

# The progressivity of personal income tax in South Africa since 1994 and directions for tax reform

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## ABSTRACT

The imperative to reduce poverty levels in South Africa requires not less but more public expenditure and probably higher tax levels. The purpose of this study is, firstly, to examine the impact of personal income tax reforms since 1994 on the tax structure and its scope to meet the challenges of rising needs and equity. Secondly, the study aims to provide a broad outline of personal income tax approaches that are globally considered as alternative reform options. The study finds that in South Africa, direct taxes as a percentage of total tax revenue increased in importance between 1993/94 and 2010/11. The personal income tax burden for wage earners in South Africa has remained fairly constant since 1995. The personal income tax structure is progressive, but there was a declining trend in progressivity between 1994 and 2009. Increasing personal income tax rates is constrained by low company tax rates, possible increased efficiency costs and 'herd behaviour'. The income tax system in South Africa conforms to a semi-comprehensive income tax system. The tax reform option that holds the most promise for developing countries (and South Africa) is the dual income tax system.

**Key words:** personal income tax, tax reform, progressivity, tax burden, marginal tax rates, tax threshold, comprehensive personal income tax, dual income tax

## Introduction

Tax systems evolve over time in a quest to improve economic performance and to finance social goals. Various factors – some of which are internal to countries and others of which are global – impact on tax reforms in individual countries. The South

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African economy is characterised by high unemployment, large social and income inequalities and low levels of foreign direct investment. Economic growth rates are at levels that are unlikely to reduce poverty significantly over the short term and even longer term. To achieve all the UN Millennium Development Goals (MDGs), major investments are required that need to be financed (UN Millennium Project 2005). The impact of the global financial crisis of 2007/08 led to huge bailouts and rescue plans for governments, which resulted in budget deficits and bloated public debt to GDP ratios. South Africa was less affected, but not spared, and faces fiscal austerity measures that will hamstring expenditure and/or lead to tax increases.

The UN assumes major increases in government expenditures on the MDGs of up to four percentage points of GDP until 2015 and suggests using a broad-based revenue source such as a value-added tax. The Organisation for Economic Cooperation and Development (OECD) (2010a: 20–21) concluded that the best tax policy options for promoting economic growth (from a least-distortionary perspective) are recurrent taxes on immovable property, then taxes on consumption followed by other property, personal income tax and lastly corporate income taxes. Globalisation tends to put pressure on developing countries to lower their levels of taxation (Tanzi 1996, 2004). We note, however, that the imperative to reduce poverty levels in developing countries, including South Africa, requires not less but more public expenditure and probably higher tax levels. These opposing pressures force policy-makers to reduce inefficiencies in public expenditure and at the same time to change the tax system to generate sufficient revenue in an equitable manner. Tanzi (2004: 534) remarks that the two ‘work horses’ that must carry this burden are the value-added tax (VAT) and personal income tax. VAT was introduced in South Africa in 1991 and has become what is generally considered to be an efficient revenue ‘milch cow’ but regressive tax. Personal income tax serves the purpose of raising revenue and ensuring that equity objectives are reached. Since high-income earners generally benefit most from globalisation, the personal income tax system is ideally suited to capture revenue from these income groups for redistributive purposes (Tanzi 2004: 540).

In this study, the focus will, firstly, be on the impact of personal income tax reforms in South Africa since 1994 on the tax structure and the scope of personal income tax to meet the challenges of rising expenditure needs and equity. Secondly, the study aims to provide a broad outline of personal income tax approaches that are globally considered as alternative reform options. Trends in the composition of taxes before 1994 and changes in the direct tax (income tax) mix in South Africa since 1994 are reviewed. The personal income tax (PIT) burden, the progressivity of the PIT rate structure and the distributional impact of PIT reforms are analysed. The potential of PIT rate changes and reform alternatives in the design of the tax system to address

