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VAT Policy Reform in South Africa: An Equitable Redress to Income Inequality

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University of the Witwatersrand, Johannesburg

Faculty of Commerce, Law and Management

VAT Policy Reform in South Africa: An Equitable Redress to Income Inequality

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A research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce (specializing in Taxation)

Johannesburg, 2022

Declaration

I declare that this research report is my own unaided work except as indicated in the references and acknowledgements. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not submitted before for any other degree or examination in any other university.

_____

Sibongiseni Sharon-rose Mabunda

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Abstract

The purpose of this research report is to discuss how VAT reform can reduce inequality and bridge the gap between the rich and the poor. It comprises a review of quantitative and qualitative evidence and provides an overview of VAT as a consumption tax and its role in the economy and social equity.

> Anti-poverty policies are often evaluated in isolation from the taxes used to pay for them. If, however, taxes cancel out the benefits of transfers for many poor households, so that some poor pay more in taxes than they receive in transfers, the objective of these policies might be compromised.
>
> (Higgins & Lustig, 2016:63)

Features of an efficient tax regime, reform measures that improve redistribution and equity in optimal VAT reform, are discussed in this report.

Keywords: VAT Reform, Equity, Vertical Equity, Horizontal Equity, Inequality, Income Inequality, Taxpayer, Tax Burden, Income Redistribution, Tax Incidence or Tax Burden.

Concepts and Definitions

Decile – Van der Berg *et al.* (2007: 13) describe it as the division of a group into equally sized groups of ten.

Food poverty line – Statistics South Africa (STATSSA: 2021: 3) provides the inflation-adjusted national poverty line value for food poverty at R624. This refers to the amount of money that an individual will need to afford the minimum required daily energy intake.

Household – A group of persons who live together and provide themselves jointly with food and/or other essentials for living, or a single person who lives alone (STATSSA, 2009: 65).

Household expenditure – According to the OECD (2022), this is final consumption expenditure made by households to meet their everyday needs, such as food, clothing, housing (rent), energy, transport, durable goods (notably cars), health costs, leisure, and miscellaneous services.

Household income – STATSSA (2012: 31) defines this as income acquired for basic use per household; all receipts by all members of a household, in cash and in kind, in exchange for employment, or in return for capital investment, or receipts obtained from other sources, such as pension, etc.

Income redistribution – The OECD describes income redistribution as the relative reduction in market income inequality achieved by levelling the distribution of wealth or income in a society through transfer of income from the rich to the poor, by direct or indirect means, through the adoption of economic policies and strategies like progressive taxation to implement this phenomenon (Causa & Hermansen, 2017: 3).

Inequality – Refers to the distribution of income (Van der Berg *et al.*, 2007: 13)

Lower-bound poverty line –R890 per person per month (in April 2021 prices). This refers to the food poverty line plus the average amount derived from non-food items of households whose total expenditure is equal to the food poverty line (STATSSA, 2021: 3).

Poverty – Sen (1999: 346) describes poverty as the deprivation of capabilities rather than merely low income. STATSSA (2020) defines poverty in three categories: the food poverty line, the lower

bound poverty line, and the upper bound poverty line. About 20% of the South African population lives below the food poverty line, meaning they cannot afford food that meets a minimum calorie intake.

Poverty Line – Following the definition of poverty as the deprivation of capabilities, the poverty line should be set at the level of income that enables individuals to achieve certain capabilities, like education and active participation in life. The poverty line stipulates the level at which these capabilities are attained, making it possible to make the determination of those who are poor in the population. (Van der Berg *et al.*, 2007: 13)

Quintile – Van der Berg *et al.* (2007: 13) describe it as the division of a group into equally sized groups of five.

The poor - According to STATSSA (2009: 66), the proportion of the population living below a poverty line were considered poor.

Upper-bound poverty line – R1,335 per person per month (in April 2021 prices). This refers to the food poverty line plus the average amount derived from non-food items of households whose food expenditure is equal to the food poverty line (STATSSA, 2021: 3)

Abbreviations and Acronyms

‘ANC’ means African National Congress

‘GDP’ means Gross Domestic Product

‘OECD’ means Organisation for Economic Co-operation and Development

‘SARS’ means South African Revenue Service

‘STATSSA’ means Department of Statistics South Africa

‘the Act’ means Value-Added Tax Act 89 of 1991

‘VAT’ means Value-Added Tax

Chapter 1: Introduction

1.1 VAT Policy Reform

Value-added tax (VAT) was increased from 14% to 15%, as announced in the February 2018 National Budget, effective from 01 April 2018. The increase in the VAT rate was part of a set of tax proposals designed to increase revenue collection in light of an estimated gross tax revenue shortfall of R48.2 billion for 2017/18. The set of tax proposals was expected to raise R36 billion in the 2018/19 financial year. The largest contribution to the increase in tax revenue was VAT at R22.9 billion. Public spending was also revised to balance new spending commitments (e.g., free higher education and training for poor and working-class households) and an increase in social grants, with the poor revenue outlook. The budget deficit for 2017/18 was estimated at R 204.3 billion which was 4.3% of Gross Domestic Product (GDP). The shortfall was the difference between budgeted and revised estimates of tax revenue. (Roos *et al*., 2019: 90-91.)

The increase in VAT rate would subsequently raise the tax on the poorest 50% of households by an estimated R1.8 billion or an average of R216 per household per annum (National Treasury, 2018c: 7). As Grown and Valodia (2014: 1) argue, whilst VAT is a central feature of fiscus revenue in over 125 countries, and its use is pervasive by governments as a means to generate public funding, there remain important questions of equity.

1.2 Mitigatory Measures

Zero rating is a VAT policy objective by government that is part of a fairly comprehensive macroeconomic framework aimed at alleviating poverty and lowering the degree of income inequality intended to indirectly target poorer households, for whom food and other household expenditures may take up a large proportion of their total budget (National Treasury, 2018c: 10). If a good or service is zero-rated, then it is subject to VAT, but the VAT rate is 0%. Exemption is different; if a good or service is exempt, its production is in effect ignored completely for VAT, with no VAT charged on sales or credited on inputs. It means that sales are not subject to VAT but, in contrast to zero-rating, the firm cannot reclaim the VAT paid on its inputs. (Mirrlees, 2011a: 171-174.)

Appendix 1 to this research report details all food items which, in terms of s 11(1)(j) of the Value-Added Tax Act 89 of 1991, are to be taxed at a rate of zero percent (0%). Examples include dried beans, samp, and maize meal. Appendix 2 to this report details the goods and services of the Act that shall be exempt from the tax imposed under s 7(1)(a).

Arising from a report of the Standing Committee on Finance and the Select Committee on Finance (compiled after public hearings) and the statement of Cabinet of 28 February 2018, the Minister of Finance, through the Davis Tax Committee, appointed a panel of independent experts (from here on referred to as the 'VAT Panel') to consider and review the list of zero-rated food items. The outcome was a report detailing a set of recommendations on zero ratings titled *Recommendations on Zero Ratings in the Value-Added Tax System* (National Treasury, 2018b). During his 2018 mid-term budget speech, Minister Tito Mboweni announced that the zero-rated list would be expanded to include three more items, enlisted below, from 01 April 2019 (National Treasury, 2018b):

- sanitary pads;
- bread flour; and
- cake flour.

Two types of costs, identified by the VAT Panel, were imposed on the state as an outcome of zero rating, namely:

- the loss of tax revenue from higher income groups; and
- the cost of the administrative burden. (National Treasury, 2018b: 20.)

The revenue loss associated with zero rating these additional commodities was estimated at R1.2 billion but deemed a necessity by National Treasury as a means to target low-income households (National Treasury, 2018b).

In its review, the VAT Panel determined that zero-rating, as a tax relief, resulted in the reduction of VAT in the tax paid by *all* households, not just poorer households, thereby making zero rating a blunt instrument in the pursuit of equity objectives. Zero rating, according to the VAT Panel, is a non-targeted subsidy and benefited those that belong to the higher end of the expenditure distribution, i.e., those who consume the most in absolute monetary terms. (National Treasury, 2018b: 66.)

Roos *et al.* (2018: 94) echo this sentiment, in that all income earners benefit from an expanded list of zero-rated commodities and zero rating is not well targeted as a redistribution tool. However, showing that a zero rate is poorly targeted does not necessarily mean it is unjustified (van Oordt, 2018: 5).

The VAT Panel also acknowledged the challenge that some individuals did not live in households in receipt of social assistance, and so any increase in grant values would not mitigate the impact of the VAT increase:

> [F]or example, working-age adults who are either unemployed or have poorly paid employment and who do not live with children or older persons would be essentially excluded from the benefits of higher social grants.
>
> (National Treasury, 2018b: 71.)

Further to expanding the zero-rated list, the VAT Panel in its report of recommendations proposed alternatives to VAT zero rating that included food vouchers, low positive VAT rates and increases in all monthly social grants amongst other alternatives (National Treasury, 2018b: 67).

It was the view of the VAT Panel that the standard measure of redistribution through the state is the extent to which taxation and expenditure are progressive. As a result, the government has a role in ensuring greater equity both:

- in the short term, through tax policy and spending that favour low-income households, and,
- in the long run, by promoting an equitable economy in terms of opportunities, equality in remuneration, asset ownership and education. (National Treasury, 2018b:17.)

1.3 The Effectiveness of the VAT Instrument as a Source of Revenue

1.3.1 The History of VAT

From relatively inauspicious beginnings in the early twentieth century, VAT has been adopted by more than 150 countries and accounts for approximately 20% of worldwide tax revenue, becoming one of the most dominant revenue instruments within less than half a century across the world (OECD, 2012: 211–19).

The theoretical origins of the concept of VAT are usually given to two theoreticians, U.S. Treasury Department and Yale University political economist, T.S Adams and German businessman, Wilhelm von Siemens' writings in 1920 (Krever, 2008: 15). German businessman, Dr Wilhelm

von Siemens, proposed the VAT in 1918 as a 'refinement' or improvement to the German cascading turnover tax (Von Siemens, 1921: 14 – 18).

According to Mehrotra (2018), Adams' early writing on the subject of VAT began in 1921. Adams advocated for the administrative simplicity and economic efficiency of a national business sales tax. As a Tax Administrator, Adams had a vision of combining high-end progressive income taxes with a unique business tax on manufacturers and retailers capable of clear definition and successful administration. Adams wrote:

> In the case of producers and sellers of 'goods, wares and merchandise' further simplicity could be achieved by giving the tax the form of a sales tax with a credit or refund for taxes paid by the producer or dealer (as purchaser) on goods bought for resale or for necessary use in the production of goods for sale (Adams, 1921: 527-56).

This proposal was one of the first conceptual articulations of what is today known as a 'credit invoice' method of value-added taxation. For this pronouncement, Adams is regarded as one of the intellectual godfathers of the VAT. (Mehrotra, 2018: 6-7.)

1.3.2 VAT in South Africa

In South Africa, VAT was introduced in September 1991 to replace the General Sales Tax (GST) at a statutory rate of 10%; the rate increased to 14% in 1993 and to 15% in 2018 (Roos, 2019: 93).

The VAT was levied on a very broad base with few exemptions which included certain education and health services, financial services, and services of non-governmental organisations. Furthermore, certain commodities consumed mainly by low-income households were zero-rated. In 1996, pursuant to the Katz Commission recommendations, the VAT base was extended to include all fee-based financial services, with the exception of premiums on life policies, contributions to pensions, provident funds, retirement annuities and medical aid funds. (National Treasury, 2002: 9-10.)

VAT as a main component of tax revenue, contributed around 26% of total revenue to the tax mix and thus its widespread use requires broader examination of equity in tax (Grown & Valodia, 2014: 207). Furthermore, while taxes like VAT are often horizontally equitable, they remain vertically

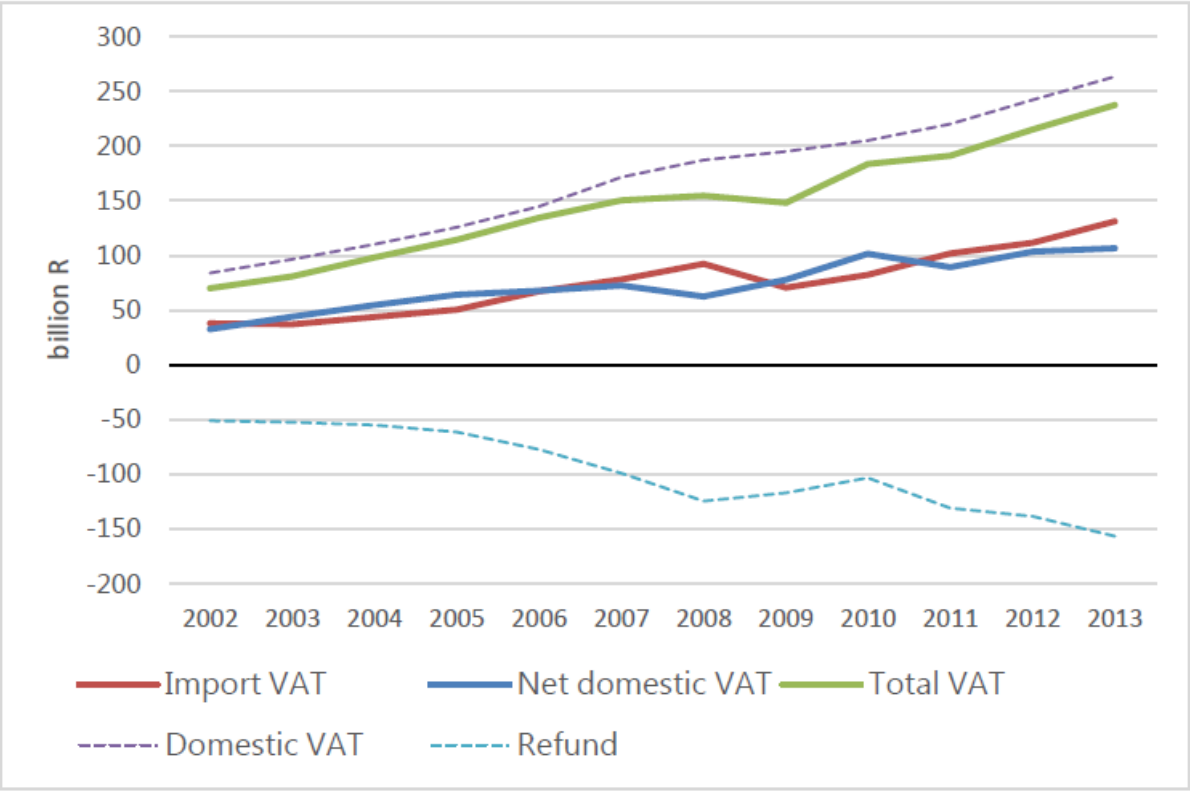
inequitable and important aspects, such as incidence, impact, and progressivity, need to be considered (Grown & Valodia, 2014: 14).

1.3.3 Revenue Performance and Success of VAT

The revenue performance of VAT in South Africa is analysed in terms of the VAT gap which comprises both the compliance gap and the policy gap. The Revenue Administration Gap Analysis Programme approach is used to estimate these gaps. The VAT compliance gap for a particular year is the difference between revenues actually collected and the potential revenues that could have been collected given the policy framework that was in place during that year. This policy gap is made up of two components: the *rate gap* and the *exemption gap*. The rate gap represents the loss in VAT revenue due to reduced VAT rates, and the exemption gap is due to certain goods and services being exempt from VAT. (Ueda & Thackray, 2015: 10 -24.)

In South Africa, VAT revenues increased in nominal terms from R70 billion to R238 billion between the 2002 and 2013 financial years, largely owing to economic growth and inflation, see Figure 1, below:

Figure 1: VAT revenues in nominal terms, 2002 - 2013



Source: Tax Statistics (NT and SARS).

Source: Ueda and Thackray (2015: 11)

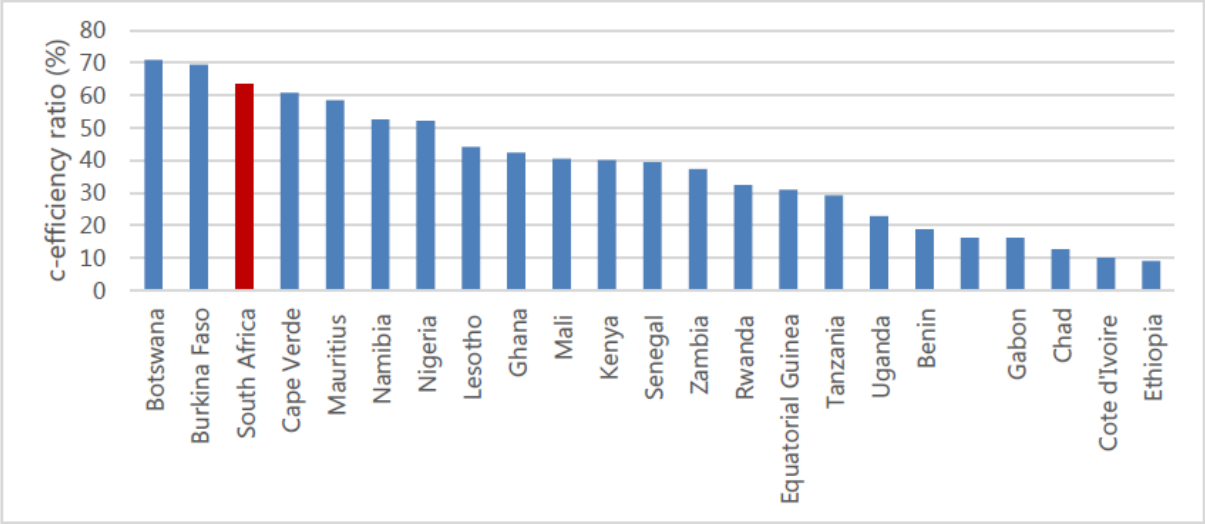
Total VAT revenues for South Africa are the sum of net domestic VAT which shows the difference between gross payments and refunds and import VAT collected by Customs during each year. Due to the high magnitude of imports relative to household final consumption in South Africa (50% on average between 2002 and 2013), import VAT collections are of a similar level to net domestic VAT. (Ueda and Thackray, 2015: 10.)

