properties abroad, not by Abdullah and Bushra in Sadiqabad. With the proposed tax-free threshold of Rs 100 million, less than 2 percent of estates left on death would be liable for tax. On Jean-Baptiste Colbert's well-known principle of taxation-pluck most goose feathers, with least hisses-it should score high.

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