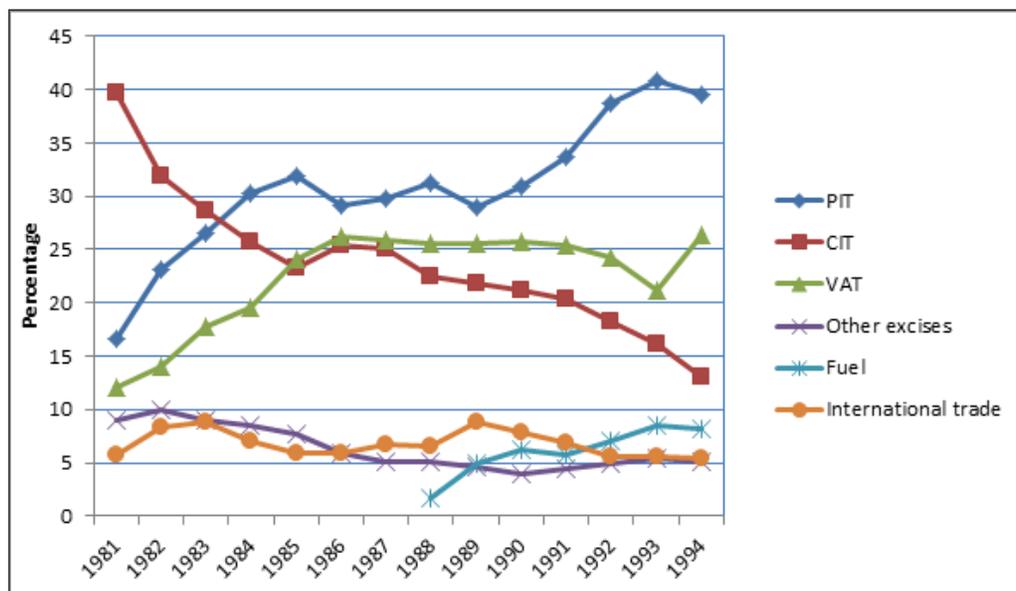
the revenue and distributional challenges are briefly reviewed. Of particular interest are the findings of two comprehensive reports on tax reform in the United Kingdom (IFS 2010, 2011; OECD 2006, 2010a). A developing country perspective is obtained by reviewing the research of eminent fiscal economists on tax policy and reform in developing countries.

## **Tax composition and trends in direct (income) taxes since 1994**

Direct (income) tax trends in the post-1994 period cannot be viewed without considering trends in the composition of taxes in the preceding years. Figure 1 provides some perspective and shows how the composition of the main sources of tax revenue (as a percentage of total tax revenue) changed between 1981 and 1994 (financial year ending March). It is observed that corporate income tax (CIT) and personal income tax (PIT) exhibit a scissor-like pattern, with PIT increasing from a low 16.6% in 1980/81 to 39.6% in 1993/94. In contrast, CIT decreased from 39.7% to 13% over the same period. At the same time, VAT as a percentage of total revenue increased from 12% in 1980/81 to 26.3% in 1993/94. PIT and VAT are ultimately borne by persons, and if one were to add the incidence of the fuel levy and other tax types such as user charges, it becomes clear that the relative tax share of individuals in total tax revenue increased significantly from the early 1980s to the early 1990s.

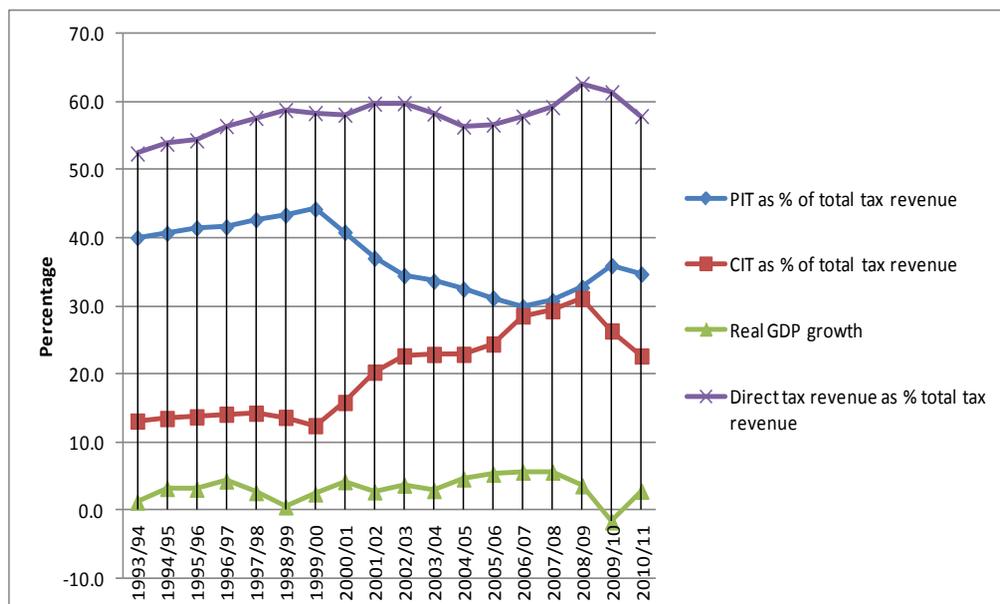
Against the backdrop of a rising personal income tax burden, the Katz Commission was tasked with a comprehensive review of the tax system in South Africa and released its first interim report in 1994 (Katz Commission 1994). This report was followed by another nine reports between 1994 and 1999. In giving direction to tax reform, the Katz Commission at the outset recognised that the high fiscal burden had to be addressed by paying attention to reducing most marginal individual rates, reducing the direct personal income tax burden and nominal rates of corporate tax, increasing the tax base, and improving tax collection (Katz Commission 1994: 11). The Katz Commission (1994: 12) was also astutely aware that political and equity considerations precluded a shift to higher VAT rates and instead bargained on improving economic growth rates and other policy interventions to increase tax revenue.