The c-efficiency is a general measure widely used to compare the overall performance and efficiency of VAT revenue collections of VAT systems. It can be calculated using VAT revenues, standard VAT rate and GDP final consumption aggregates. C-efficiency ratio is a rough estimator for the overall tax gap for a VAT (which is the product of the compliance gap and the policy gap). C-efficiency represents the ratio of actual VAT collections to the amount that would be collected

under a perfectly enforced tax levied at the standard rate on overall final consumption. (Ueda & Thackray, 2015: 12.)

The average of c-efficiency ratios in South Africa between 2007 and 2013 was 63.6%, which is relatively high, see Figure 2, below:

Figure 2: C-Efficiency Ratio in Sub-Saharan African Countries



Source: Ueda and Thackray (2015: 13)

The ratio suggests that the revenue administration in South Africa is relatively effective, compared to its peer countries. This result is among the highest in Sub-Saharan African countries over the same period and can be attributed to South Africa's limited number of exempted and zero-rated goods and services. It also means that room for additional revenue mobilization by improvement of tax compliance and expanding the tax base of VAT could be limited compared with other countries in the region. (Ueda & Thackray, 2015: 13.)

There are other ways in which the success of VAT systems can be measured, including, but not limited to:

- the measurement of net revenue they generate in absolute terms;
- the measurement of the taxes in terms of the proportion of total consumption;
- the extent to which they apply neutrally across business transactions;

- the proportionate and absolute amount of compliance costs they impose on business; and
- the cost of administering the taxes by tax authorities.

The overall effectiveness of a VAT system depends on its design and how it is translated into law. (Krever, 2008: 9.)

1.4 Research Problem and Sub-Questions

This research report outlines the effect of the recent VAT legislation amendments that have contributed to prevailing income inequality in South Africa. It looks at the government's dependency on indirect taxes like VAT as a central aspect of revenue generation and the cause-and-effect relation between an extremely unequal income distribution and regressive tax.

Furthermore, this research report studies the impact of the VAT legislation on low-income households in South Africa and discusses potential reforms that not only create an equitable redress to income inequality but alleviate the tax burden on the poor through direct and indirect redistribution. Indirect taxes are often regressive and make up a larger incidence of poorer household income; this means that a large portion of disposable income is spent paying VAT (Grown, 2014: 14). This research examines policy options that could counter the negative outcomes of VAT legislation.

1.4.1 Research problem

Which VAT policy reforms can South Africa pursue to achieve equity, promote income redistribution, and alleviate the tax burden on the poor?

1.4.2 Sub-questions

a) Who are the poor in South Africa?
b) What is meant by equity in tax and how can it be achieved?
c) What is the VAT burden on the poor and how can it be alleviated?
d) What is income redistribution and how can it be promoted?

1.5 Research Methodology

In order to satisfy the objectives of the research problem, qualitative research was undertaken using existing subject literature, including statistical analysis and information which was derived from

primary sources, including STATSSA, OECD, government policy documents, SARS, published books and journals on the subject matter that were examined to answer the research problem.

Following the VAT increase on 01 April 2018, the report aims to establish and review the effects that the increase has had on the poor and low-income households across various income deciles/quintiles as well as potential government policies that could achieve a better outcome in the pursuit of bridging income disparities and inequality, as expressed in the *National Development Plan* (National Planning Commission, 2011: 12). The research also considers policy reforms from other jurisdictions on the extent to which VAT policy could be more progressive and equitable. Sections refer to the VAT Act, unless stated otherwise.

The following falls outside the scope of this report and are not examined: other consumption taxes, such as specific excise duties, fuel levy, *Ad Valorem* excise duties and environmental taxes.

Chapter 2: The Poor and Income Inequality in South Africa

2.1 Introduction

This chapter examines poverty in South Africa and its link to labour market trends (wage and employment) that contribute to income inequality. Empirical evidence emphasizes the importance of dealing with unemployment and the ensuing household level income disparity to reduce high levels of poverty (Cingano, 2014: 6). The largest contributor to overall income inequality in South Africa came from the labour market at 74,2% (STASSA, 2019).

> Income inequality, deeply rooted in South Africa's history, plays a central role in overall income distribution, and patterns of human capital development are fundamental to the future growth path and therefore to poverty and income distribution.
>
> (Van der Berg *et al*., 2005: 2)

IMF studies describe income inequality, as measured by the Gini coefficient, as 0 when everybody has the same income and 1 when one person has all the income (Dabla-Norris *et al*., 2015: 6).

2.2 Characteristics of Poverty and Indicators

In 1997, a participatory study, referred to as the South African Participatory Poverty Assessment (SA-PPA) under the title, *A Difficult Life: The Perceptions and Experience of Poverty in South Africa,* was completed, the purpose of which was to provide a fuller and more integrated understanding of poverty from the perspective of those who were considered poor. The study detailed the experiences of the poor themselves and the indicators by which they perceived and evaluated their lives. The Participatory Appraisal methodology allowed for a discussion of social indicators, as analysed by communities and individuals, and provided new insight into the measurement of poverty, as seen by the poor. (May & Norton, 1997: 3.)

> The poor characterized their poverty as:
>
> - Alienation from kinship and the community: The elderly without care from younger family members were seen as 'poor', even if they had an old-age state pension (which provided an income which is relatively high by local standards). Similarly, young single mothers without the support of older kin or the fathers of their children were perceived to be 'poor'.
> - Food insecurity: Households where children went hungry or were malnourished were seen as living in poverty.
> - Crowded homes: The poor were perceived to live in overcrowded conditions and in homes in need of maintenance.

- Use of basic forms of energy: The poor were regarded as lacking safe and efficient sources of energy. In rural communities, the poor - particularly women - walk long distances to gather firewood.
- A lack of adequate paid, secure jobs: The poor perceived lack of employment opportunities, low wages and lack of job security as major contributing factors to their poverty.

(Woolard, 2002: 2.)

Chambers (1988: 9) distinguishes five dimensions of poverty:

- 'poverty proper' being a lack of adequate income or assets to generate income;
- physical weakness due to under-nutrition, sickness or disability;
- physical or social isolation due to peripheral location, lack of access to goods and services, ignorance or illiteracy;
- vulnerability to crisis and the risk of becoming even poorer; and
- powerlessness within existing social, economic, political, and cultural structures.

2.3 Who is poor in South Africa?

Woolard and Leibbrandt (1999) point out that most approaches to identifying the poor begin with the specification of a set of basic needs, wherein minimum levels for certain consumption items are specified (e.g., food, clothing, housing) and where an individual does not meet these minimum levels for each commodity, they are classified as being poor, however, there exists levels of consumption of food, clothing, and housing, below which, survival is threatened. The difficulty, they continue, arises where a person may be, for example, 'food-poor' but not 'energy-poor' making this a cumbersome measurement to use in practice. (Woolard & Leibbrandt, 1999: 8.)

The conventional approach to poverty measurement uses income estimates or consumption to construct measures of poverty's extent (Baulch, 1996: 36). Greeley (1994) argues that an absolute and objectively determined poverty line is the most appropriate means of measuring poverty. According to Greely, subjective perceptions of well-being fail to capture important dimensions of poverty as it confuses measure of poverty with measure of well-being and counting problems with concept problems. (Greely, 1994: 2.)

2.4 Poverty Lines in South Africa

Since 2004, the South African government has sought to establish a poverty line as the basis for presenting indicators of poverty in monetary dimensions. A poverty line is a monetary cut-off point

below which a person is deemed to be poor. A set of three pilot poverty lines were to be used by Statistics South Africa (STATSSA) in reporting monetary poverty statistics. A poverty line measure provides statistical standards and a systematic approach to reporting monetary poverty indicators. These include indicators of poverty levels (e.g., the headcount index, poverty depth) and inequality indicators (e.g., decile shares, the Gini coefficient). (STATSSA, 2008: 3.)

Living standards are closely correlated with race in South Africa. While poverty is not confined to any one racial group in South Africa, it is concentrated among Black Africans (Woolard, 2002: 2). According to the *Living Conditions Survey 2014/2015* approximately half (49,2%) of the adult population in South Africa were living below the upper-bound poverty line. Close to half (46,79%) of black African-headed households were in the bottom two income quintiles. The overwhelming majority (87,61%) of Black African-headed households were earning less than R71 479 per annum (roughly R5 957 per month or R199 per day). (STASSA, 2015: 21.)

> South Africa is known as one of the most unequal countries in the world, reporting a per-capita expenditure Gini coefficient of 0,67 in 2006, dropping to 0,65 in 2015 (the higher the coefficient, the higher the inequality)
>
> (STATSSA, 2019)

2.5 Income Inequality

2.5.1 Historical Context of Income Inequality

South Africa, with its high levels of racial inequality, has a particularly large and persistent inequality in income distribution. South African social indicators, such as, life expectancy, infant mortality or quality of education are closer to those of lower-middle income or even low-income countries. This reflects the unequal distribution of resources and opportunities. South African inequality, and even poverty, is commonly ascribed to racial discrimination and in particular, to apartheid. Colonial settlement followed by the mineral discoveries laid the basis for a highly dualistic economy that was from the outset, highly unequal. Racial discrimination under first British colonial rule and then apartheid distributed the spoils of economic growth along racial lines, which laid the foundation for privilege in a society stratified by race. (Van der Berg, 2010: 3.)

2.5.2 Income Inequality Explained

Income inequality in its simplest sense is usually defined as the 'inability [of an individual or household] to attain a minimal standard of living', where standard of living is measured in terms of consumption or income levels (Woolard & Leibbrandt 1999: 42).

In the *Living Conditions Survey 2014/5*, households were grouped and ranked into per capita income deciles. The richest decile represents households belonging to the upper 10% in terms of per capita income, while the poorest decile represents households in the lower 10% in terms of per capita income. The upper limit for an income decile 6 household in the data sets is R63,000 per annum (or approximately $7,400) for the entire household; the upper limit for income decile 7 is R96,000 per annum (about $11,300) and the upper limit for income decile 8 is R165,000 per annum (about $19,400). The social grant system mainly assists households in income deciles 2-7. There is limited support for households in the lowest income decile and it is primarily a result of households in this income decile receiving few old-age and disability grants. For South Africa, having one of the highest income inequalities in the world (World Bank, 2015) means that the difference in income disparity between income deciles is high at the top of the distributional scale and low at the bottom. South Africa also has a high concentration of low-income earners (the poor) and a few very high-income earners (the rich or elite), but only a small number of middle-income earners, resulting in a high level of income polarization and a narrow tax base. For a developing nation, income inequality at this level means that a household in income decile 6 or 7 could potentially be considered poor. (Van Oordt, 2018: 6.)

In their findings report, Causa and Hermansen (2017) observe that household incomes have become more unequally distributed in most OECD countries over the past several decades. According to Causa and Hermansen (2017), rising income inequality is driven by two factors, those being soaring top income shares and a tendency for lower incomes to fall increasingly behind relative to the rest of the population. They further note that while the extent, timing and characteristics of rising inequalities vary across OECD countries, a common feature in all of them is rising wage dispersion and job polarisation. (Causa & Hermansen 2017: 4.)

> [T]here is not one distribution of income but many: income is distributed across racial groups, income classes, present and future generations, and so on. Moreover, a given distribution is not a one-dimensional magnitude: it has as many dimensions or components as there are relevant 'classes' (Norman Bromberger, 1982: 166). (Van der Berg, 2005: 3)

2.5.3 Drivers of Income Inequality

The distribution of earnings harshly depicts the heavily racialized inequality in the South African labour market. High levels of unemployment and income inequality (or wage disparities) are attributable to labour market institutions and a rigid regulatory environment. Labour market incomes, education, gender, and race are important drivers of income inequality in South Africa. Income inequalities are further driven by low labour force participation (the number of persons in the labour force as a percentage of the working age population) and high unemployment. In addition to having the worst employment outcomes, Black Africans also earn the lowest wages when they are employed. The average real earnings between 2011 and 2015 amongst employed Black Africans was R6,899 (real earnings) per month. For Coloureds and Indians/Asians, the corresponding figures are R9,339 and R14,235 per month, respectively. Amongst whites, it was R24,646 per month, or more than three times as high as it was amongst Black Africans. (STATSSA, 2019: 61-62.)

A decomposition analysis (which is an analysis that identifies the main drivers of observed conditions) suggests race, education, and labour market income are the main contributors to the observed high level of income inequality. Labour market incomes were an important source of poverty reduction between 2006 and 2015. (STATSSA, 2018: xvi-xvii.)

2.6 Policy Initiatives to Reduce Poverty and Inequality

As discussed above, the major source of poverty and inequality in South Africa is the inability to obtain productive jobs. Poverty and inequality are closely linked to the general macro-economic environment. A decomposition analysis of inequality measures demonstrates that 80% of inequality between households results from inequality in access to wage income. Economic growth favours skilled and educated labourers; in a skills-hungry economy, less skilled labourers will experience widening income inequality. Given that inequality derives from the labour market, the likelihood that income distribution will improve as a result of social grants is limited. (Van der Berg, 2007: 39.)

The National Planning Commission is a government initiative responsible for developing a long-term vision and strategic plan for South Africa (South Africa, 2010: 4). The National Planning Commission was given its mandate in the Green Paper published in September 2009; later revised and issued in February of 2010. The National Planning Commission, an advisory body made up

of experts drawn largely from outside the government, drafted the *National Development Plan* which was later supported by all political parties at a special joint sitting of Parliament on 15 August 2012. (South Africa, 2010: 4.)

In the Foreword of the *National Development Plan*, undersigned by then Minister of the Presidency, Minister Trevor Manuel, it is premised that poverty elimination and poverty reduction are the impetus for the initiative's formulation. The *National Development Plan* asserts the need to integrate the Department of Trade and Industry's Industrial Policy Action Plan and the Economic Development Ministry's New Growth Plan into the new National Planning Framework. (National Planning Commission, 2011: 5.)

There has not been any significant progress in the implementation of the aforementioned objectives in the *National Development Plan*, however, challenges include political and ideological differences, insufficient rigour and detail on implementation and capacity to drive the agenda of the *National Development Plan*, which has been eroded by:

> [L]ooting of key state institutions, poor management in the public service, ineffective support to SMMEs, rising debt and collapsing confidence.
>
> (National Planning Commission, 2020: 5.)

2.7 Conclusion

The research herein indicates that South Africa shows particularly high levels of poverty and income inequality which are inherently tied to features of the labour market (paragraph 2.4 of this report). The labour market in South Africa suffers from a history of unequal access to jobs and pay disparities (paragraph 2.5.1 - 2.5.3 of this report); and while the democratic government administration has done much to reduce poverty and improvements in poverty measures such as the Gini Coefficient are evident; employment remains a pivotal bridge to access higher living standards for the impoverished people of South Africa (paragraph 2.6 of this report).

Chapter 3: The VAT Burden on The Poor

3.1 Introduction

Governments, the world over, face the issue of raising financial resources to reduce poverty and fund essential public services. Fiscal policy, including taxation, is at the heart of the debate on which services government should provide and who should pay for them. Over time, many countries have embarked on reforms of their tax systems, including reforms to broaden their tax bases and reduce the highest marginal tax rates, all of which has led to increasing reliance on broad-based value-added taxes (VATs) and reduced reliance on trade taxes. One of the cornerstones of tax policy, and central to tax reform efforts, is the issue of equity, along with issues of efficiency and ease of administration. A key challenge facing developing countries is the ability to generate sufficient public resources in a way that does not place an undue burden on the poor and marginalized. (Grown & Valodia, 2014: 1.)

In this chapter, the research report analyses studies from Grown and Valodia (2014), Inchauste *et al*. (2015), National Treasury (2018b) and others, on the incidence of tax or the tax burden on the poor. While Grown and Valodia's (2014) research focuses on the equity of taxes and the tax burden from a gender perspective, their analysis is still relevant for the purposes of this research report as it focuses on the contents of tax laws, equity dimensions and the incidence of taxation among the poor in developing countries, South Africa specifically.

> VAT can have important gender and age implications with women and the elderly more vulnerable to its burdens as these groups are often more severely impacted by poverty. Casale (2010) finds that 'female-type' households, defined by a variety of measures, in the lowest quintiles face a disproportionate burden from VAT. This is especially true for poor 'female-type' households with children.
>
> Njozela (2018:10-11)

It should also be noted that in some of the studies, a combined analysis on all indirect tax types, such as the fuel taxes and excises, is conducted and not only on VAT.

3.2 The VAT Incidence (Burden) on the Poor

3.2.1 Welfare Measures in Incidence Analysis and Methodology

There are two types of welfare measures used in tax incidence analysis, namely household income, and household consumption expenditure. There are arguments in literature about the best welfare measure to use in incidence analysis with some advocating that income is a preferred base for equity comparisons because income provides well-being whether it is spent immediately or saved for the future. However, studies of developing economies more often use household consumption expenditure. (Grown & Valodia, 2014: 33.)

