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Submission to the Davis Tax Committee

Introduction

In February 2013 the Minister of Finance Pravin Gordhan announced during his 2013/14 budget review that government will initiate a tax review this year, “To assess our tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability”. According to the Terms of Reference of the Tax Review Committee, “The committee will in its work take into account recent domestic and global developments and, in particular, the long term objectives of the National Development Plan (NDP)”.¹ The Free Market Foundation has made extensive submissions on the NDP.

According to the TOR, “The committee should evaluate the South African tax system against the international tax trends, principles and practices, as well as recent international initiatives to improve tax compliance and deal with tax base erosion”.²

Government expenditure, taxes and economic freedom

There is little merit in discussing the “tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability”, without examining the best available economic system in which these desirable ends are most likely to be achieved. Rigorous economic analyses published in the annual *Economic Freedom of the World (EFW)* reports and conducted over almost three decades show that the size of government measured by the levels of government consumption expenditure, transfers and subsidies, government enterprises and investment as a share of total investment, which are determinants of taxation levels, have a significant influence on economic activity. Excessive levels of government involvement in the economy and takings in taxes from the productive sector have a dampening effect on economic activity.

¹ Ministry of Finance Media Statement: Minister Gordhan announces further details of the Tax Review Committee and the Terms of Reference 17 July 2013.

² Ministry of Finance Media Statement: Minister Gordhan announces further details of the Tax Review Committee and the Terms of Reference 17 July 2013.

EFW, which has measured levels of economic freedom in more than 100 countries over almost three decades suggest that greater economic freedom results in higher economic growth rates. An accumulating body of literature analysing the relationship between economic freedom and investment, income, growth, reductions in poverty, improvements in human welfare, co-operation, tolerance, peaceful relations, entrepreneurship, and honesty in government, has found positive consequences for the people of countries with high and increasing levels of economic freedom. The National Planning Commission (NPC) appears to be asking similar questions to those posed by the various authors that have carried out the analyses and the EFW studies therefore offer a fruitful source of answers to some of the NPC's questions regarding South Africa's most troubling problems.

The *Economic Freedom of the World: 2013 Annual Report*³ states that, "the key ingredients of economic freedom are: personal choice, voluntary exchange coordinated by markets, freedom to compete in markets, and protection of persons and their property from aggression by others."

These fundamental core ingredients, established with the involvement of many eminent economists, have been utilised as a basis for measuring and comparing the world's most important economies. The government cannot afford to ignore what the EFW figures are telling us about the South African economy.

This submission discusses the aspects of the study that relate to the size of government and the taxes levied in order to cover the resultant government expenditure. The latest ratings for the various areas of government activity are based on a total of a possible 10 in each area.

Area 1: Size of Government (Overall rating 5.45 out of 10)

The South African government is currently embarking on increasing its role in the economy. The stated intention is to improve the economy and lives of the country's people. This initiative no doubt reflects the views of the socialist/communist members of the tripartite alliance. This development is unfortunate as all the indicators predict that this policy will lead to less rather than more economic growth, with unfortunate consequences for the poor and unemployed.

A fallacy involved in decisions on increased government participation in an economy was described by the 19th century economist Frédéric Bastiat who wrote about what is "seen" and what is "not seen". When government builds bridges, roads, harbours and railways, using current and future taxpayers' money, the activities are immediately visible. What are not visible are the thousands of investments that taxpayers would have made if the additional taxes and other resources taken to carry out the public works had not been taken from them. This does not suggest that infrastructure is not necessary; it does suggest that they can be done without imposing an impossibly high cost on the country's people.

An alternative and more promising approach for government to embark upon, rather than the massive initiative it has in mind, is to reduce rather than increase the role of government in the economy. Such a reduction, if done in an innovative and bold manner, would bring about far-reaching benefits for the people of South Africa, especially the poorest among us. It would also give the economy an impetus that no other policy would be capable of doing.

Instead of burdening government, the economy, and the country's people with huge debts and high taxes, the government should consider a massive reduction in its participation rate. It should also

³ Gwartney, Lawson & Hall, *Economic Freedom of the World Report: 2013 Annual Report* (2013).

carefully examine the areas of the economy that are currently reducing the freedoms of the people. In the following paragraphs we will examine the specific components of the economy that the EFW report has identified as being problematical.