Figure 2 shows revenue trends in personal income tax (PIT), company income tax (CIT) and direct taxes (PIT and CIT) since 1993/94. Direct taxes as a percentage of total tax revenue increased by 10.5% between 1993/94 and 2010/11. Using three-year moving averages, the increase was 9.8%. A comparison reveals that OECD countries (18 of the 30 countries) have also increased their share of direct taxes since 1996 (OECD 2010a: 28). In contrast, developing countries have increased their share of



Source: SARB (2011b)

Figure 1: Main sources of tax revenue as a percentage of total tax revenue (1980/81 to 1993/94)



Source: National Treasury 2011 (Annexure B: Table 2); SARB 2011a (S148)

Figure 2: Direct taxes (PIT and CIT) as a percentage of total tax revenue (1993/94 to 2010/11)

indirect taxes from 34.9% in 1990 (25.5% in 1970) to 40.1% in 2000 (see Bahl & Bird 2008: 282). It seems that the tax mix in South Africa is more aligned to patterns in developed countries.

A further inspection of the trends in the relative importance of PIT revenue and CIT revenue to total tax revenue is revealing. Between 1993/94 and 1998/99, the contribution of PIT far exceeded the CIT share, and these ratios remained fairly stable until 1998/99. This period coincided with the economic downswing that lasted from December 1996 until August 1999. From 1999/2000, a converging pattern emerged. PIT revenue as a percentage of total tax revenue declined as real GDP growth increased until at least 2006/07. However, CIT revenue as a percentage of total tax revenue increased over the same period and seems to be in tandem with the upturn in the economic cycle that lasted from September 1999 to November 2007. As the economy grew, CIT revenue increased dramatically (although from a low base) by over 450% in nominal terms compared to the approximate 64% increase in PIT revenue. When the economy started slowing down in 2008, income tax revenues continued to increase, but from 2009/10 the share of CIT decreased sharply as CIT tax revenue started to drop in nominal terms. Overall the share of PIT in total tax revenue decreased somewhat from 39.6% in 1993/94 to 34.1% in 2010/11. In contrast, the share of CIT almost doubled from 13% to 22.7% over the same period. Income tax shares in the OECD area exhibit a similar pattern between 1995 and 2007 (OECD 2010a: 28).

Changes in the income tax shares are largely endogenous, but some may be attributed to policy interventions such as the successes of the South African Revenue Service (SARS) in broadening the tax base and sharpened administrative vigilance, which impacted on compliance and tax rate reductions. In the case of company tax revenue increases, there may be a Laffer-type response to lower company tax rates. Since 1994, the personal income tax system was changed in many respects (see National Treasury and Department of Finance [various issues]; Manuel 2002) and in response to the recommendations of the Katz Commission. The number of tax brackets was reduced from ten to six; the child rebate was scrapped; the individual is now the unit of taxation; and the primary rebate was increased annually to compensate for inflation and to retain progressivity. South Africa also moved from a source of income principle to the worldwide base of taxation. The tax base was broadened by making almost all fringe benefits taxable and by taxing capital gains since 2001. Capital gains tax from individuals netted government R4.4 billion in revenue in 2009/10 (approximately 2.1% of taxes on persons and individuals).

## **The personal income tax burden and progressivity in South Africa**

What was the impact of the post-1994 reforms (including rate reductions) on the personal income tax burden, the progressivity of the PIT schedule and the distribution of personal income?

### **The personal income tax burden**

A measure of the average (effective) personal income tax rate (or burden) is obtained using national accounting data (see SARB 2011a). In 1995, current taxes on income and wealth of households in South Africa were R51 623 million. If the gross balance of primary income of households as defined in the national accounts is used as the tax base (R398 605 million), the personal income tax burden was 13.0%. In 2010, the burden came to 13.5%. Over the 15-year period, it reached a maximum of 14.2% in 1999 and recorded a low of 11.3% in 2004. This narrow definition indicates that the personal income tax burden has remained fairly constant since 1995.

The burden of personal income tax can also be expressed as a percentage of GDP. Calculated from IMF (2008), the unweighted average central government PIT/GDP ratio for South Africa was 8.4 in 2007. This compares to a PIT/GDP ratio of 8.2 for a selection of 13 developed countries and 2.0 for a selection of ten developing countries. However, once social security contributions are added (10.1) to the personal income tax revenue in developed countries, the PIT (including social security contribution)/GDP ratio increases to 18.3.