In the studies analysed, data sets used for tax incidence analysis were sorted into quintiles and deciles based on per capita household income or household consumption expenditure; the methodology and measure is expounded for each study examined in this chapter.

Grown and Valodia (2014)

The consumption expenditure data used by Grown and Valodia (2014) to calculate the gendered tax incidence were drawn from the *Income and Expenditure Survey (IES) of 2000* which is conducted every five years by the national statistical agency, Statistics South Africa (STATSSA), among a nationally representative sample of 30,000 households. The survey contains granular information on the spending patterns of households, with data on almost 600 expenditure items. The tax rate and price information used to calculate the tax incidence per item comes from various government sources such as National Treasury; South African Revenue Service's VAT Guide for Vendors and monthly retail prices collected by Statistics South Africa for the year 2000. (Grown & Valodia, 2014: 216.)

To estimate the gendered incidence of indirect taxes (VAT, excise, and fuel levy), Grown and Valodia (2014) used three sets of household classifications; the first is based on the number of male and female adults (aged 18 years and older) in the household and includes three categories: adult male-majority households, adult female-majority households, and equal-number adult households. The second and third classifications take into account gendered spending power in the

household by adding the dimension of control over resources, measured through headship and employment status. (Grown & Valodia, 2014: 217.)

The results of the incidence analysis are presented in Table 1 (below) and report the overall tax incidence for the different household types using the three gendered household classifications:

Table 1: Overall indirect tax incidence by household type, South Africa (% of expenditure)

	Total tax	*VAT*	*Excise tax*	*Fuel tax*	*Distribution of individuals across household types (%)*
Household sex composition					
Adult male-majority	9.23	7.29	1.1	0.84	21.9
Adult female-majority	8.13	7.07	0.47	0.59	42.0
Equal-number adult	8.84	7.12	0.85	0.88	36.1
Employment categories					
Male-breadwinner	9.36	7.36	1.12	0.88	26.4
Female-breadwinner	8.14	7.05	0.45	0.64	21.6
Dual-earner	9.15	7.13	0.89	1.14	24.2
No-employed	7.84	6.99	0.49	0.37	27.8
Headship					
Male-headed	9.06	7.17	0.96	0.94	59.1
Female-headed	7.99	7.08	0.44	0.48	40.9

Source: Authors' calculations from IES 2000.

Source: Grown and Valodia (2014: 219)

Households that report being headed by women are concentrated at the lower end of the income distribution. In South Africa, 40% of individuals live in female-headed households, a far higher percentage than in other countries. Among other reasons, this is due to a high incidence of labour migration, particularly among men (resulting in the female in the household being reported as the *de facto* resident head), and relatively low levels of marriage and partnership. The female-type households and those with no employment tend to be among the less well-off, concentrated in the lower quintiles of the expenditure distribution. Total indirect tax incidence is lower in female-type households than in male-type households by 1%. The pattern of incidence among households with no employed members is similar to the pattern among female-type households, while the dual-

earner and equal-number adult households resemble the male-type households in their tax incidence. (Grown & Valodia, 2014: 218- 219.)

Table 2, below, depicts the incidence results for the employment status classification only, disaggregated by expenditure quintile and the presence of children (aged seventeen years or younger) in the household. Individuals were then sorted into quintiles based on per capita household expenditure. The household groups are ordered from rich (1) to poor (5) by quintiles of the population on the basis of a number of assumptions about who bears the final burden. (Grown & Valodia, 2014: 219 -220.)

For all four of the employment status household categories, *total* indirect tax incidence tends to fall most heavily on the middle quintiles, particularly quintiles 3 and 4, with the poorest quintile paying a smaller share of expenditure on tax than the richest quintile (Grown & Valodia, 2014: 223).

Table 2: Indirect tax incidence by employment status, presence of children and quintile, South Africa (% of expenditure).

Quintile	*Total tax*	*VAT*	*Excises*	*Fuel*	*Total tax*	*VAT*	*Excises*	*Fuel*	*Total tax*	*VAT*	*Excises*	*Fuel*
	Total male-breadwinner				*Male-breadwinner children*				*Male-breadwinner w/o children*			
1	8.17	6.98	0.85	0.35	8.13	6.97	0.81	0.35	9.36	7.25	1.85	0.26
2	8.95	7.4	1.08	0.47	8.88	7.38	1.01	0.48	9.77	7.6	1.85	0.32
3	9.64	7.78	1.24	0.62	9.61	7.83	1.15	0.64	9.82	7.51	1.77	0.54
4	9.92	7.53	1.31	1.08	9.77	7.54	1.12	1.11	10.22	7.51	1.67	1.04
5	9.36	6.97	0.99	1.4	8.83	6.64	0.65	1.53	9.84	7.26	1.29	1.29
Total	9.36	7.36	1.12	0.88	9.14	7.34	0.98	0.82	9.95	7.39	1.51	1.06
	Total female-breadwinner				*Female-breadwinner children*				*Female-breadwinner w/o children*			
1	6.9	6.27	0.29	0.33	6.87	6.26	0.29	0.32	8.36	7.03	0.59	0.74
2	8.2	7.27	0.52	0.41	8.2	7.28	0.52	0.4	8.18	7.08	0.58	0.51
3	8.72	7.59	0.49	0.64	8.78	7.65	0.47	0.66	8.36	7.23	0.61	0.52
4	8.73	7.43	0.53	0.77	8.83	7.5	0.55	0.78	8.41	7.19	0.47	0.74
5	8.08	6.41	0.41	1.25	7.87	6.19	0.4	1.28	8.37	6.73	0.43	1.21
Total	8.14	7.05	0.45	0.64	8.11	7.06	0.45	0.6	8.37	7.01	0.5	0.86
	Total dual-breadwinner				*Dual-earner children*				*Dual-earner w/o children*			
1	7.95	6.73	0.9	0.33	7.94	6.72	0.89	0.33	8.62	7.07	1.35	0.21
2	9.24	7.45	1.23	0.57	9.22	7.45	1.19	0.58	9.72	7.43	1.9	0.38
3	9.5	7.7	1.04	0.76	9.48	7.71	0.97	0.8	9.79	7.67	1.79	0.33
4	10.07	7.78	1.01	1.27	10.02	7.73	0.95	1.34	10.35	8.09	1.39	0.87
5	8.69	6.4	0.61	1.68	8.57	6.35	0.56	1.66	8.99	6.54	0.74	1.71
Total	9.15	7.13	0.89	1.14	9.11	7.14	0.86	1.11	9.39	7.02	1.03	1.33
	Total no-employed				*No-employed children*				*No-employed w/o children*			
1	7	6.39	0.39	0.23	6.98	6.38	0.37	0.23	7.66	6.48	0.97	0.21
2	7.82	7.12	0.44	0.26	7.83	7.14	0.43	0.26	7.76	6.84	0.72	0.2
3	8.56	7.63	0.59	0.34	8.56	7.7	0.51	0.36	8.54	7.34	0.93	0.28
4	8.96	7.67	0.72	0.56	8.91	7.87	0.42	0.62	9.01	7.46	1.04	0.51
5	8.72	6.73	0.56	1.43	8.76	6.59	0.32	1.85	8.71	6.77	0.62	1.32
Total	7.84	6.99	0.49	0.37	7.7	6.97	0.42	0.31	8.58	7.09	0.85	0.64

Source: Own calculations from IES 2000.

Note: Data are weighted.

Source: Grown and Valodia (2014: 220)

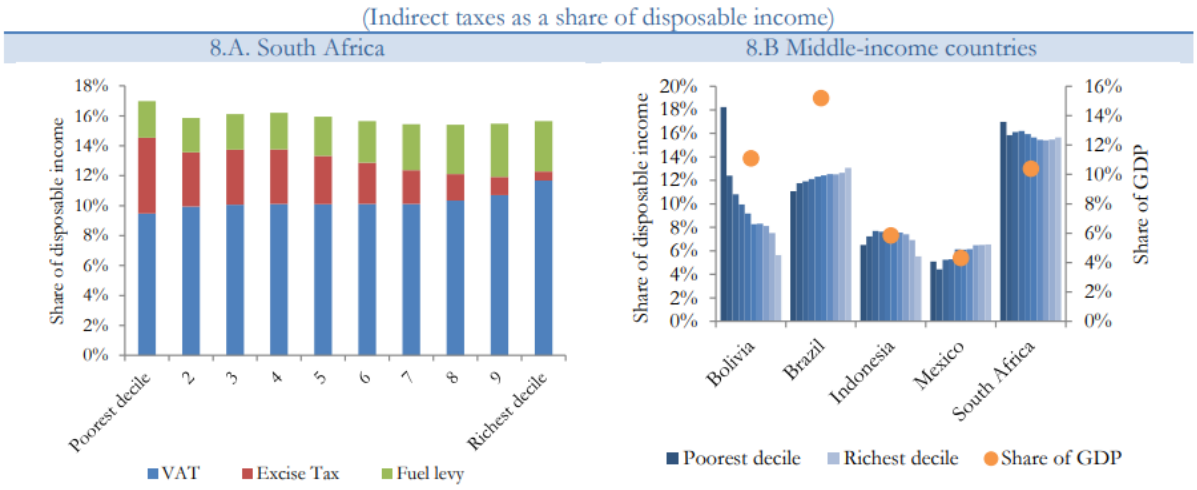
Inchauste et al. (2015)

Inchauste *et al.* (2015) also examined the incidence of indirect taxes (VAT, excise, and fuel levy), to determine who bears the tax burden and who benefits from social spending in their 2015 report. Their study, using data from the *Income and Expenditure Survey 2010/11* (STATSSA, 2012) assesses the incidence of all indirect taxes with respect to disposable income, in order of income deciles, and determine whether or not government taxes and spending are progressive. The *Income and Expenditure Survey* detailed consumption data that allowed for the estimation of the burden of VAT, the fuel levy, and specific excise duties on alcohol and tobacco. (Inchauste *et al*., 2015: 14.)

The study conducted by Inchauste *et al*. (2015) is known as 'fiscal incidence analysis'. Fiscal incidence analysis is designed to analyse the incidence of taxes (who bears the burden of taxation) and spending (who benefits from the various forms of social spending) (Lustig, 2017: 1). This chapter of the research report focuses only on the portion that is concerned with the incidence of tax or the tax burden.

Inchauste *et al.* (2015) assess the incidence of indirect taxes with respect to disposable income (i.e., share paid by disposable income decile). Disposable income comprises the sum of market (labour) income plus direct transfers, net of (after) direct taxes. Inchauste *et al.* (2015) make use of disposable income, based on the assumption that households make their consumption decisions taking into account government cash transfers as part of their income, and therefore consume much more than their market (labour) income would allow them to consume in the absence of these transfers. Households would therefore have paid much less in indirect taxes. The household groups are ordered from poorest (1) to richest (10) by deciles of the *Income and Expenditure Survey* data. (Inchauste *et al*., 2015: 18.)

Figure 3: Incidence of indirect taxes.



Source: Inchauste *et al.* (2015: 19).

Figure 3 (8.A), above, illustrates that the share of disposable income paid in VAT increases from just under 9.5% of the disposable income of the poorest decile to almost 12% of the disposable income of the richest decile. However, excise taxes on alcohol and tobacco tend to take up a higher share of the disposable income of the poorer deciles. The poorest decile pays about 4.3% of disposable income in such excises compared to 0.6% for those in the richest decile. This result is partly offset by the fuel levy, which makes up a slightly higher share of the disposable income of the top deciles, 0.03%, compared to 0.02% for the bottom decile. Figure 3 (8.B) shows the combined burden of indirect taxes in percentage of disposable income. The indirect tax burden is quite even across the income distribution compared to other middle-income countries. In comparison to Brazil and Mexico (Figure 3 (8.B)), the overall burden of indirect taxation increases more sharply with income than it does in South Africa. (Inchauste e*t al*., 2015: 19-21.)

Overall, the study conducted by Inchauste *et al.* (2015) indicates that indirect taxes as a whole are regressive[1] in South Africa. Up to the seventh income decile, the cumulative share paid of total indirect taxes exceeds their cumulative share of disposable income. VAT and the fuel levy are

[1] A progressive tax is where the average tax rate, or the total amount of tax paid as a percentage of income, increases as the taxpayer's income increases (Valera, 2016: 1).

progressive[2] due to zero rating of basic food items; this is due to the fact that the fuel levy is included in the price of fuel which in turn, is related to the input costs of purchasing of basic goods in the market. Excise taxes, in contrast, are regressive and the bottom deciles pay a substantially higher share of the total disposable income than their share of disposable income This is the result of the fact that the poor consume proportionately more of the so-called sin goods (e.g., excise on tobacco products; or duty on wine). (Inchauste *et al*., 2015: 18.)

Valodia and Francis (2018)

Valodia and Francis (2018) measured the incidence of VAT in South Africa for the richest decile in South Africa at about 12% of its disposable income (in other words, paying 12% of its disposable income towards VAT), and the poorest decile at about 9.5% of its disposable income (meaning, paying 9.5% of its income towards VAT). Valodia and Francis (2018) estimated, at the time, that the one percentage point increase in VAT, would result in a VAT revenue increase of about R22.9 billion. Income deciles 1-9 was projected to pay about R9.26 billion (43.34%), while decile 10 (the richest) was projected to pay R13,63 billion (56.66%). The poorest households, which spend R13,782 a year, will, after the VAT increase to 15%, pay R13,902 to buy the same basket of goods. The poorest people will pay an extra R121 a year in VAT, while the richest households will pay an extra R5,694 in VAT a year. The burden on the very poor will thus be about R10 a month. Households in the poorest decile spend 35% of total household expenses on food, compared to just 6% for the richest decile. (Valodia & Francis, 2018.)

National Treasury (2018b)

The study detailed below was conducted by the VAT Panel, herein referenced as National Treasury (2018b). The VAT Panel made use of the of 2014/5 conducted by STATSSA which detailed information on household expenditure on individual items by overall expenditure and income level. The *Living Conditions Survey* is nationally representative, with 27 527 households participating in the 2014/5 survey. (National Treasury, 2018b: 23-24.)

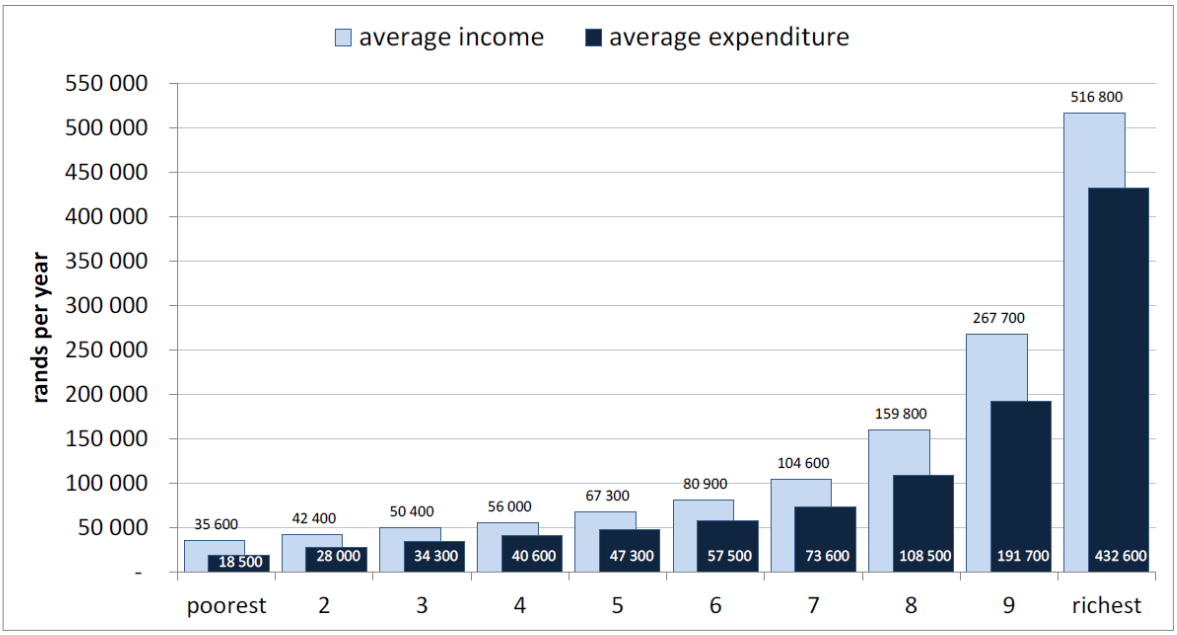
In its analysis, the VAT Panel considers the expenditure patterns of households across the income distribution and rank households from poorest (1) to richest (10) based on per capita household

[2] A regressive tax is the opposite, where the average tax rate, or amount of tax paid as a percentage of income, decreases as income increases (Valera, 2016: 1).

expenditure and divide them into ten groups of equal size (i.e., ten deciles). Expenditure is used (instead of income) to rank households as income is generally less accurately recorded in surveys of this nature. (National Treasury, 2018b: 25.)

Figure 4 (below) shows expenditure patterns by income decile; the richest 10% of households in South Africa accounted for over 40% of all household spending in 2014/5. The poorest 30% accounted for less than 10% of total household purchases in comparison.