A. Government consumption - Rating 3.88 (26.80%)

Government consumption expenditure has been relatively high as a percentage of GDP for many years; higher than can generally be afforded by a developing country. This expenditure could be reduced considerably by utilising the substantial state assets accumulated prior to 1994 to improve conditions for the people. Every low-income person who is legitimately and permanently living in a state-owned house, or on state-owned land, should be given freehold title to the property. On community owned land, freehold title to homesteads could be given without disturbing the traditional processes of the communities. This substantial transfer of property (called “dead capital” by Hernando de Soto) from the state to the people would transform the lives of low-income South Africans, reduce the level of government’s consumption expenditure, and bring about a transformation in the lives of the affected people. It would also allow a metamorphosis of the artificially created apartheid “townships” into towns and suburbs through transformation of the land use in these areas.

This redistribution of wealth would reduce demands on the government welfare budget, provide a significant impetus to entrepreneurship and economic activity in the areas where the property titling occurs, and bring about a considerable reduction in the necessity for welfare grants.

B. Transfers and subsidies – 8.43 (6.26%)

This component is measured as general government transfers and subsidies as a percentage of GDP. The figures for the other BRICS countries are Brazil 8.5%, Russia 16.7%, India 9.0%, and China 6.8%. Countries with substantial economies that have lower or similar transfer and subsidy rates to South Africa’s are Hong Kong 2.4%, Indonesia 4.1%, Kenya 1.5%, Malaysia 5.7%, Mauritius 6.1%, Nigeria 1.9%, Singapore 0.0%, South Korea 6.5% and Taiwan 3.0%. South Africa is in the precarious position of having a large number of people receiving subsidies, a high unemployment rate and a low tax base. This aspect of the government budget will have to be handled with continuing care to ensure that it does not become unmanageable. The property titling discussed under government consumption (above) would reduce the level of transfers and subsidies payable out of the annual budget.

C. Government enterprises and investment - Rating 4.00 (37.70%)

On size of government South Africa is ranked 117th out of the 152 countries rated in the EFW report. The second lowest rating in this area is on “government enterprises and investment”. It stands to reason that the greater the percentage of government ownership and control of property and the means of production, the less space there is for the population to invest in, thus reducing their freedom of activity. In making large investments in the provision of services such as electricity, railways, harbours and airports, government also tends to crowd out the private sector’s ability to borrow funds to finance its enterprises. If government were to sell such enterprises so that those services are run by privately owned companies, there would be increased competition and substantially more investment could be drawn from foreign sources. This would lighten the load on the government budget and on taxpayers. The benefits are innumerable, not least of which will be the substantial funds that would be available from the sale of public enterprises for government to invest in improving conditions for the poor.

South Africa's second worst of all 42 areas measured in compiling the ratings, occurs in the component "government enterprises and investment". South Africa has a rating of 4 out of a possible 10. And government appears intent on making this even worse. If we were merely dealing here with differing opinions, any one of which had the potential to produce positive outcomes for the economy, a high government participation rate would not be marked down so badly in this component of the EFW study.

A policy of divestment of public enterprises would create the following huge benefits for the economy:

- Government enterprises could be converted into public companies with listings on the stock exchange and all low-income people could be given shares. Designated unit trusts could be appointed to exchange shares in the new companies for units in their trusts at a specified rate for a specified minimum period to give share recipients an investment alternative. The new public companies should, in the interests of all citizens, not be given statutory monopolies in their fields of activity.
- The following benefits could be expected:
 - Low-income people would be enriched by the shares they would receive and the need for welfare expenditure would decline.
 - The new public companies would be subject to the disciplines of the market place, would be able to raise capital without putting pressure on the Treasury or taxpayers, and would rapidly expand their businesses and increase their services.
 - Matters relating to the activities of the new companies would be removed from the political arena and become routine economic matters.
 - Open competition would function in all aspects of the activities of the new companies to the benefit of citizens.
 - The EFW rating of South Africa would improve and the country's attractiveness to investors would increase considerably.
 - There would be an improvement in GDP, an increase in per capita incomes, more jobs and less poverty.