Figure 4: Average household income and expenditure by decile, 2014/5

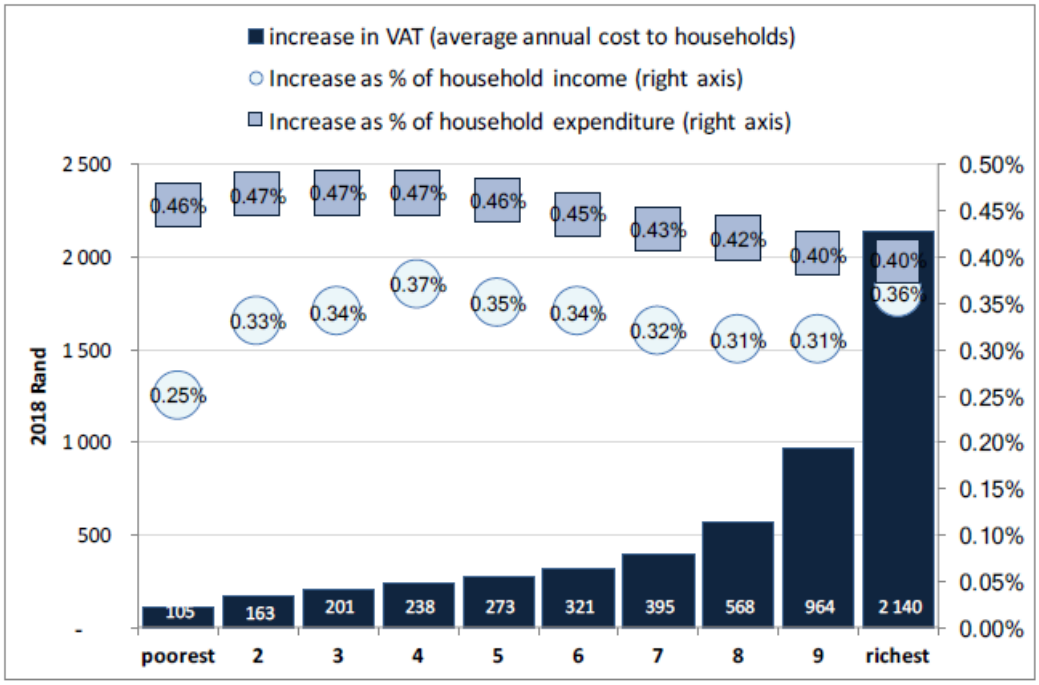


Source: Statistics South Africa. Living Conditions Survey 2014/5. Electronic database.

Source: National Treasury (2018b: 17)

Figure 5 (below) shows VAT incidence from the fourth to the eighth decile – that is, from incomes of around R40,000 a year to around R100,000 a year – as a share of income, the VAT increase has a lower impact on higher income households than on lower income ones. For this range of income levels, higher-income households (richest) pay more VAT in Rand terms, but that is still a lower share of their income than for lower-income households (poorest). (National Treasury, 2018b: 18.)

Figure 5: Incidence of the increase in VAT by household decile and compared to household income and expenditure



Source: Statistics South Africa. Living Conditions Survey 2014/5. Electronic database.

It follows that increasing the VAT rate with the existing system of zero rating places a heavy burden on low and middle income groups. International experience demonstrates that maintaining a strongly progressive tax system overall is necessary for economic equality in the long run.

Source: National Treasury (2018b:18)

Njozela (2018)

The study conducted by Njozela (2018) was originally prepared as background research to inform the submission to the VAT Panel made by civil society group, Budget Justice Coalition (BJC). Njozela's (2018) analysis is based on the *Living Conditions Survey* covering the years 2014 and 2015. Households were separated by per capita consumption expenditure deciles. These deciles were used as income data is often inaccurate as a result of under-reporting by survey respondents. Household consumption expenditure data is considered more accurate. The deciles were taken from existing variables in the datasets, as calculated by STATSSA. (Njozela, 2018: 11-12.) Progressivity/regressivity analysis is used which compares the relative amount spent by deciles on a particular item as a share of their total expenditure. Where the lower deciles (poor and lower-income households) spend a higher share than upper deciles (higher-income households) then

removing VAT from that item would be progressive, whereas adding VAT to that item (in the case of existing zero-rated items) would be regressive. Even where people do not live in poverty, the lowest seven deciles contain low-income individuals and households which should also be protected from the consequences of the VAT increase. The lowest seven deciles pay a negligible share of personal income tax and raising personal income tax is an alternative to increasing VAT – the lowest seven deciles are therefore poor or low-income, non-personal income tax paying households. (Njozela, 2018: 17-26.)

3.3 Assessing VAT Policy Reform and its Impact

3.3.1 The Impact of Zero Rating

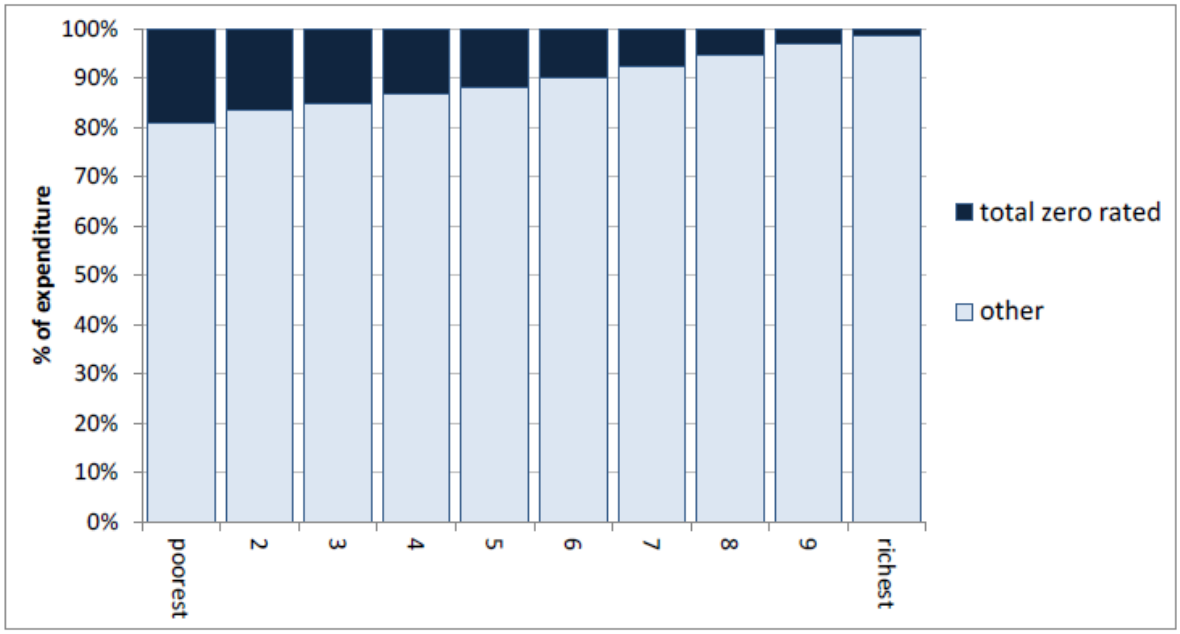
Zero Rating

The current list of zero-rated food stuffs is detailed in Appendix 1 in this report. Zero-rated supplies are taxable supplies on which VAT is levied at a rate of 0%. (SARS, 2019: 41.)

National Treasury (2018b)

Zero rating identifies goods and services that have the most progressive impact, but there are few products remaining that would improve the progressivity of VAT. Figure 6 (below) depicts the share of expenditure on zero-rated and other goods by decile, and clearly indicates that lower-income households spend more of their share of income on zero-rated goods than higher-income households:

Figure 6: Share of expenditure on zero-rated and other goods by decile, 2014/5



Source: Statistics South Africa. Living Conditions Survey 2014/5. Electronic database.
19

Source: National Treasury (2018b: 19)

South Africa's unusually deep income inequalities mean that the majority of households can be considered low income. The VAT Panel agreed that zero rating should be measured in terms of the benefits to the poorest 70% of households (deciles one to seven). (National Treasury, 2018b: 19.)

Njozela (2018)

The general test, which is a baseline measure, assesses whether poor and low-income households (deciles1-7, the lowest consuming 70% of the population) receive more than 70% of the benefits of zero rating. Njozela (2018) considered the efficacy of existing zero rating (which measures how well targeted zero rating is) and demonstrated that for approximately two-thirds of zero-rated items, the poorest 70% derived more than 70% of the financial benefits of zero-rating (Table 3). The total cost of zero rating outweighs the benefits. Zero rating would result in a loss of revenue

of R17bn rand in 2018 prices with R5.5 billion benefiting the poorest four deciles and R11.5 billion lost to the consumption by the richest six deciles. This indicates that zero-rating is, in general, an effective pro-poor measure. (Njozela, 2018: 15- 25.)

Table 3: Consumption of existing zero-rated items across decile groups

Consumption item	Deciles 1-4 (R mn 2018)	Percentage of total	Deciles 1-7 (R mn 2018)	Percentage of total
Rice	3 427	43%	5 851	73%
Brown bread	5 975	43%	10 593	76%
Mealie meal/Maize flour	8 250	54%	12 871	84%
Mealie rice	11	14%	32	41%
Samp	333	51%	546	84%
Beans dried	647	59%	930	84%
Lentils dried	9	22%	22	51%
Canned pilchards	1 130	39%	2 168	75%
Vegetables	7 867	31%	14 679	58%
Powdered milk	229	38%	443	74%
Sour milk/maas	1 004	45%	1 725	78%
Milk	2 042	20%	4 932	47%
Cooking fat (vegetable)	8	64%	12	91%
Edible oils (e.g. cooking oils)	2 411	45%	4 129	77%
Fruits	846	13%	2 099	32%
Eggs	1 591	28%	3 365	60%
Paraffin	786	56%	1 239	88%

Source: Statistics South Africa, Living Conditions Survey 2014/15. Own calculations

Source: Njozela (2018: 15)

3.3.2 Revenue Forgone as a Result of the VAT Increase

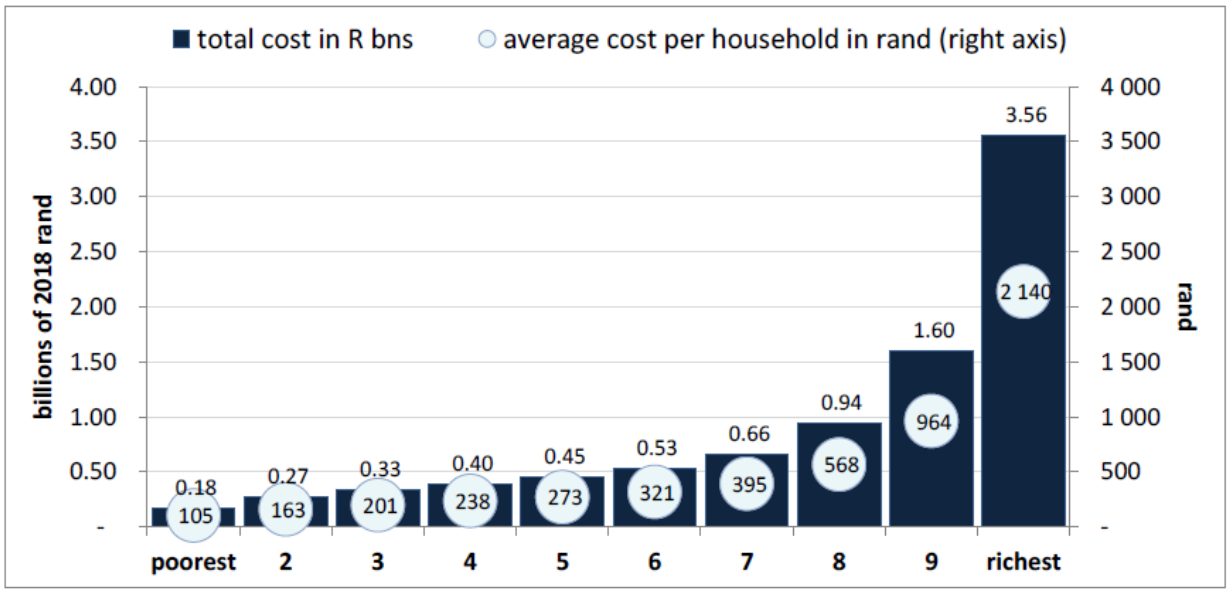
As an important instrument of revenue generation, Njozela (2018) considered the effects of expanding zero-rated items and the resultant revenue foregone. Njozela (2018) considered non-zero-rated items and computed potential VAT payments for each item by multiplying the items' value by 15/115. As indicated above, for all the identified items, zero-rating would result in a loss of revenue of R17 billion rand in 2018 prices with R5.5 billion benefiting the poorest four deciles

and R11.5 billion lost to the consumption by the richest six deciles. Only about 22% of the items benefit the poor more than they cost the state from foregone revenue (Njozela, 2018: 25-26).

3.3.3 The Tax Burden as a Result of the Increase in VAT

Based on the adjusted *Living Conditions Survey* data of 2014/5, the total cost of the VAT increase to the poorest 70% of households amounted to R3.1 billion in 2018, or an average of R267 per household per annum; for the poorest 50% the average cost was R1.8 billion or just under R216 per household. Figure 7 (below) depicts average increase by expenditure decile (National Treasury, 2018b: 66):

Figure 7: Cost of the increase in VAT by household expenditure decile, total and average per household (in 2018 Rand terms)



Source: Calculated from Statistics South Africa, Living Conditions Survey. Interactive database. Analysis of LCS data kindly supplied by Ada Jansen of Stellenbosch University.

Source: National Treasury (2018b: 66)

In monetary terms, the rich benefit more from zero rating than the poor, because they account for a much larger share of total spending. Even when the poor spend a larger share of their income on a good, zero rating usually gives high-income households more tax relief in monetary terms. For zero-rated goods, households in the poorest 10% spent around R830 million in 2014, while households in the richest 10% spent R1.3 billion in the same period. For goods that were not zero

rated, the poorest decile spent R3 billion, while the richest deciles spent R87 billion. (National Treasury, 2018b: 21.)

3.4 Conclusion

This chapter investigated the VAT burden on the poor, as well the efficacy of the targeted VAT policy objective by government, that is, zero rating. The research discussed herein shows not only that there is a considerable financial burden of VAT on the poor and low-income households (paragraph 3.2 of this report), but that applying the zero-rate reduces the financial VAT burden on the poor. It is also evident from the studies that a broader range of considerations should be applied when setting tax policy; social norms such as gender, employment, consumption patterns are important considerations when setting policy (paragraph 3.3 of this report). A gender analysis by tax incidence, for example, shows that women bear a greater tax burden than men in the same income decile simply based on consumption patterns. The experience and burden of poverty is not homogeneously shared by any one low-income group (paragraph 3.2.1 of this report).

Chapter 4: The Case for Equity in Tax

4.1 Introduction

In this chapter, the requirement for equity in tax is discussed, as well as the historical origins of equity as a principle of taxation (or principles of tax theory). The research report furthermore looks at reforms instituted by South Africa in its pursuit of a more equitable tax system.

4.2 What is Equity in Tax?

> The principle that similarly situated people should pay the same tax is referred to as 'equity'.
>
> (Sneed, 1965: 567)

Sneed (1965: 567) referred to 'equity' and to mitigating economic inequality as two of these principles of tax theory. Tax equity is commonly discussed according to two normative definitions of 'fairness'; that being horizontal and vertical equity (Grown, 2014: 8). The term 'horizontal equity' was coined by Musgrave (1959: 160) as being the equal treatment of equally well-off taxpayers. The term's common usage rose during the 1960s and 1970s (Elkins, 2006: 43).

The concept of a tax structure that imposes similar burdens on equally well-off persons was first mentioned by Simons (1938):

> [W]e may say that tax burdens should bear similarly upon persons whom we regard as in substantially similar circumstances (Simons, 1938: 30).
>
> [T]axes should bear similarly upon persons similarly situated (Simons, 1938: 106).
>
> (Elkins, 2006: 43.)

Pigou (1929: 61) differentiated between those principles of equality applicable to equally well-off individuals and those relevant to those unequally well-off individuals, i.e., between horizontal and vertical equity:

> [E]qual sacrifice among similar and similarly situated persons is an entirely different thing from equal sacrifice among all persons.

4.2.1 Horizontal Equity in Tax

The principal of horizontal equity demands uniformity in the tax burdens of similar people; this is generally accepted as a more significant trait of 'good tax' (Elkins, 2006: 43). Said differently, horizontal equity requires that taxpayers in similar financial positions pay the same tax (Vivian, 2006: 99).

'Horizontal equity' as a term (referring to equal treatment of equally well-off taxpayers) was coined by Musgrave (1959: 160):

> Perhaps the most widely accepted principle of equity in taxation is that people in equal positions should be treated equally.

'Horizontal equity' is defined as the measurement of any characteristic of a tax system that requires the use of the prior or pre-tax positions of taxpayers (Elkins, 2006: 43).

4.2.2 Vertical Equity in Tax

Vertical equity is concerned with the distribution of the tax burden along a socio-economic spectrum (Elkins, 2006: 51).

Berliant and Strauss (1985) define 'vertical equity' as any comparison of the after-tax income distributions generated by tax systems. They describe measures of vertical equity (or inequity) as essentially measures of after-tax income inequality. To describe the vertical characteristics of the tax system, they follow Wertz (1978) and group taxpayers into three:

- the fraction of taxpayers whose tax liability is progressively distributed,
- the fraction of taxpayers whose tax liability is proportionately distributed and
- the fraction of taxpayers whose tax liability is regressively distributed.

The concepts employed are obtained by making pairwise comparisons of relative income and effective tax rate positions. A comparison of two taxpayers shows progressivity when both the income and effective tax rate of one taxpayer are greater than the income and tax rate of another taxpayer. Proportionality occurs when the incomes of the two taxpayers being compared are different, but the effective tax rates are the same. Finally, regressivity is said to occur when one taxpayer has a larger income but a lower effective tax rate than the other in the comparison. (Berliant & Strauss 1985: 182.)

4.3 Classical Economists on Equity in Tax

References to equity made before the twentieth century were in the context of what is referred to today as 'vertical equity'. Classical economists, such as John Stuart Mill (1848), were considering the principle of equality when distributing the tax burden among those not equally well off. (Elkins, 2006: 43.)

Adam Smith (1776)

Adam Smith published *The Wealth of Nations*, which outlined the now widely codified principles of taxation (canons/maxims of taxation) which he considered essential for taxation not to alter the wealth of a nation:

> - The subjects of every State ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities—that is, in proportion to the revenue which they respectively enjoy under the protection of the State.
> - The tax which each individual is bound to pay ought to be certain and not arbitrary. The form of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the contributor and to every other person.
> - Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it.
> - Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. (Smith, 1776: 451 – 453.)

Vivian (2006: 84) explains that 'in proportion to their ability to pay' makes it clear that the point of departure is an individual's ability of bear the burden of taxation, which was the same departure point used by Montesquieu (1748: XIII.1) decades earlier:

> To fix these [state] revenues in a proper manner, regard should be had for both the necessities of the state and those [i.e., necessities] of the subject. Nothing requires more wisdom and prudence than the regulation of that portion of which the subject is deprived [by taxation] and that which he is suffered [permitted] to retain.

Vivian (2006: 85) further explains 'their respective abilities' implies that those who have no ability or limited ability to pay tax should not be subject to any tax, and in instances where they are, they carry a very limited tax burden.

Montesquieu (1689 - 1755)

Montesquieu advocates limited progressive taxation and with regard to a tax on persons:

> [A]n unjust proportion would be one that followed strictly the proportion of goods (*Spirit* XIII, 7, 216)

Montesquieu distinguishes between taxes on land, people, and commodities, with commodities tax being regarded as being the tax least felt by people as no formal demand for its payment is made. Montesquieu argued that each person had physical necessities (subsistence minimum) and only the needs that come after the basic physical need should be taxed. Thus, Montesquieu made a huge contribution to the public opinion embracing these social political measures. Progressive taxation, and considering the subsistence minimum, were crucial to a new ideal of equality. (Gribnau, 2021: 19.)

John Stuart Mill – 1848

Mill (1848) suggested the principle of proportionate taxation:

> 'Equality of taxation, requires to be more fully examined, being a thing often imperfectly understood, and on which many false notions have become to a certain degree accredited … For what reason ought equality to be the rule in matters of taxation? For the reason that it ought to be so in all affairs of government'
>
> (Mill, 1848:156)

These economists were of the opinion that if taxes are levied in proportion to the incomes of the individuals, it will extract equal sacrifice. Mill proposed an income tax on the basis of the principle of equal sacrifice of enjoyment. He also proposed a progressive inheritance tax and a variable land tax, regarding unearned income as a fit subject for a special tax. (Dome, 1999.)

4.4 Principles of a Good Tax System

Mirrlees *et al*. (2011b) outline the principles of a good tax system; a good tax system is one that:

- considers the whole system as a whole (system),
- seeks neutrality (neutral);
- and achieves progressivity as efficiently as possible (progressive).

Mirrlees *et al.* (2011b) refer to progressivity as redistribution between rich and poor taxpayers and how progressivity plays a central role in the tax system (albeit one where there can be a trade-off with economic efficiency). Furthermore, Mirrlees *et al.* (2011b) state that neutrality requires that similar activities are taxed equivalently unless there are good reasons to do otherwise, to avoid distorting taxpayer behaviour and creating opportunities for tax-avoidance; and lastly, 'system' emphasises that the way taxes fit together is what ultimately matters – the collective effect of each tax within the system. (Mirrlees *et al.*, 2011b: 333.)

Whilst reviewing the New Zealand tax system, the Tax Working Group (2019) considered options for reform in terms of six principles of a good tax system:

- the overall coherence of the system;
- efficiency and growth;
- equity and fairness;
- revenue integrity;
- fiscal cost; and
- compliance and administration costs.

Moreover, a good tax system, the group noted, should reduce uncertainty over future tax rates and the future application of tax bases. To achieve this, it must be, and be seen to be, both economically and politically sustainable. (Tax Working Group, 2019: 13.)

4.5 Equity and Tax Policy in South Africa

4.5.1 Margo Commission (1986)

During the apartheid years, the tax system contained several explicit elements of gender discrimination; for example, the tax schedules defined a 'married person' as male, with a separate category provided for 'married women'. Married persons (male) were taxed at a lower rate than unmarried persons (who could be male or female). (Grown & Valodia, 2014: 211.)

The reforming of South Africa's tax system began in 1986 with the Margo Commission of Inquiry into the Tax Structure of the Republic of South Africa, the aim of which was to remove any bias in the tax system. The Margo Commission was a more extensive reform programme of the then-apartheid government, which sought both to shift the economy on to more market-based principles and to incorporate segments of the Black population into the economic mainstream (Morris & Padayachee, 1988). One of the main recommendations of the Margo Commission, of specific importance to women, was that the unit of taxation for personal income tax be changed from the couple to the individual. The Commission also recommended a move towards a simpler income tax structure with fewer, broader income brackets and lower marginal rates. Many of the Commission's recommendations were accepted, but married couples continued to be taxed jointly – this provision has since been repealed and this no longer applies. (Grown & Valodia, 2006: 209.)

4.5.2 Katz Commission (1994)

Virtually all commissions of taxation in South Africa refer to the canons of taxation, including the Katz Commission (1994: s1.5.4). In 1994, a commission of inquiry was appointed by the then Minister of Finance, Trevor Manuel, under Professor Michael Katz, to examine certain aspects of the South African tax structure and instigate radical changes to South Africa's personal income tax system, based on the declaration of equality in terms of the Interim Constitution of the Republic of South Africa, Act 200 of 1993. (Vivian, 2006: 79-80.)

This appointment was part of the attempt by the new state to adopt a more developmental approach to economic policy, and to link taxation with issues of income distribution and poverty relief (Grown & Valodia, 2014: 209).

The Commission was tasked to bring about equity of taxation; a theory widely debated by classical economists. Since the canons of taxation, a foundation of discussion on principles of taxation, tax laws, tax policy and tax administration have emerged; traces of these canons are purported to have been applied by Commissions tasked to reform the South African tax system. (Vivian, 2006: 79-80.)

The adoption of the Interim Constitution of South Africa was widely believed to be ushering in a new non-discriminatory era. The Katz Commission was tasked to make recommendations that removed discrimination in the tax system. (Vivian, 2006: 91.)

The tax reform measures introduced between 1994 and 1999 can be grouped under three broad themes – constitutional, institutional, and specific policy changes. Since then, the Katz Commission has published nine interim reports. (National Treasury, 2002.)

According to the Katz Commission (1995), the success of a tax system depends, to a large extent, on its fairness. Prior to the new dispensation of 1994, South Africa followed the classical economists' measure of equality through a system of rebates. The Commission also recommended a unified rebate system. (Katz Commission, 1995: 4.)

In line with the recommendations of the Katz Commission, the South African government has introduced a number of tax policy changes since 1994. The Katz Commission made several recommendations to introduce non-discriminatory reforms. Some of the changes that relate broadly to gender equality include:

- the amendment of various tax laws in order to comply with the new Constitution, including the elimination of formal discrimination based on gender;
- the introduction a unified marginal tax table;
- the introduction of a unified income tax rate structure for individuals (i.e., eliminating the distinction between married and unmarried people, with its related difference in treatment of women and men in respect of marital status); and
- the introduction of tax relief for low- and middle-income taxpayers through adjustments to tax rates and income tax brackets. (Vivian, 2006: 93-105.)

Since 1994, the most significant change in the tax structure has been the reversal of the emphasis on direct taxation, established by the Margo Commission in the mid-1980s, in favour of indirect taxation. (Grown & Valodia, 2014: 209.)

Vivian (2006), however, levelled several criticisms at the Commission's work. He found that the Katz Commission did not compare the South African tax system to that of other jurisdictions, as was the norm with other Commissions, nor did it draw comparisons with previous South African Commissions. References to gender or marital status were simply removed from the Income Tax Act despite the fact that the Constitution did not deem references to marital status as discriminatory. According to Vivian (2006), the Commission had not, in fact, removed unconstitutional discrimination from the income tax system nor did it apply the principles of the classical economists; it merely stated words it found in the legislation that were discriminatory in its report. (Vivian, 2006: 91.)

Vivian (2006) elaborates further on the Commission's oversights which included, according to him, its failure to enquire on whether rebates had kept up with inflation. In his view, inadequate rebates violated the principle of 'necessities of life'; and if a rebate is inadequate, it fails to alleviate households from poverty. Rebates that adequately cover the 'necessities of life' are essential for tax equality. Moreover, Vivian (2006) found that the tax system lacked coherence structurally and conceptually, which was an indication of the absence of fixed principles. For example, as part of its recommendations, the Katz Commission found that rebates for children that had been in existence, encouraged large families. As a result, this rebate was repealed on the advice of the

Commission; and this meant government had and could, in future, underhandedly increase the tax burden on the poor. (Vivian, 2006: 91 – 92.)

The primary focus of Vivian's (2006) analysis was equality; the first canon of taxation. Vivian levels various criticisms of the Katz Commission recommendations which can be concluded as discriminatory in contrast to the principles designed by classical economists; and whilst the Commission rightly points out the Constitution prohibition of discrimination, the tax reforms recommended were contrary to the Commission's claims. (Vivian, 2006: 93 – 105.)

4.5.3 South African Women's Budget Initiative (1996)

Despite government commitment to eliminate gender disparities, the disparities persisted through the differential impact of the national budget on men and women, including not only expenditures, but also taxation. The first publication of the South African Women's Budget Initiative (1996) included several chapters on public expenditure from a gender perspective as well as the first study of taxation from a gender perspective (Hartzenburg, 1996). The studies reviewed, among other things, changes in personal income taxes, pensions and retirement funds, company taxes and value-added tax (VAT) in South Africa after 1994. The overall conclusion of the research was that while the new government had quickly addressed the explicit bias in the tax system, government needed to collect gender-disaggregated data on taxes and consider the subtler gender implications of its taxation policies. In 2002, the Women's Budget Initiative conducted a second study, which updated and expanded upon Hartzenburg's work in 1996, particularly with regard to capital transfer taxes, taxation of non-profit organizations, transfer duties, the fuel levy and the then recently set-up, national lottery. These studies reached similar conclusions with regard to the impact of taxation on gender equality, specifically, that although tax policies no longer explicitly discriminated against women, government needed to do much more to consider the gender impacts of its policies. (Grown & Valodia, 2014: 206-207.)

4.6 Conclusion

The history of the theory in taxation affirms the need for equity in taxation as a basic principle (paragraphs 4.1 and 4.2 of this report). While distributive justice and public finance provide important insights into what more equitable taxation might look like in practice, more needs to be done to promote equity in tax (paragraphs 4.5.2 and 4.5.3 of this report). Increasing revenue

collection without recognizing the implicit bias in tax policy, can undermine efforts to tackle poverty and inequality (paragraph 4.5.2 of this report).

Chapter 5: Redistribution of Income Through Tax Policy and Potential VAT Reforms for South Africa

5.1 Introduction

In this chapter, the role of tax policy in instituting income redistributive reforms is discussed. The research report examines social transfers in South Africa and the incidence of social spending and assesses its distributional impact against the policy instrument of zero rating. Furthermore, this chapter reviews and considers VAT systems and VAT policy reforms in the United Kingdom and New Zealand tax jurisdictions, and against this backdrop, considers appropriate reforms that promote redistribution and better target the poor and low-income households in South Africa.

5.2 Redistribution and Tax Policy

5.2.1 What is Redistribution?

> Redistribution is quantified as the relative reduction in market income inequality achieved by personal income taxes, employees' social security contributions and cash transfers, based on household-level micro data.
>
> (Causa and Hermansen, 2017: 3)

In other words, the transfer of wealth through social mechanisms such as land reform, tax, welfare, and public services (amongst others) (Causa & Hermansen, 2017: 3).

5.2.2 Redistribution Through Tax Policy

> Despite the prevalence of redistribution as a guiding motive in the design of tax systems in developing countries, poverty and inequality considerations have generally been of secondary importance.
>
> (Gemmel, 2002:1)

It has commonly been believed that public social expenditures provide a better means to target the poor and reduce poverty, with taxes viewed as essentially an instrument for revenue raising (Gemmel, 2002:1). The redistributive impact (progressivity) of a tax system is often judged by how much tax individuals or households pay relative to their income (Mirrlees *et al.*, 2011b: 23).

The main, direct, policy tool to reduce income inequality is via taxes and transfers (benefits); policies to reduce income inequalities should not only be pursued to improve social outcomes but

also to sustain long-term growth. Redistribution policies via taxes and transfers are a key tool to ensure these benefits. (Cingano, 2014: 6.)

The Katz Commission (1995) held the view that taxation should be addressed in a clear and strategic communication programme; that tax collection should not be perceived of as 'damaging' to the economy and that tax is collected in order to raise revenue to:

- assist economic growth and development; and
- fund the socio-economic programmes carried out as part of the redistributive function of government. (Katz, 1995: 4.)

5.3 Cash Transfers (Social Grants) in South Africa

South Africa has a very large system of cash transfers in the form of social grants. Social grants are targeted at categories of individuals who are unlikely to be able to provide for their own needs, namely the elderly, the disabled, and children. Accounting for 3.1% of GDP (or 10.2% of total consolidated government expenditure) in 2014/15, spending on social assistance in South Africa is very high by international standards. In 2009, the World Bank reported that South Africa's spending was roughly twice the median spending across developing economies. (Inchauste *et al*., 2015: 8-9.)

These cash transfers or social grants are in line with the mandate spelled out in Section 27(1) of the South African Constitution (South Africa, 1996), which states that:

> Everyone has the right to have access to […] (c) social security, including, if they are unable to support themselves and their dependents, appropriate social assistance; and
>
> The state must take reasonable legislative and other measures, within its available resources, to achieve the progressive realization of each of these rights.

Social grants in South Africa are classified as family and children grants (41.7% of all transfers), old-age grants (38.6% of all transfers), disability grants (19.2% of all transfers) and other grants (0.5% of all transfers). As at 2018, the time of collection of the data, 44.3% of households in South Africa received at least one social grant. (Van Oordt, 2018: 6.)

At the time of publication of Inchauste *et al.'s* (2015) study, a little over half of South Africa's total general government expenditure was dedicated to social spending with 3.3% of GDP allocated directly in cash transfers to individuals; this includes non-contributory pensions and child grants but excluding free basic services. Over the past decade, the number of beneficiaries receiving social grants doubled from almost 8 million in 2003/04 to 15.8 million in 2013/14, reflecting the expansion of direct cash transfers to children and the elderly. (Inchauste *et al.*, 2015: 6.)

Total general government spending in South Africa is higher than the average for middle-income countries. Total general government spending, excluding interest payments, amounted to 32.2% of primary government spending in 2010/11 (Table 4, below):

Table 4: South Africa: General government expenditure, 2010/11

	2010/11 (% of GDP)	Incidence analysis (% of GDP)
Total General Government Expenditure	**34.8**	**14.9**
Primary government spending	***32.2***	***14.9***
Social spending	*17.6*	*14.9*
Total Cash Transfers	3.8	3.8
Child Support Grant	1.1	1.1
Old age pension (non-contributory)	1.3	1.3
Disability grant	0.6	0.6
Foster care grant	0.2	0.2
Other grants	0.6	0.6
Free Basic Services	0.5	0.5
In-kind transfers	12.6	11.1
Education	7.0	7.0
Health	4.1	4.1
Housing and urban	1.5	…
Other social spending	1.1	…
Nonsocial spending (incl. public sector pensions)	14.6	…

Source: : Statistics South Africa, 2012b , "Financial Statistics of Consolidated General Government," November 22, 2012, for totals. Line items under direct and indirect taxes from 2013 Budget Review, National Treasury. For Free Basic Service, data represent the amount transferred under the equitable share formula for 2010/11 to municipalities to compensate them for providing basic services to poor households, and was provided by the Financial and Fiscal Commission of South Africa.

Source: Inchauste *et al.* (2015: 6)

South Africa's social government spending (as a share of GDP) is among the highest in the world; comparable against other 'big' social spenders, such as Brazil and Bolivia. (Inchauste *et al.*, 2015: 6.)

The number of social-grant beneficiaries had grown by 75% from 9.4 million in 2004/05 to 16.5 million in 2014/15, owing to the revised age eligibility rules of the child support grant (see Table 5, below). By 2014/15, around one in three South Africans was in receipt of a cash transfer. The old age pension is means-tested at a high threshold; thus, it reaches about 70% of age-eligible individuals. The disability grant is paid to working-age people who are unable to work because of chronic illness or disability. The cash transfer system includes three child grants. The child support grant (CSG) is the main poverty-oriented child grant available to all primary caregivers who pass a means test. The care dependency grants (CDG) is provided to caregivers of severely disabled children with intensive care needs. The foster child grants (FCG) is available to foster parents of children who have been found by the courts to be in need of 'care and protection' in terms of the Children's Act. (Maboshe & Woolard, 2018: 4-5.)

Table 5: Cash transfers, 2014/5 fiscal year

	Monthly value of grant (R)	Number of beneficiaries (thousands)	Annual expenditure (R millions)
Child support grant	315	11,677	43,428
State old age pension	1,350 (1,370 if over 75)	3,070	49,422
Disability grant	1,350	1,133	18,957
Foster care grant	830	478	5,851
Care dependency grant	1,350	138	2,259

Source: National Treasury (2015).