D. Top marginal tax rate – Rating 6.00 (41%)

South Africa has a high marginal tax rate by international standards, which reduces savings and investment. The marginal income and payroll tax rates of countries that have more competitive rates than South Africa are: Bahamas 10 per cent, United Arab Emirates 16 per cent, Bahrain 17 per cent, Hong Kong 17 per cent, Singapore 20 per cent, Botswana 25 per cent, Costa Rica 25 per cent, Mauritius 26 per cent, Brazil 28 per cent, and Kenya 30 per cent.

On each reduction of Russia's marginal tax rate, first from 80 per cent to 30 per cent, and then to 13 per cent, the total tax receipts increased. According to economist Arthur Laffer, tax reductions cause taxpayers to spend more time on increasing their incomes and less time on plans to minimise their tax liabilities. They also decide at some level that taking the risk of illegal tax evasion is not worth the taxes saved. If the government were to embark on the asset transfers to low income people as suggested above, it would be in a position to make the country more tax-competitive to attract investment and arguably increase the total tax receipts in the process.

Simplifying South Africa's tax system

Capital Gains Tax

According to a joint publication between the National Treasury and the South African Revenue Service, *Tax Statistics 2012*, "The cumulative liability raised for Capital Gains Tax⁴ since its inception on 1 October 2001 to the end of March 2012 was R42.9 billion" (see Table below).

Table: Capital gains tax raised, prior to 2007/08 – 2011/12

| R million | Capital gains tax raised | | |
|-------------------|--------------------------|---------------|---------------|
| | Individuals | Companies | Total |
| Prior to 2007/08 | 1,850 | 3,241 | 5,091 |
| 2007/08 | 1,167 | 2,494 | 3,661 |
| 2008/09 | 3,807 | 4,136 | 7,943 |
| 2009/10 | 4,357 | 6,023 | 10,380 |
| 2010/11 | 2,012 | 7,049 | 9,061 |
| 2011/12 | 1,550 | 5,263 | 6,813 |
| Cumulative | 14,743 | 28,206 | 42,949 |

Source: National Treasury and South African Revenue Service

Taxes on property

Taxes on property consists of donations tax, estate duty, securities transfer tax (STT) and transfer duty:

- *Donations tax* is levied at a flat rate of 20% on the value of the donation (R100 000 exemption available to natural persons).
- *Estate duty* is levied at a rate of 20% on the dutiable amount of the estate (there are certain admissible deductions allowed on the total value of the estate).
- *STT* is a tax levied at a rate of 0.25% on every transfer of a security.
- *Transfer duty* is the largest source of revenue in this category and is levied on the acquisition of property at a progressive rate for all persons including companies, close corporations and trusts (maximum of 8% on the value exceeding R1.5 million as from 23 February 2011).

Reducing the burden of paying tax

The best way to stimulate growth is to allow people to work, save and invest. Unfortunately, our labour policies in this country discourage the hiring of low and unskilled workers and high marginal tax rates and other burdensome taxes discourage savings and investment. When we combine all taxes, many people are paying upwards of 40 per cent of their annual earnings. Typically, these are the individuals who would fund new investment in the economy, which, in turn, would create the essential new jobs South Africa so desperately needs. A lack of investment retards capital accumulation. A lower capital to labour ratio reduces real wages and perpetuates the poor savings and investment cycle. In simple terms, without investments to fund and establish new ventures that create jobs, the smaller the economy and the lower the economic growth rate will be.

⁴ Capital gains tax is raised on assessment and forms part of normal income tax liability. The revenue collected from CGT is reflected either under taxes on persons and individuals or taxes on companies and is based on the disposal value of assets.

An additional justification for a policy that removes taxes such as estate duties, transfer duties, taxes on retirement funds, capital gains taxes, etc, is that it eliminates currently pervasive double taxation. Double taxation occurs because personal and corporate incomes are taxed and then whatever returns derive from these savings and investments are taxed again. One of the South African government's first priorities should be to eliminate taxes on savings and investments.

In addition to removing all taxes that constitute double taxation, government could encourage savings and investment by flattening personal income tax. A flat tax would reduce the large cost of tax compliance and encourage greater investment and work effort. A 'true' flat tax makes no allowances for deductions and provides no special dispensation for low-income earners. However, for both compassionate and practical reasons, there is no merit whatsoever in taxing the poor. The compassionate reasons are obvious while the practical reason is that, below a certain level of income, the cost of collecting taxes from the poor will exceed the amount collected. Low-income earners, therefore, should be exempt from paying any tax on personal income.