Source: Maboshe and Woolard (2018: 4)

5.4 Distributional Impact of Tax Policy and Transfers (Social Spending)

> Experience internationally indicates that in the long run, improving income distribution requires a strongly overall progressive incidence for taxation.
>
> (National Treasury, 2018b:8)

This section of the chapter discusses the income redistribution and poverty reduction effects of the direct taxes and social grants discussed in 5.3 (above).

Despite South Africa's high inequality (with strong racial dimensions) and poverty that continues to persist alongside prosperity long after the transition to democratic rule, South Africa has made progress in the reduction of the national poverty line, which fell by 57.2% to 45.5% between 2006 and 2011 using the national upper-bound poverty line of R620 per month. Progress towards greater income equality has, however, been elusive because of the enduring legacy of the apartheid system. The South African government has tried, through the Constitution (South Africa, 1996), to tackle the inequality inertia at its roots on several fronts, including most prominently through taxation and social spending. Owing to social grants, disposable income for the South African population grew between 1995 and 2005; without which two-fifths of the population would have seen its income decline in the first decade after apartheid. It is estimated that redistributive spending policies had undone about 40% of the increase in the market-income inequality (measured by the Gini coefficient), with the expansion of social cash transfers being particularly important. (Inchauste *et al.*, 2015: 2.)

The tax system in South Africa generates considerable resources for potential redistribution by middle-income country standards. South Africa relies relatively more on Personal Income Tax and less on indirect or consumption taxes, a desirable feature of its tax system in terms of equity as Personal Income Tax tends to be more progressive than consumption taxes (Inchauste *et al.*, 2015: 4).

5.5 Progressivity and Redistributive Effect in South Africa

South Africa uses fiscal instruments (or interventions), such as cash transfers or social grants, to significantly reduce market (or labour) income inequality and poverty through a progressive tax system and a highly progressive social spending programme. Inchauste *et al.* (2015) consider the poverty and redistributive effects of South Africa's fiscal instruments by examining each fiscal instrument at income level and 'map' the taxes and transfers from South Africa's national accounts and administrative fiscal data to individual members in households; this is done to measure the redistributive effect. Inchauste *et al.* (2015) make use of the 2010/11 *Income and Expenditure*

Survey (IES) data due to its exhaustive and granular data on household income, expenditures, cash transfers, and utilization of educational services collected from 25,328 households across the country over a period of 12 months. (Inchauste *et al*., 2015: 13.)

The outcome of the analysis by Inchauste *et al.* (2015) showed that direct cash transfers as a whole in South Africa are strongly progressive and progressive in absolute terms as well. The fact that transfers are progressive in absolute terms is of significance, especially in the context of South Africa because, given the very unequal market income distribution, even badly targeted transfers would turn out progressive in relative terms. (Inchauste *et al.*, 2015: 21.)

A standard way to measure the progressivity of a tax (transfer) is by comparing the cumulative distribution of their burden (benefit) with the cumulative distribution of market income; also known as the tax (transfer) redistribution approach (Inchauste *et al*., 2015: 11). Inchauste *et al.* (2015) analyse various fiscal instruments, such as free basic services, Reconstruction and Development Programme (RDP) housing, but for the purposes of this research report, the analysis is only on direct cash transfers.

Whilst South Africa may boast a higher social spending than other middle-income countries, spending more does not necessarily mean that the poor always benefit from redistributive programmes. Poorly targeted or designed social programmes often result in the benefits leaking to higher-income groups. (Inchauste *et al*., 2015: 20.)

5.6 VAT Reforms and Lessons from the UK and NZ

In considering reforms for South Africa, this section of the research report considers successful VAT reforms of the United Kingdom (UK) and New Zealand (NZ). The UK tax and benefit system as a whole redistributes significantly from high-income to low-income households. (Mirrlees & Adam, 2011a: 79.)

Birdman and Oldman (1990: 3) suggest that the best approach to tax reform is one that takes:

> [I]nto account a taxation theory, empirical evidence, and political, and administrative realities and blends them with a good dose of local knowledge and a sound appraisal of the current

> macroeconomic and international situation to produce a feasible set of proposals sufficiently attractive to be implemented and sufficiently robust to withstand changing times, within reason, and still produce beneficial results.

The introduction of both VAT in the UK in 1973 and its equivalent Goods and Sales Tax (GST) in New Zealand, in 1986 are consistent with the criteria for successful tax reform as described by Birdman and Oldman (1990). (James & Alley, 2008: 36.)

One of the features of reform identified above by Bird and Oldman (1990) was that a reform had to be 'sufficiently robust to withstand changing times' and this is evidenced by VAT and GST in that the way in which these taxes have developed, did not match the original arguments for their introduction. The main reasons for introducing VAT in the UK was due to a desire for a tax:

- that was broadly based;
- on consumption;
- that promoted harmonisation in Europe;
- that made a contribution to balance of payments policy; and
- that was self-enforcing.

In 1984, the NZ government had general consensus that:

- a switch from direct taxes to more indirect taxes was necessary;
- any package would need to be self-balancing;
- the reform package had to be seen to be fair;
- a new tax had to be simple to operate;
- the tax had to be broad-based to allow for a low rate; and
- the tax reform would see the end of wholesale sales taxes. (James & Alley, 2008: 39-40.)

Three reviews, for the purposes of reform, have been undertaken on the New Zealand tax system namely, the McLeod Review in 2001; the Victoria University of Wellington Tax Working Group (VUW TWG) in 2009-2010; and, the Tax Working Group (TWG) in 2018-2019, the details of which are discussed in 5.6.2.1 (White, 2020: 5).

The Mirrlees Review was a comprehensive review of taxes and transfers in the UK chaired by Nobel economics laureate, Sir James Mirrlees. The review was undertaken from 2006 to 2011 and

involved a multi-disciplinary, international team in a two-step process. The first process involved studies dealing with different aspects of the tax system and the second process entailed final conclusions regarding tax design and policy recommendations for the United Kingdom, both of which were published in two separate books. (White, 2020: 7-8.)

5.6.1 United Kingdom (UK)

VAT was introduced in the UK in 1973 at a standard rate of 10% and later reduced to 8% in 1974. A 'luxury rate' followed, effective from 1975 but subsequent to the introduction of the luxury rate, anomalies arose due to wide disparities between the two rates as well as complexities in administration. (Simon & Clinton, 2008: 37.)

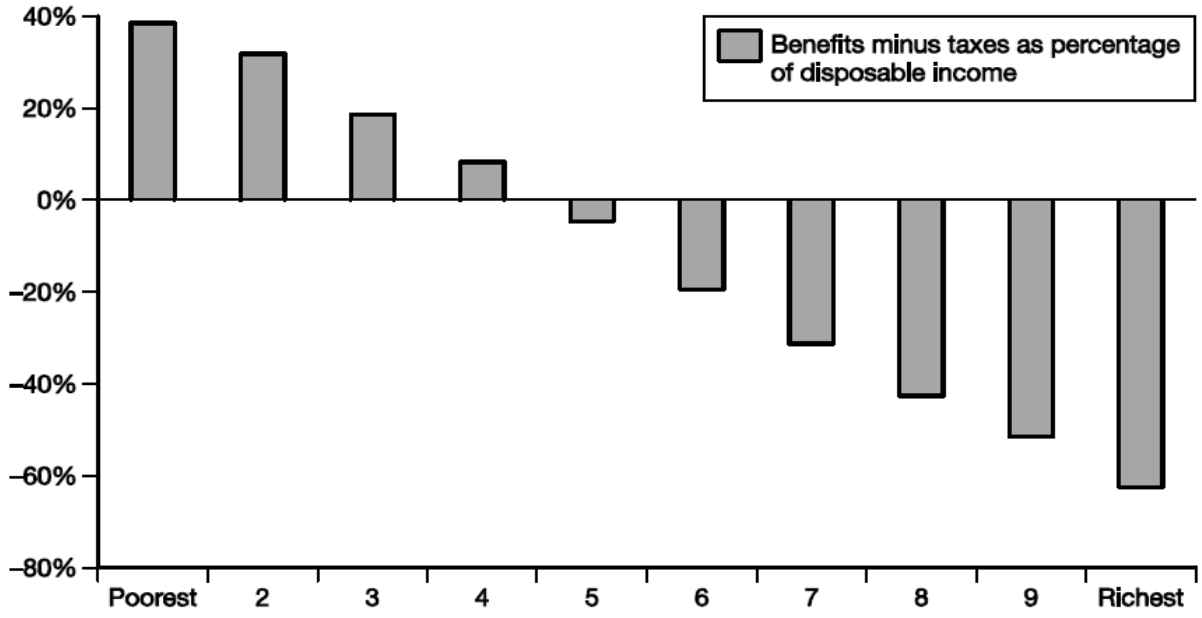
The basis for introducing VAT that were put forward were that it was a broadly based tax; a tax on consumption; that it promoted tax harmonisation; made a contribution to balance of payments policy and that it was self-enforcing. The UK Government's Green Paper proposing the introduction of VAT stated that the existing system had become too complex and discriminatory. It was intended to replace the existing 'system of indirect taxation by a more broadly based structure, which, by discriminating less between different types of goods and services, would reduce the distortion of consumer choice. (James, 2000: 74 -75.)

The VAT system in the UK uses differentiated rates; a standard rate of 20% on most goods and services, 5% reduced rate on some goods and services, such as, home energy and children's car seats and 0% on zero-rated goods and services, such as, children's clothes and some foods (United Kingdom, 2022). VAT raises nearly 30% of tax revenue in the UK (Mirrlees, 2011a :148).

In the report, Mirrlees and Adam (2011a: 153) examined the need for a singular tax rate on all goods and services for consumption, and whether or not there are good reasons for applying different rates to different goods and services.

The UK tax and benefit system as a whole redistributes significantly from high-income to low-income households. Benefits and tax credits are overwhelmingly important for the poorest households, making up 85% of the disposable incomes of the lowest-income tenth of households and steadily declining in importance further up the income distribution:

Figure 8: Distributional impact of the UK tax and benefit system in 2009–10



Source: Mirrlees and Adam (2011a: 79)

Figure 8, above, shows that the benefits of taxes in the UK make up nearly 40% of the disposable incomes of households in the bottom tenth of the income distribution. (Mirrlees & Adam, 2011a: 79.)

5.6.1.1. Problems with the UK VAT System

In their review, Mirrlees *et al. (*2011b) identify a host of failings in the UK VAT system, chief amongst which being the application of zero rating, exemptions, and reduced rates which, in their view, created a 'combination of administrative complexity, arbitrary distortions between different kinds of consumption and inequitable treatment of consumers with different tastes'. They argue that a narrow VAT base is not inevitable and that the cost of a narrow VAT base is large. Using a 17.5% standard rate of VAT, Mirrlees and Adam (2011a: 230) calculated that if zero and reduced rates are removed in the UK, the government could – in principle – compensate every household to leave them as well off as they were before paying VAT and still have approximately £ 3 billion of VAT revenue remaining. New Zealand, in their view, made for a great case study in the

application of a standard rate of VAT to almost all goods and services. *(*Mirrlees *et al.,* 2011b: 343.)

The exemption of housing in the UK rather than the levying of VAT on new properties when they are built (or when existing properties are sold), for example, was perceived as a missed opportunity for raising VAT revenue by Mirrlees *et al.* (2011b: 344-353). The existing VAT policy as a whole, also resulted in large administrative and compliance costs, and whilst there might be arguments for differential taxation to offset work disincentives, most of the potential gains were not sufficient to outweigh practical problems and the costs of complexity and distorting spending patterns (White, 2020: 7).

5.6.1.2. Proposed Reforms for the UK VAT System

Guided by economic theory, the evidence on the impact of taxes, the evidence on the distribution of incomes and the working of the economy, Mirrlees and Adam (2011a) proposed multiple VAT reforms to the UK VAT system; the first involves removing distortions in the system where substantial evidence exists that significant economic welfare can be achieved. Broadening of the VAT base where the singular (standard) rate of VAT is levied on a wider range of products and services results in less distortion in the buying decision and thus an increase in consumer welfare. (Mirrlees & Adam, 2011a: 230-231.)

Imposing a uniform VAT rate avoids interfering with the consumption choices people make between different goods (Mirrlees & Adam, 2011a: 149). A uniform VAT rate also avoids the complexities and political lobbying from various interest groups that are inevitable in a differentiated regime; it can reduce both the administrative and compliance burdens of the tax system (Mirrlees & Adam, 2011a: 154).

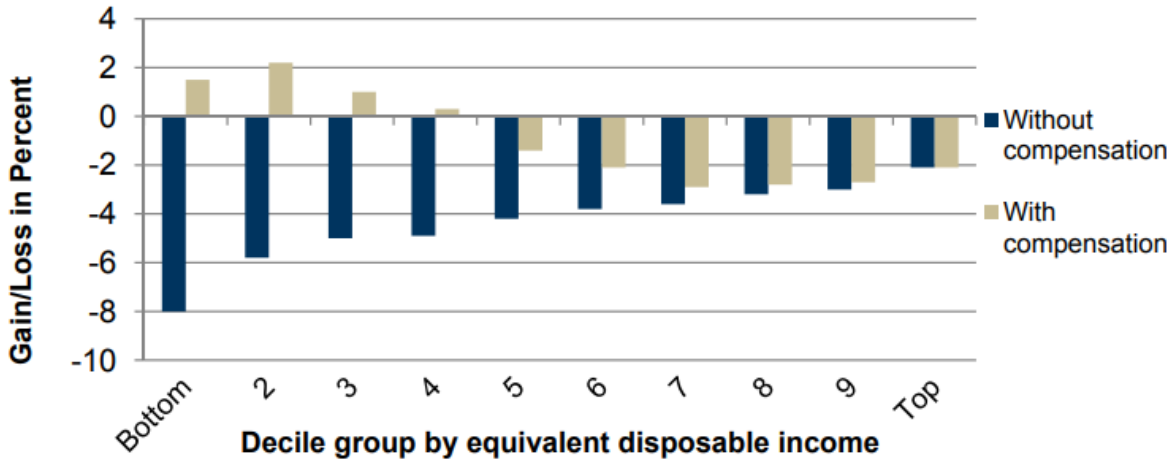
Further reforms tabled by Mirrlees and Adam (2011a) suggest the retention of a destination basis for VAT while ending the zero rating of exports, the introduction of a tax equivalent to VAT on financial services and the replacement of council tax and stamp duty land tax on housing with a tax proportional to the current value of domestic property, to stand in place of VAT on housing.

It is the view of Mirrlees *et al.* (2011b) that VAT is a poor choice of taxation as a means to achieve redistribution (Mirrlees *et al.,* 2011b: 343).

VAT, they argue, should be extended to all goods at a full rate with a benefit system to address the distributional effects of broadening the VAT base. They suggest zero rates should be restricted to a few specific services like childcare (which can be important in allowing parents to re-enter or remain in employment) and housing (the consumption of which could be taxed via a property tax rather than at the point of sale). (Mirrlees *et al*., 2011b: 353.)

The UK zero-rates a large part of consumption, including most foods. If these items were instead to be charged at the standard VAT rate, this would imply the regressive pattern of losses as shown by the dark bars in Figure 9 (below):

Figure 9: Removing zero rating in the UK, with and without compensation



Source: Crawford, Keen, and Smith (2010). Figures based on unifying VAT at 17.5 percent in 2005–06; compensation is by a 15 percent rise in means-tested social assistance and tax credits (and costs only around half of the revenue gained from eliminating zero-rating).

Source: Keen (2013: 7)

In other words, the proportion of income spent on food and other zero-rated items would decrease with the level of income, so the loss from taxing these commodities, as a proportion of income, is higher at lower income levels. But the UK also has a comprehensive system of income-related transfers, and the lighter bar shows that by using part of the revenue raised by eliminating zero-rating to increase these benefits, the losers from eliminating zero-rating can be more than compensated, while the government still enjoying a net revenue gain. (Keen, 2013: 7.)

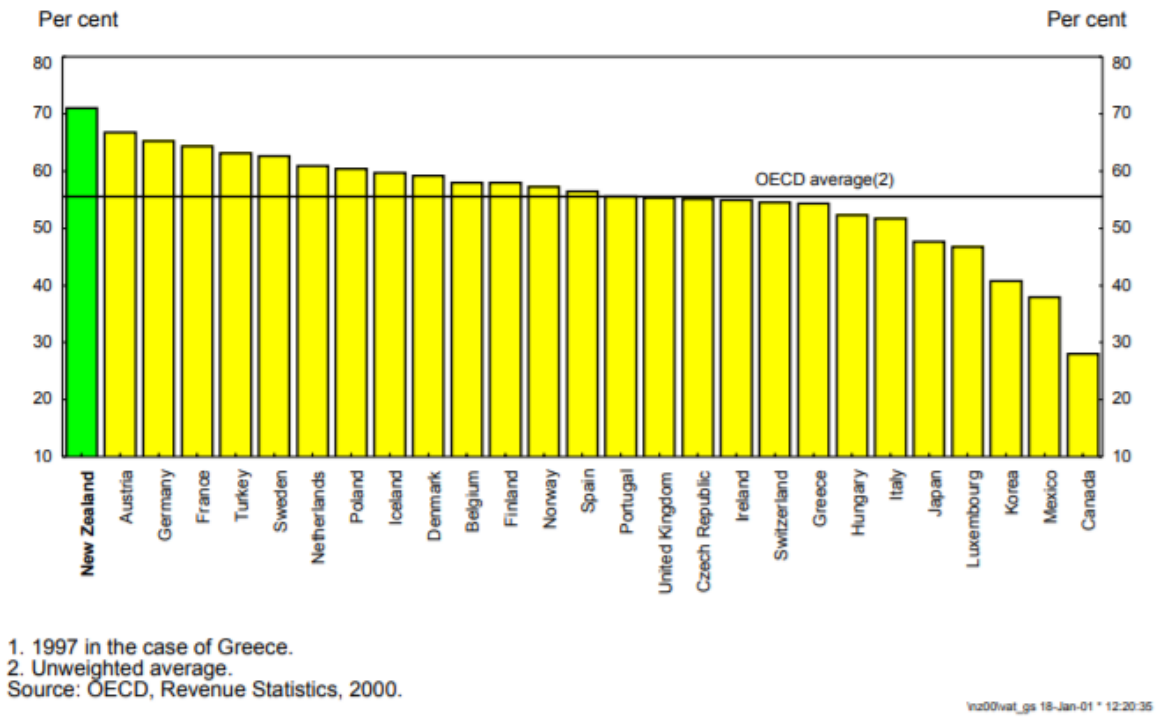
5.6.2 New Zealand (NZ)

New Zealand's general sales tax (GST), the equivalent of value-added tax, was introduced in 1986 at a 10% rate, and later revised to 12.5% in 1988 where it remained unchanged until 2010 where it was increased to 15% (Simon & Clinton, 2008: 37).

New Zealand GST law has become the model for modern VAT law. Lauded as the world's most efficient VAT system, it has spread across the English-speaking world, including Canada, Singapore, South Africa, and Australia. The 1986 New Zealand GST law follows the format and administrative structure of the traditional European VAT. The substantive rules of the New Zealand GST differed from those of the traditional VAT, as it sought to avoid the inefficiencies, complexity, and consequent losses that had become apparent in the European VAT by using a single rate and keeping exemptions to an absolute minimum. (Krever, 2008: 17-19.)

More than 50% of total revenue raised in New Zealand is raised from income taxation with consumption taxes just above one-third of total revenues, slightly higher than the OECD average. Consumption taxes are also raised more efficiently than elsewhere, since the share of total consumption tax revenue raised through value added taxes is the highest among OECD countries levying such a tax (as shown in Figure 10, below) (Dalsgaard, 2001: 8):

Figure 10: Share of value added tax in total consumption tax revenues in OECD countries 1998(1)

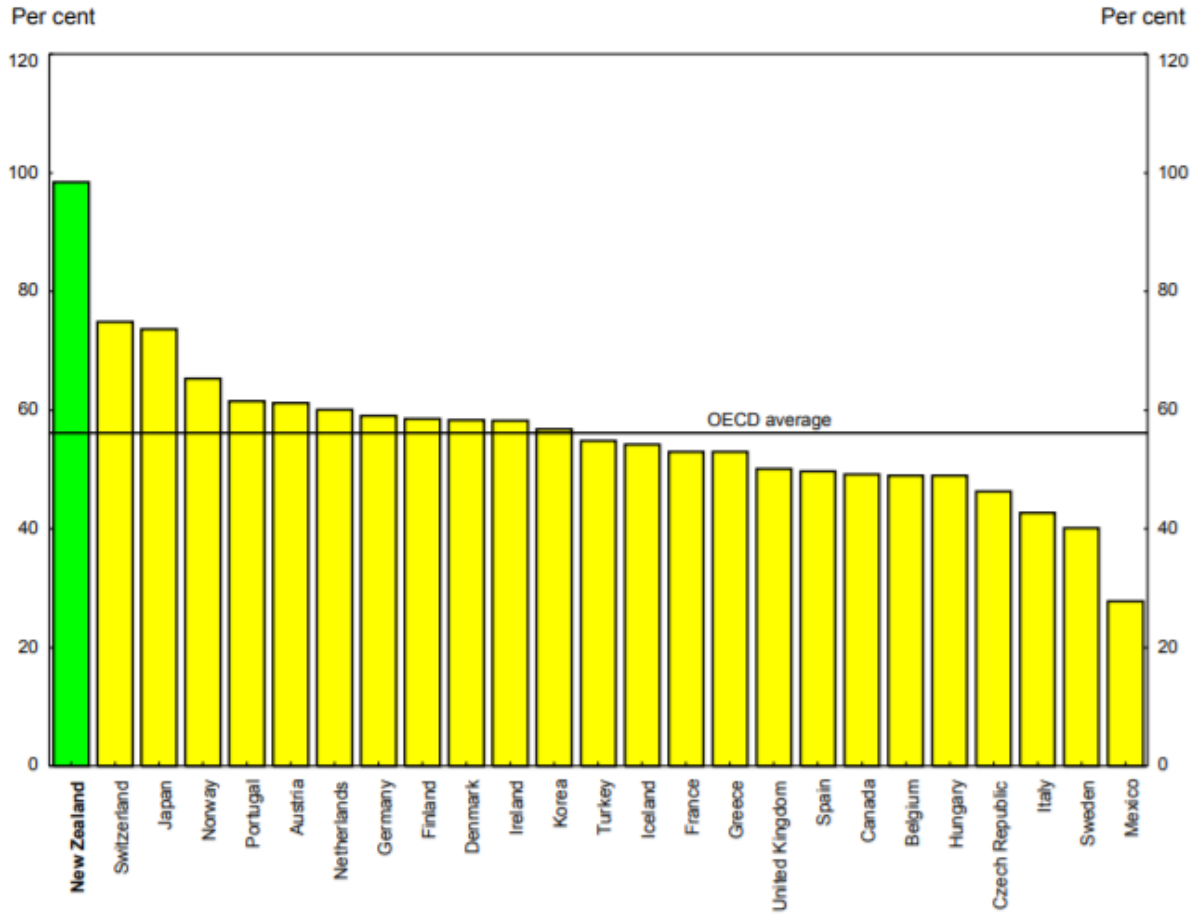


Source: Dalsgaard (2001:43)

> Tax policy in New Zealand is grounded within a coherent overall strategy, and changes to various parts of the system are generally scrutinised with a view to how these might affect the efficiency, equity and simplicity of the system as a whole.
>
> (Dalsgaard, 2001:5)

By imposing a single uniform rate, the New Zealand GST avoids the shortcomings of systems with multiple rates. New Zealand has also kept the level of exemptions to a minimum compared to other countries, leading to the highest degree of effectiveness of the value-added tax in the OECD (Figure 11, below) (Dalsgaard, 2001: 10-11).

Figure 11: Effectiveness of value added taxes in OECD countries 1998



Note: Effectiveness of the VAT is measured as the effective VAT rate as a per cent of the standard statutory rate, where the effective rate is VAT revenues divided by the potential VAT base (i.e. consumption minus VAT). The effectiveness of the VAT reflects the broadness of the VAT base and the level of compliance.
Source: OECD calculations.

Source: Dalsgaard (2001; 48)

5.6.1.3. Problems with the New Zealand VAT System

Despite New Zealand's GST system widely being acclaimed as being a soundly designed, world-class, value-added tax system the world over, New Zealand's overall tax system, including its GST, has been reviewed and reformed by its government since its inception more than 30 years ago, with three reviews and reforms having occurred in the last 20 years: The McLeod Review in 2001; the Victoria University of Wellington Tax Working Group (VUW TWG) in 2009-2010; and, the Tax Working Group (TWG) in 2018-2019. There was broad consensus across all three working

groups on the broad-base, uniform rate design of the New Zealand GST. The McLeod review did not propose any material reform arguing primarily that 'GST is roughly proportional to income for more than 80% of households' and came to the assessment that 'using multiple rates or exemptions to remedy concerns about regressivity would create other costs and anomalies likely to have worse impacts.' The McLeod review overall concluded that any envisaged increases in tax should be implemented via GST and reductions focused on income tax, as GST distorted economic decisions to a lesser extent than income tax. The Victoria University of Wellington Tax Working Group proposed material tax-mix reform: a shift away from income tax and rather towards GST and tax on immovable property; the group supported New Zealand reducing income tax rates to reduce the potential adverse impact on the overall tax structure and support economic growth over the short to medium-term. The government accepted many of the VUW TWG recommendations. From 1 October 2010, the standard GST rate was increased from 12.5% to 15%, all personal income tax rates were reduced and a GST compensation package for adversely-affected welfare groups was implemented. The third New Zealand tax review came from the government-appointed Tax Working Group which questioned the efficacy of GST exceptions in achieving distributional goals and the degree of pass-through of GST reductions to consumers. While the Tax Working Group acknowledged the regressivity of GST in their report, they did not recommend a reduction in rate or the introduction of exemptions. Instead, they noted that maintaining the 15% GST rate ensured that GST was collected from people, such as tourists, who would ordinarily not form part of the New Zealand tax base. The Tax Working Group also noted the significant compliance costs of GST exemptions and were of the view that welfare payments or personal income changes were more effective ways to increase progressivity than making changes to the GST. (White, 2020: 6.)

5.6.1.4. Proposed Reforms for New Zealand VAT System

According to White (2020:18), while the VAT system regularly requires maintenance, there exists a widely held sentiment that the New Zealand broad-base, uniform-rate design is a 'virtue' that should be retained; it remains a less costly way of raising revenue and other government instruments can be used to achieve distribution, well-being and other objectives.

5.7 VAT Reform in South Africa

Subsequent to the announcement of a 1%-point increase in the VAT rate from 14% to 15% effective from 1 April 2018, a number of alternatives to a uniform VAT increase were suggested by the VAT Panel, namely:

- the introduction of multiple VAT rates (e.g., higher rates on luxury goods);
- increase in personal income tax rates; and
- increase in corporate tax rates.

National Treasury did not deem it appropriate to increase Personal Income or Corporate Income Tax rates and felt that a VAT system with multiple rates would not improve equity in the VAT system; National Treasury is therefore opposed to a VAT system with multiple VAT rates as it would add significantly to the complexity and administrative burden of the tax. In the context of fiscal policy, simplicity of tax systems and efficiency is important, and equity and social objectives should be addressed via the expenditure side of fiscal policy (e.g., national school nutrition programmes or food stamps). (National Treasury, 2018c: 44.)

5.7.1 Proposals for VAT Reforms for South Africa

While Crawford *et al.* (2011) and Mirrlees and Adam (2011a) synthesize the optimal commodity (good or service) tax literature and advance the argument that income tax and direct transfers are much better tools to achieve distributional targets than indirect taxes; their recommendations were originally written for a developed country case. A developing country and transitional nation like South Africa cannot completely neglect distributional concerns when setting commodity tax rates, the case for their recommendations are weaker because developed countries do not necessarily have benefit (social grants) or transfer systems that pursue and champion distributional goals. In the case for South Africa, a better and uncomplicated transfer system is considered a more efficient distributive tool than differentiated commodity taxes. (Gcabo *et al.*, 2019: 2.)

The VAT reform proposals for South Africa in this research report draw on the works of Keen (2013), Van Oordt (2018) and Harris *et al.* (2018), inter alia, summarised by Gcabo *et al.* (2019) which examine the general conditions under which a uniform lump-sum grant, financed through the removal of zero-rating, leads to more redistribution. The VAT Panel similarly observed that:

> [I]t would be cheaper to return the cost of the VAT increase to the poorest households than to extend zero rating (National Treasury 2018b: 8).

Harris *et al*. (2018) demonstrate the return of this cost to the poorest households in practice by simulating the impact of introducing a universal basic income financed, in part, by a more uniform VAT rate in four African countries, namely Ghana, Ethiopia, Senegal, and Zambia. The results reveal that introducing a universal basic income would lead to lower-income inequality and poverty than what can be achieved via zero-rating.

Jansen and Calitz (2015) and Van Oordt (2018) consider the re-design of the benefit (social grant) system, which would allow compensation for both the recent VAT hike and the hypothetical removal of the zero-rating in a way that includes people who do not currently receive any grants (Gcabo *et al*., 2019: 3). Jansen and Calitz (2015) conclude that zero-rating (preferential VAT treatment) is a poor way of channelling resources towards low-income households. Although these preferential rates do reduce poverty, and sometimes by a significant amount, they are expensive and much of their benefit accrues to better off individuals (Jansen & Calitz, 2015: 16). Van Oordt's (2018) analysis assumes that all additional revenue from standard-rating previously zero-rated foodstuffs is used to increase social grants; empirical evidence in his paper, shows that removing zero rating improves the equity of the tax and transfer system (Van Oordt, 2018: 24).

5.7.1.1. Proposal 1: Removing Zero-Rating

Harris et al. (2018)

Harris *et al.* (2018) examine the distributional impact of VAT exemptions, reduced rates and direct cash transfer schemes using micro-simulation methods to estimate the impact of preferential VAT rates in four Low-Middle Income Countries (LMIC), considering their effect on revenues, poverty, inequality, and across the consumption distribution. The models were developed by researchers working in the Institute for Fiscal Studies' TAXDEV programme, the Commitment to Equity (CEQ) Institute and the World Bank for the countries in question. The models were used to:

- Estimate the distributional impact of existing VAT exemptions and reduced rates;
- Estimate the distributional impact of the main non-contributory cash and/or near-cash transfer scheme in place in each country; and

- Simulate the distributional impact of abolishing VAT exemptions and reduced VAT rates and introducing a Universal Basic Income using 75% or 100% of the VAT revenue raised. (Harris *et al*., 2018: 4.)

In the simulations, VAT exemptions are maintained on a few specific sectors where the administrative case for exemptions is strong: public services (including health and education) – this is due to data and administrative reasons that make bringing these sectors into the VAT system complex (Harris *et al*., 2018: 5-6).

The results from their analysis indicate, in particular, the conclusion that VAT exemptions and reduced rates, taken together, are not particularly well targeted at redistributing resources towards poorer households and furthermore that, if successfully delivered, a Universal Basic Income that utilised 75% of the revenues from broadening the VAT base would be more progressive and of benefit to approximately the poorest 50% of the population, on average, than existing VAT exemptions and reduced rates. (Harris *et al.*, 2018: 6.)

Jansen and Calitz (2015)

Jansen and Calitz (2015) studied the outcomes of a scenario where zero-rating was abolished, estimated the revenue gains from abolishing zero rating and reviewed whether zero rating could be replaced by an income support programme (Jansen & Calitz, 2015: 3).

Their results found that an estimated net fiscal gain of about R5 billion might be achieved by replacing all zero-rating with a compensatory targeted social assistance programme. Such a change, they conclude, would improve the after-tax income distribution of the poor without sacrificing poverty alleviation. (Jansen & Calitz, 2015: 21.)

5.7.1.2. Proposal 2: Broadening the VAT Base and Efficient Transfer Systems

Van Oordt (2018)

Van Oordt (2018) contends that nearly all VAT systems apply reduced rates, including zero rates, or exemptions to a list of food items that poor individuals consume; and that VAT as a singular regressive tax, coupled with a progressive transfer system, can result in a progressive tax burden

distribution. In his assessment, he states that equity concerns can be addressed more effectively through transfers than by reduced rates of VAT, specifically in a developing country. However, this is only true if governments are perfectly efficient in carrying out transfer policies. In the absence of efficient systems to facilitate transfers, i.e., when government is inefficient or unable to use transfer policies to fully offset the increased tax burden on the poor that arises if zero rating is eliminated, a zero rate on foodstuffs can be preferred on equity and efficiency grounds. The transfer system would be better targeted at ensuring distributional fairness than would the application of a reduced rate as the inefficiencies associated with applying the reduced rate would also be avoided. (Van Oordt, 2018: 2.)

Using South African data, Van Oordt (2018) applies the standard rate to different groups of currently zero-rated foodstuffs, coupled with various increases in cash transfers (called social grants). He considers how well the zero-rating of foodstuffs, and the social grant system of South Africa are targeted at assisting the poor. (Van Oordt (2018: 4.)

Van Oordt (2018), in his assessment, found that the social grant system mainly assists households in income deciles 2–7; with 1 being the poorest and 10 being the richest. There is limited support in the lowest decile (1) but this is primarily as a result of households in this income decile receiving

fewer old-age and disability grants Although not the focus his research, he notes that re-evaluation of the targeting of the social grant system should be on the policy agenda for South Africa. While he notes that the social grant system is not poorly targeted, it could be better targeted at assisting poorer households. (Van Oordt, 2018: 6).

The research conducted by Van Oordt (2018) investigated whether, in a developing economy, the zero rating of foodstuffs can be considered as an inefficient way in which income is used to pursue redistribution since these objectives can be better achieved through income support. Table 6 (below) provides a summary of Van Oordt's (2018) policy options for VAT reform.

Table 6: Policy options and aims

Policy options and aims

Number	*Policy option*	*Aim*
1	Standard-rate fruit and dairy; full increase in social grants	Increase equity, increase efficiency[a]
2	Standard-rate fruit, dairy, vegetables and fish; full increase in social grants	Increase equity, further increase efficiency[b]
3	Standard-rate all currently zero-rated foodstuffs; full increase in social grants	Increase equity, further increase efficiency
4	Standard-rate fruit and dairy; partial increase in social grants	Increase revenue, increase equity, increase efficiency
5	Standard-rate fruit, dairy, vegetables and fish; partial increase in social grants	Increase revenue, increase equity, further increase efficiency
6	Standard-rate all currently zero-rated foodstuffs; partial increase in social grants	Increase revenue, increase equity, further increase efficiency

[a]Efficiency increases due to both reduced economic distortion and reduced administrative and compliance cost.
[b]Theoretically, the efficiency of the VAT will increase further if zero-rating is eliminated on a greater amount of supplies.