The government should consider simplifying the tax dispensation by having a zero rate for individuals below a certain threshold and a tax of perhaps 15 per cent for everyone else, including companies. Apart from the efficiency gains that SARS will enjoy by exempting the poor from tax and administering one tax rate, as a result of this simple policy proposal, the income tax base will be widened because there will be a higher level of compliance and employment will increase as a result of greater returns from savings and investment.

Hall and Rabushka Flat Tax System

Eastern European countries, most notably Russia, have made their economies more competitive by adopting low, flat, tax rates. Russia cut its tax rate to a flat 13 per cent in 2000 and almost doubled its tax receipts as a percentage of GDP in 2001. Estonia (21%) and Latvia (25%) led the way in the 1990's, but were less bold in cutting the rate. However, they are remarkably successful, with average growth rates of 6.1% in 2002. The Slovak Republic introduced a 19% flat tax and Iraq's top tax rate was slashed in 2004 from 45% to a flat 15% for individuals and businesses.

Low flat taxes reduce compliance costs and minimise the economic distortions caused by taxes. Taxes change the behaviour of citizens and tax systems that are designed to have the least negative effect on their behaviour allow economies to achieve the best results.

If the flat tax system developed and refined by economists Robert E Hall and Alvin Rabushka of the Hoover Institution, USA, were to be adopted by South Africa it would simplify South Africa's tax system to such an extent that it would be understood by the vast majority of taxpayers. The system taxes all income at a low flat rate and has various features that reduce complexity:

- A generous personal allowance that exempts the poor from income tax.
- Two postcard-size tax returns, one for Business Tax and another for Individual Wage Tax.
- An integrated system applying the same rate to businesses and individuals, removing the incentive to utilise companies and other legal entities to reduce tax.
- Consumption is taxed and saving is not because all investment spending is removed from the tax base.
- There are no special allowances.
- Fringe benefits are not deductible by businesses or taxable in the hands of employees.

- Capital equipment, structures and land purchased by businesses are deductible when purchased and taxable when sold.
- Interest paid is not deductible as a business expense and interest received is tax-free in the hands of recipients (interest rates would adjust to lower levels to take the change into account).
- According to the authors a flat rate of about 19% would raise the same amount of federal revenue for the American government as their existing complex system and high tax rates.
- The draft tax act prepared by the authors to replace the existing U.S. federal tax laws is 3½ pages long, compared to over 2000 pages of basic tax law and 10,000 additional pages of tax regulations.

South Africa is a developing country and needs to simplify its laws and administration to enable its citizens to understand and cope with them. A 3½-page tax act and 13% flat tax – perhaps 18% if VAT is abolished – would be a great improvement. Citizens should be allowed to concentrate their minds on earning a living and not be forced to waste their time and hard-earned money dealing with time-consuming complexity. A simple, low, flat tax system would lift the burden of the current system yet raise the same amount of revenue, given the propensity of low tax rates to raise unexpectedly high revenues, as predicted by Arthur Laffer and demonstrated by Russia.

A highly complex progressive tax system costs as much as 62 per cent of actual taxes received by government. While wealthy countries may be able to afford this waste, South Africa cannot. Our developing economy has too many serious socio-economic problems to resolve and should seek to cut waste to a minimum. As demonstrated by the Eastern European countries, and by Hong Kong which introduced a low flat tax many decades ago, increased economic efficiency, reduced compliance costs and lower tax rates have substantial positive effects on economies.

Many newspaper columns have been filled with reports on tax evasion and how SARS is dealing with the issue. Yet the evidence shows that the best way to reduce tax evasion is to reduce the tax rates. Taxpayers who are risk-takers will evaluate the risk of being caught against the benefit gained from tax evasion. As tax rates are reduced, more and more people will choose to pay the taxes rather than risk the penalties imposed on evaders.

An estimated 500,000 American lawyers, accountants and other professionals make a living out of U.S. tax laws. Even if South Africa's numbers are not in the same proportion to total population, we could still have in the region of 40,000 professionals living off the tax laws. Introducing a simple flat tax would allow these highly skilled people to do something more productive.