Source: Van Oordt (2018: 15)

Using a 14% standard rate, Van Oordt (2018) estimated the following outcomes:

- After applying a standard-rate of 14% on fruit and dairy and a full increase in social grants, he estimated that VAT revenue will increase by R2 billion - a 1.62% increase in domestic VAT revenue. This translates into an increase of R20.13 per month (about $1.5) that could be added to each social grant paid;
- After applying a standard-rate of 14% on fruit, dairy, vegetables, and fish; and a full increase in social grants, he estimated an additional R4.05 billion in VAT revenue - a 3.29% increase in domestic VAT revenue. The additional revenue allows for a monthly increase in the value of social grants of R42.33 per grant (about $3);
- After applying a standard-rate of 14% on all currently zero-rated foodstuffs; and a full increase in social grants, he estimated an additional R8.62 billion in VAT revenue - an increase of 7% in domestic VAT revenue;
- After applying a standard-rate of 14% on fruit and dairy and a partial increase in social grants, he estimated an additional R1.54 billion in VAT revenue - an increase of 1.2%

in domestic VAT revenue); the partial increase in social grants is calculated as R7.80 per social grant per month (about $0.5);

- After applying a standard-rate of 14% on fruit, dairy, vegetables and fish and a partial increase in social grants, he estimated an additional R2.99 billion in VAT revenue - an increase of 2.43% in domestic VAT revenue; the partial increase in social grants is calculated as R14.35 per month (about $1); and lastly,
- After applying a standard-rate of 14% on all currently zero-rated foodstuffs and a partial increase in social grants; he estimated an additional R6.075 billion in VAT revenue - an increase of 4.93% in VAT revenue; the partial increase in social grants translates to R34.16 per month per social grant (about $2.5). (Van Oordt, 2018: 16-23.)

Van Oordt (2018) argues that special treatment of certain foodstuffs may be the only way to protect the poor; developing countries have two options:

- zero-rate; or
- exempt such foodstuffs.

There needs to be careful consideration, however, as to which foodstuffs this zero-rate can be extended to since some inputs are also used in other sectors. He proposes that the zero-rate should enjoy preference over the exemption of certain foodstuffs in developing countries. If developing countries choose to exempt certain foodstuffs, this exemption should be coupled with a zero-rate on major agricultural inputs because without this zero-rate, unclaimed input VAT on agricultural inputs will likely be shifted into the price of exempt foodstuffs. The benefit of applying the zero rate is that the indirect VAT burden on the poor will be less than under the exemption (Van Oordt, 2018: 24-25).

Keen (2013)

Keen (2013) also explores whether a reduced rate of VAT on some commodities make sense as a way of addressing equity concerns. The research was focused on India, and Keen (2013) explored whether or not the notion that ‘a low rate on a broad base’ is always good tax policy. The study found that a uniform lump-sum grant, financed via removing zero-rating, leads to more

redistribution and finds even poorly targeted spending may be a better way to support the poor than a reduced rate (Keen, 2013: 22).

Gcabo *et al*. (2019), much like the other aforementioned experts, also used microsimulation models, specifically the South African tax-benefit microsimulation model (SAMOD) developed for government over the past ten years, to apply a set of policy rules to household survey data. The tax-benefit microsimulation provides an opportunity to test the effects of an almost infinite number of reform scenarios to explore options for redress. The results of Gcabo *et al.*'s (2019) study demonstrate the extent to which government resources can redistribute income through the system of cash transfers, rather than indirectly through the zero rating of items; further substantiating arguments that have been made internationally by the likes of Keen (2013); Mirrlees *et al.* (2011b); Harris *et al.* (2018) and in South Africa, by van Oordt (2018). The hypothetical scenarios also respond to the call made on constitutional grounds by the South African Human Rights Commission (2018) and others to broaden the social security coverage to mitigate the impact of the VAT hike (Gcabo *et al.*, 2019: 18).

5.8 The Rationale for VAT Rate Differentiation and Exemptions

It is the view of Mirrlees and Adam (2011a) that VAT rate differentiation (multiple VAT rates) and exemptions are anathema to the whole logic of VAT (Mirrlees & Adam, 2011a: 175). In contrast, authors such as Ebrill *et al*. (2001) Abramovsky *et al.* (2017), review the various rationales and make the case for multiple VAT rates and exemptions.

Abramovsky *et al.* (2017) consider rate differentiation, including zero rating, based on administrative efficiency, broader economic efficiency, as a constructive redistributive instrument ('equity' concerns). On rate differentiation, Abramovsky *et al.* (2017) contend that in high-income countries, VAT rate differentiation accompanied by well-developed social protection systems with targeted cash transfer schemes for poor households mean governments can redistribute much more effectively than via zero rating (Abramovsky *et al.*, 2017: 4). From a broader economic and administrative efficiency perspective, Abramovsky *et al.* (2017) argue that a single rate may encourage consumers to produce at home to avoid market purchases that include VAT, and/or a shift by consumers to informal traders who do not have any tax obligations, in which case one can

argue for lower differentiated rates of tax on these items. Furthermore, VAT act as a disincentive for working and earning more when it is levied as a single rate (Abramovsky, 2017: 14).

Ebrill *et al.* (2001) raise similar sentiments; their argument for differential commodity taxation is based on two sets of consideration: efficiency and equity. Ebrill *et al.* (2001) state that levying lower tax rates on commodities for which demand is more elastic, and higher rates on commodities for which demand is inelastic, minimizes the impact of taxation on the pattern of consumption and furthermore, that taxing most heavily those goods whose consumption is associated with the enjoyment of leisure will tend to mitigate the distortion of decisions away from paid work. 'Leisure' in this context broadly refers to time spent other than in the formal labour market. This is a general efficiency argument for differential commodity taxation, based on efficiency considerations that involves the interaction between consumption of commodities and (untaxed) 'leisure'. In terms of equity considerations, it is desirable, all else equal, to tax most heavily those goods that account for a greater share of the expenditure (Ebrill *et al.*, 2001: 70-74).
Much of the deviation from uniformity, such as those seen in the UK VAT system and elsewhere, where multiple VAT rates are used, is driven by considerations of equity. Zero and reduced rates of VAT are used to promote fairness. A strong case for differentiating tax rates is observed where there are concerns about equity, that seek to help low-income households by imposing lower taxes on goods that they consume disproportionately (Mirrlees & Adam, 2011a: 156).

Crawford *et al.* (2011) explore rate differentiation tax reform wherein they consider the structure of commodity taxes and whether it is appropriate to differentiate commodity tax rates. Whilst VAT rate differentiation is justified on distributional grounds, they contend that the notion may be misleading due to the variability of income over time:

> Put differently, a commodity tax looks regressive when assessed relative to current incomes in part because those with high incomes tend to have high savings, and so appear to escape the tax—but they will face it when they come to spend those savings.
>
> (Crawford *et al*., 2011: 285)

Crawford *et al.* (2011) make a case for differential commodity taxation and suggest it rests primarily on efficiency considerations. They base this on the 'inverse-elasticity rule' which means

that tax rates should be especially high on commodities when demand for them is relatively insensitive to their price; in such cases, a relatively high tax rate does little to reduce demand, and so causes little distortion of behaviour, while providing a robust revenue source (Crawford *et al.*, 2011: 283-285).

5.8.1 The Cost of VAT Rate Differentiation and Exemptions

The cost of VAT rate differentiation can be divided into two main categories:

- increased administration and compliance costs; and
- political vulnerability.

Ebrill *et al.* (2001) explain that multiple VAT rates increase the volume of tax forms, increase VAT audit time as well as create incentives for misclassification of items; all of which exacerbate the burden of tax administration and impact the effectiveness and economic efficiency of tax administration. Another concern with rate differentiation, is political vulnerability, which Ebrill *et al*. (2001) describe as the vulnerability or pressures on governments to consider other measures of exemption. By permitting rate differentiation, governments may reveal themselves to be amenable to the complications differentiation brings, thereby increasing government's vulnerability to further erosion of the tax base (Ebrill *et al.*, 2001: 78-80).

The cost of exemption is associated with VAT registration thresholds. The cost of administering VAT and tax liabilities of small firms are likely to be larger than the actual profits these small businesses generate. To avoid the administration burden, it is sensible for governments to impose VAT registration thresholds for small businesses. Keen and Mintz (2004) state that the key factor affecting the appropriate level of the VAT registration threshold is the VAT revenue that is foregone from excluding firms below a given threshold from the scope of VAT; and the administration and compliance costs saved from such exclusion (Abramovsky *et al.*, 2017: 8-9).

5.8.2 The Rationale for a Uniform Rate

Increasingly, arguments are being touted for expenditure policies, in areas such as education and health, as being more effective tools for pursuing equity objectives than the use of differential VAT rates (Ebrill *et al.*, 2001: 75). Abramovsky *et al.* (2017) contend that a uniform rate can

reduce compliance and administration burdens, and reduce opportunities for tax evasion at boundaries between product categories; a uniform rate generates a paper trail as it collected incrementally at each stage of the production chain amongst VAT registered vendors (who reclaim the inputs of their purchases); thus reducing the incentive for tax evasion. A successful claim for a deduction for input VAT for an entity requires an output VAT invoice from their supplier; invoices provide a useful audit trail for tax authorities, allowing governments to check that deductions have a corresponding payment through data linkages (Abramovsky *et al.*, 2017: 3-7).

Exempt goods and services where suppliers cannot reclaim the VAT paid on their inputs can create both significant administration and compliance costs and impact the efficiency of production (Harris *et al*., 2018: 4). A uniform rate promotes the principle of neutrality in tax (Abramovsky *et al*., 2017: 14).

> Neutrality requires that similar activities are taxed equivalently unless there are good reasons to do otherwise, to avoid distorting taxpayer behaviour and creating opportunities for tax-avoidance.
>
> (Abramovsky *et al*., 2017: 12)

5.9 Conclusion

Inchauste *et al.* (2015) clearly demonstrate in their study, that fiscal instruments such as social grants are effective in reducing market (labour) income inequality through social spending (paragraphs 5.3 and 5.4 of this report). Whilst the distributional objectives are achieved, income inequality remains extremely high (paragraphs 5.4 and 5.5 of this report).

Advanced economies like the UK and NZ demonstrate that zero rating is an inefficient way to achieve distributional objectives. Having fewer zero-rated items and differentiated VAT rates removed economic distortions, reduced administrative and compliance costs (Paragraphs 5.6.1.2, 5.6.2.1 and 5.6.2.2 of this report).

In the absence of a perfectly efficient social transfer system, zero-rating is still an efficient and necessary policy instrument (paragraph 5.7.1.2 of this report). The various studies examined indicate, however, it is preferred to broaden the tax base and remove zero rating but for South Africa, the underlying assumptions of this policy advice is that all additional revenues obtained will be earmarked towards income support and that government is perfectly efficient in

administering the tax system and has a functional social transfer system (paragraph 5.7 of this report).

Chapter 6: Conclusion

This chapter concludes the research report by summarising key research findings in relation to the research aims, as well as answer research questions, indicates the limitations of some of the studies discussed herein and proposes opportunities for future research.

The purpose of this research report was to analyse the impact of the recent VAT legislation reforms (an increase in VAT by 1% and subsequent expansion of the list of items that are to be taxed at a zero-rate beginning 1 April 2018) on the poor and low-income households and how these reforms have contributed to prevailing income inequality in South Africa. The research report discusses potential reforms that could not only create an equitable redress to income inequality but may alleviate the tax burden on the poor through direct and indirect redistribution. The studies examined in this research report indicate that South Africa has policy options, beyond zero rating that can achieve equity, promote income redistribution, and alleviate the tax burden on the poor.

The starting point in the research report was to identify the poor in South Africa and in particular, those individuals who would be most affected by the VAT reforms. The report makes three key findings in this regard. Firstly, that the South African government measures poverty by three threshold points: upper-bound, lower-bound and food poverty lines. Secondly, the findings indicated that women, specifically, were most vulnerable to poverty. In terms of world rankings, South Africa ranked amongst the highest in the world in 2015 in terms of inequality. According to the *Living Standards Survey 2014/5*, the country scored 0,65 in the Gini coefficient, one of the world's highest. And lastly, that Njozela (2018: 32) found that 55% of South Africans live in poverty; while Van Oordt (2018: 6) determined that households in income deciles 1-7 could potentially be considered poor in South Africa.

Having found metrics to identify the poor and low-income households, the research report sought to determine the VAT burden on the poor. Results in chapter 3, based on studies by Grown and Valodia (2014), Inchauste *et al*. (2015), Njozela (2018) and National Treasury (2018b), further indicated that the poor did in fact experience a disproportionate incidence of tax (paragraph 3.2 of this report). Raising VAT placed a significant burden to the poor and low-income households and did not promote income distribution or equity in tax. Moreover, studies conducted by National

Treasury (2018b: 74) indicated that it would be cheaper to return the cost of the VAT increase to the poorest households, through direct cash transfers, than to extend zero rating.

The research report then reviewed the theoretical concept of equity in taxation and its origins; and potentially how it could be achieved. While chapter 4 examined the theory of 'equity' in tax, chapter 5 reviewed reforms for South Africa that not only promote income redistribution and alleviate the tax burden but do so in an equitable manner.

Although there has been a fair number of reforms to South African tax legislation to address bias and equity concerns specifically, there remain biases in the tax system, according to Vivian (2006: 105) despite legislation that outlaws' discrimination. According to Vivian (2006: 106), reforms have failed to achieve equality as the burden of tax fell unequally on the poor.

In chapter 5, the research report finally delves into policy reforms that promote redistribution. There is consensus in the empirical studies conducted on the VAT increase in South Africa by National Treasury (2018b), Van Oordt (2018), Gcabo *et al*. (2019) and Njozela (2018) (chapter 3 and 5 of this report) that the VAT rate adjustment would result in the tax mix being more regressive and lower the disposable incomes of poor and low-income households (as an outcome of an increased VAT burden). The aforementioned studies all found that VAT exemptions and reduced rates, taken together, are not particularly well targeted at redistributing resources towards poorer households. There is broad consensus amongst the aforementioned researchers that there may already be an opportunity to raise more revenues and more effectively transfer resources to poor households by levying a broader-based VAT and using the proceeds to expand the scale and scope of such transfers; however, a change in policy will most likely not be earmarked and governments are not perfectly efficient in redistribution, as suggested by Gcabo *et al*. (2019), not to mention the exacerbating widespread non-compliance in the administration of VAT. Fiscal policy, does however, already go a long way toward achieving redistribution, as found by Inchauste *et al.* (2015) in chapter 5.

In a modern tax system, VAT is a poor choice of tax to use to achieve redistribution. VAT should therefore be extended to virtually all goods and services at the full rate, but this should be done in combination with an appropriate package of reforms to the personal tax and benefit system to

address the distributional and work incentive effects of broadening the VAT (Mirrlees, 2011b: 343).

Mirrlees e*t al.* (2011b) and White (2020) advocate for a broad single-rate VAT which they assert (as discussed in chapter 5 of this report) can positively increase the administrative and economic efficiency of tax collection, and ease the raising of revenues that allow the development of social protection programmes that can better redistribute income from the rich to the poor. New Zealand provided a working example in chapter 5 of how it was possible to apply the standard rate of VAT to almost all goods and services to achieve distribution.

While Abramovsky *et al.* (2017) and Ebrill *et al.* (2001) consider rate differentiation and exemption in advanced economies, their studies offer little to no empirical evidence or solutions on tax policies that promote reduced rates, VAT rate differentiation, VAT exemptions (in order to reduce VAT incidence and thus the tax burden on low-income households and the poor, as well as fulfil the redistributive goal of reducing the severity of poverty by reducing the tax burden on such households). The question as to whether such policies are well targeted towards their intended beneficiaries is generally debatable.

In sum, VAT policy in South Africa needs reform in its design and administration. A functional, efficient, and effective social transfer system is necessary to carry out distributional objectives, together with equitable VAT policies. Further studies on what the alternative to a broad-based, single rate VAT system are necessary. The studies examined that favoured rate differentiation, zero rating and exemptions, Abramovsky *et al.* (2017) and Ebrill *et al.* (2001), offered little to no empirical evidence or model for a functional and administratively efficient VAT system, with rate differentiation (including zero rating) and exemptions. There are a range of policy options for VAT in South Africa, from Harris *et al.* (2018), Jansen and Calitz (2015), Van Oordt (2018), Gcabo *et al.* (2019) that merit serious consideration (paragraph 5.7 of this report).

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Appendix 1 - List of 19 Zero-Rated Basic Food Items

Section 11 (1)(j) of the VAT Act 89 of 1991, lists the following 19 basic food items that are zero-rated:

- dried beans
- samp
- maize meal
- rice
- brown bread
- vegetables
- fruits
- vegetable oil
- mealie rice
- pilchards in tins
- edible legumes and pulses of leguminous plants
- eggs
- milk
- dried mealies
- dairy powder blend
- lentils
- cultured milk
- milk powder
- brown wheaten meal

Other services and goods that are zero-rated:

- exports
- illuminating paraffin
- goods which are subject to the fuel levy (petrol and diesel)

. international transport services

. farming inputs

. sales of going concerns

. certain grants by government

Appendix 2 – List of exempt supplies

Section 12 of the VAT Act 89 of 1991, lists the following 19 basic food items that are exempt from VAT:

- non-fee related financial services
- educational services provided by an approved educational institution
- residential rental accommodation
- public road and rail transport