This is what Hall and Rabushka had to say about the costs in the US in 1995:

Total Costs

It's time to sum the figures. Direct compliance costs, both in filing and in buying expert advice, exceed \$100 billion. Direct tax-planning costs— consulting with lawyers, accountants, purveyors of tax shelters and financial planners— exceed \$35 billion. Revenue lost to the Treasury due to evasion exceeds \$100 billion. Distortions from pursuing tax-advantaged investments in the form of lost output may exceed \$100 billion. Finally, the lobbyists who inhabit Washington's K Street corridor probably cost the economy more than \$50 billion. Total individual and corporate income taxes for the 1993 fiscal year (October 1, 1992 – September 30, 1993) were about \$625 billion. How politicians of both parties have been able to enact two major tax increases since 1990, supposedly to reduce

future deficits, without first undertaking a complete reform of the current system must constitute one of the greatest political crimes of modern American history.

South Africa's tax system is not yet as complex as that of the U.S. but it is unfortunately moving in that direction. Tax systems should be adapted to accommodate citizens, rather than have the citizens change or incur high costs to accommodate the tax system. Hall and Rabushka propose an integrated flat tax that applies to both businesses and individuals but with separate half-page tax forms for the two types of taxpayer. All businesses, whether owned by companies, close corporations, partnerships, trusts or individuals would complete the same tax form. This is the kind of simplicity we need in South Africa to accommodate the thousands of emerging entrepreneurs who have great difficulty in dealing with the current complexity.

Tax equity can be maintained by exempting the poor from income tax. Exempting everyone from tax on the first part of income could do this. This way the poor pay zero and the wealthiest continue to pay the highest average rates. For example, if the exempted income is R60,000 per year and the tax rate 13%, a person earning R60,000 would not pay tax, on R100,000 the tax would be R5,200 (6.5%), and on R2 million it would be R252,300 (12.61%). The Hall/Rabushka system would be fair, broaden the tax base, improve incentives to invest, make tax evasion more difficult and less lucrative, increase economic growth, raise local investment by encouraging capital formation, create new jobs by increasing real wages and improving incentives to work, reduce interest rates immediately, encourage taxpayers to be more honest, and attract foreign investment.

Objections to a flat tax system can be expected from vested interests, including:

- Taxpayers that currently receive special privileges that reduce their taxes below the low flat rate.
- Tax lawyers, accountants and other professionals that earn high incomes from the complexity of the existing system.
- Tax experts hired by the state to deal with the current complexity and track down tax evaders.

Globalisation makes tax reform not only desirable but essential, especially for developing economies. The globalisation process consists of increased movement of goods, capital, technology, ideas and people across borders. Gone are the days when governments, firms, and organised labour could cosily ignore the rest of the world while providing citizens and consumers with below-average service at high cost. Competition for capital, both financial and human, requires countries to have attractively competitive tax systems. South Africa is not exempt and it is hoped that the Davis Tax Review Committee will put forward proposals for extensive simplification of the tax system and a reduction in tax rates.

Flat Tax References

Canterbery, Cook and Schmitt (1985) The Flat Tax, Negative Tax, and VAT: Gaining Progressivity and Revenue <http://www.cato.org/sites/cato.org/files/serials/files/cato-journal/1985/11/cj5n2-9.pdf>

Kopczuk (2012) The Polish business "flat" tax and its effect on reported incomes: a Pareto improving tax reform? <http://www.columbia.edu/~wk2110/bin/PolishFlatTax.pdf>

Hall and Rabushka (1985) The route to a Progressive Flat Tax <http://www.cato.org/sites/cato.org/files/serials/files/cato-journal/1985/11/cj5n2-6.pdf>

Mitchell (2007) The Global Flat Tax Revolution

<http://www.cato.org/sites/cato.org/files/serials/files/policy-report/2007/7/cpr29n4-1.pdf>

Browning and Browning (1985) Why not a True Flat Rate Tax

<http://www.cato.org/sites/cato.org/files/serials/files/cato-journal/1985/11/cj5n2-14.pdf>

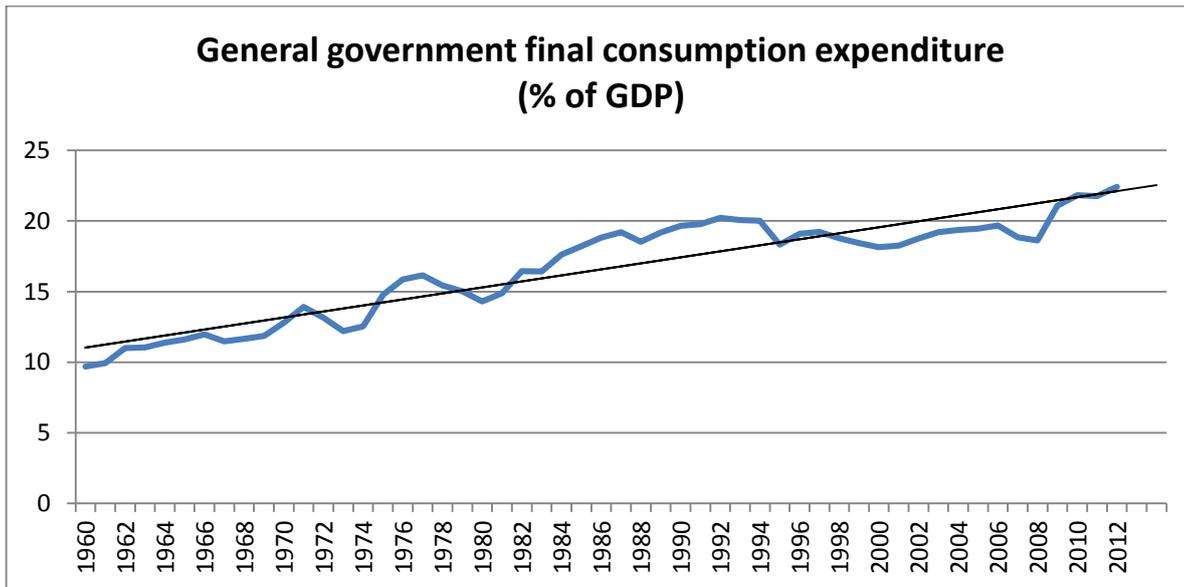
Duncan (2012) Economic impact of a “Flat” Tax. What have we learned from the Russian Experience?

http://www.indiana.edu/~spea/faculty/policy_briefs/duncan_economic_impact_flat_tax.pdf

Table: Countries that have implemented a flat tax rate

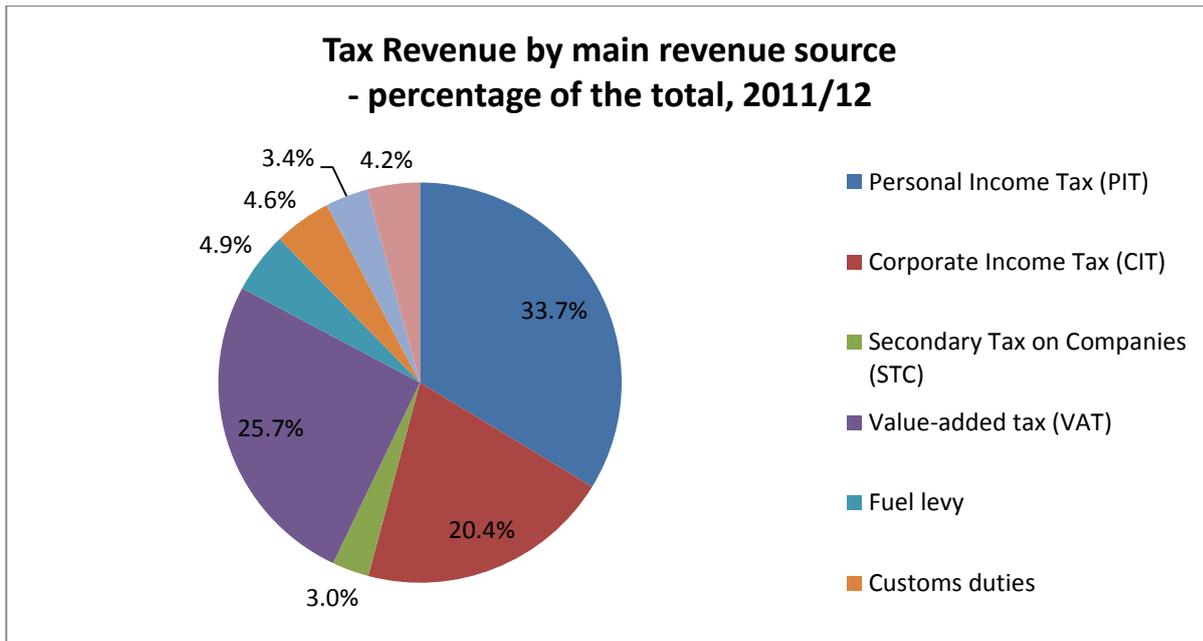
| Country | Flat Rate | Year implemented |
|------------------------|------------|------------------|
| Albania | 10 | 2007 |
| Andorra | 10 | 2011 |
| Anguilla | 3 | 2011 |
| Belarus | 12 | 2009 |
| Belize | 25 | 2009 |
| Bolivia | 13 | 2011 |
| Bosnia and Herzegovina | 10 | 2009 |
| Bulgaria | 10 | 2008 |
| East Timor | 10 | 2008 |
| Estonia | 21 | 1994 |
| Georgia | 20 | 2005 |
| Grenada | 30 | 1994 |
| Guernsey | 20 | 1960 |
| Guyana | 33.33 | 2010 |
| Hungary | 16 | 2011 |
| Iraq | 15 | 2004 |
| Jamaica | 25 | 1986 |
| Jersey | 20 | 1940 |
| Kazakhstan | 10 | 2007 |
| Kyrgyzstan | 10 | 2006 |
| Latvia | 25 | 1995 |
| Lithuania | 15 | 1994 |
| Macedonia | 10 | 2007 |
| Madagascar | 22 | |
| Mauritius | 15 | 2007 |
| Mongolia | 10 | 2007 |
| Montenegro | 9 | 2007 |
| Nagorno-Karabakh | 5 | |
| Romania | 16 | 2005 |
| Russia | 13 | 2001 |
| St Helena | 25 | |
| Saudi Arabia | 2.5 and 20 | |
| Serbia | 12 | 2003 |
| Seychelles | 15 | 2010 |

| | | |
|------------------------------|----|------|
| Slovakia | 19 | 2004 |
| South Ossetia | 12 | |
| Transnistria / Pridnestrovie | 10 | 2007 |
| Trinidad and Tobago | 25 | 2006 |
| Turkmenistan | 10 | 2005 |
| Tuvalu | 30 | 1992 |
| Ukraine | 15 | 2004 |



Source: World Bank

As an alternative to raising the bulk of income from personal income tax, which is economically destructive, costly to administer and liberty-destroying, the tax review committee should consider the introduction of user taxes. For example, South Africa's fuel levy is an appropriate means of taxation. However, the monies raised from the fuel levy should be ring-fenced into a dedicated fund and not form part general revenue. If the government wishes to raise revenue to fund the future expansion of the road network and for general road maintenance, the fuel levy is ideal because there is an almost perfect correlation between the amount of road use and the tax. Bigger and more road-damaging vehicles and those that drive more kilometres use more fuel. Rather than using revenues from an income tax to support general government expenditure, why not consider using more targeted taxes?



Source: *The National Treasury and South African Revenue Service*

If politicians had to propose a specific tax or fee to support each government programme they wanted, and if the tax had to directly relate to the spending, government budgeting would be sounder and less economically damaging.

South Africa can learn from the Chile experience. Chile pioneered a privatised and extremely successful social security program, which has been adopted in part or whole by 30-plus countries.

Conclusion

Most tax reform discussions and debates lead with the premise that any new tax system has to raise roughly as much, or more revenue as the present system. But that doesn't necessarily have to be the case. Currently, the South African government spends about 22 per cent of gross domestic product. This has steadily increased from a low of 9.7 per cent in 1960 (see Graph above).⁵ But a hundred years ago, total government spending was even less than 9 percent of GDP and most of the spending was done at the local level. As suggested at the outset, the most important approach to reforming the tax system is to give urgent attention to cut the expenditure side of the government budget so as to reduce the total tax required.

⁵ World Bank. World Development Indicators.

FMF Articles

- [A low flat tax will lead to investment, growth and jobs](#) by Jasson Urbach
- [Enslaved? Tax Freedom Day four days later than in 2012](#) by Garth Zietsman

Documents enclosed

- The Flat Tax System: A descriptive Analysis, Janet Pavey (2005)
- The Flat Tax (Second Edition), Robert E Hall and Alvin Rabushka (1995)

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