Drawing conclusions on the basis of these tentative comparisons on the potential for additional PIT revenue must be done with caution. South Africa is a developing country and has a limited tax base of approximately six million registered taxpayers (National Treasury and SARS 2011: 6). These taxpayers must support close to 14 million recipients of social assistance grants. If government proceeds with its intended course of making social security contributions by employees mandatory, it is quite clear that the personal income tax burden of South African taxpayers will rise significantly and will be even more out of line with developing country levels and patterns. In an attempt to estimate and compare tax performance, Steenekamp (2007) used the representative tax system approach to compile a tax effort index. The results for the financial years 2000/01 to 2004/05 indicate that the South African revenue authorities outperform comparable countries. When the different tax classes were considered, it was concluded that South Africa uses personal income tax and corporate income tax very intensively and that the total tax burden is high. These results suggested lower personal income taxation and corporate taxation (Steenekamp

2007: 14). As noted, the relatively small income tax base and the sharp increases in user charges on traditional public services such as education, toll fees and security on the overall tax burden of individuals must be acknowledged. It then becomes quite apparent that the scope for additional revenue from this source is indeed limited.

## **The progressivity of PIT**

Declining top rates of personal income tax in the past two decades and more is one of the most common global occurrences in taxation. As the OECD (2010a: 33) points out, however, this has not been matched by a reduction in the average income tax that is levied on the income of the average production worker. How has this impacted on progressivity in the personal income tax structure? Various methods can be used to measure progressivity. Nyamongo and Schoeman (2007) considered a number of such methods and reported empirical results for South Africa based on the procedures developed by Musgrave and Thin (1948) and Kakwani (1977). Regarding the reform period after 1994, Nyamongo and Schoeman's study produced mixed results. According to the Musgrave and Thin procedure, progressivity declined between 1994 and 2003/04, whereas the Kakwani disproportionality measure shows that progressivity increased 'impressively' between 1994 and 1999/2000, but then declined in response to tax reforms between 1999/2000 and 2003/04 (Nyamongo & Schoeman 2007: 487–489).

Progressivity is affected by marginal rates but also by what has happened to thresholds. In this study, three measures are employed to determine how adjustments to the PIT rate and thresholds affected progressivity. All three measures compare the marginal and average tax rates for an individual worker at the average wage level in the economy (excluding agriculture and the public sector). This is shown in Table 1 for South Africa and a selection of OECD countries, along with the OECD average (unweighted). For the industry categories noted in Table 1, the average annual nominal wage for South Africa was calculated at R49 014 in 1997, R66 499 in 2000 and R123 676 in 2009.

The first progressivity measure considers the threshold at which the top marginal rate applies. In 1997, taxpayers on average had to earn just twice the average wage before the top rate became applicable (column 1). This multiple increased to 3.6 times in 2000 and to almost five times in 2009 – an indication of less progressivity. This is in contrast to the OECD pattern. The income threshold (as a multiple of the average wage), where the top statutory PIT rate for the OECD is levied, declined between 2000 and 2009.

**Table 1: Income tax rates of average worker<sup>a</sup> (2000 and 2009, and 1997 for South Africa)**

	Top threshold (multiple of average wage) <sup>b</sup>		Marginal tax rate		Average tax rate (100% of average wage) <sup>c</sup>		Average tax rate (67% of average wage)		Average tax rate (167% of average wage)		Progressivity	
	(1)		(2)		(3)		(4)		(5)		(4) ÷ (5)	
	2000	2009	2000	2009	2000	2009	2000	2009	2000	2009	2000	2009
Australia	1.2	2.8	44.5	31.5	26.1	22.0	20.7	15.6	34.5	28.3	60.0	55.1
Hungary	0.9	0.8	56.0	45.0	23.2	21.2	17.5	11.9	30.3	27.7	57.8	43.0
Korea	5.5	3.2	6.6	14.5	2.1	4.2	0.7	1.3	6.4	8.7	10.9	14.9
Mexico	49.3	4.7	12.8	10.8	0.8	4.0	-5.9	-1.7	7.9	11.3	-74.7	-15.0
New Zealand	1.7	1.5	21.0	34.0	19.4	18.4	18.6	15.6	24.2	24.9	76.9	62.7
Poland	3.3	2.8	9.3	8.8	6.6	6.4	5.3	5.2	7.7	7.4	68.8	70.3
Turkey	8.1	3.0	17.8	17.6	14.7	12.2	13.2	9.5	18.0	15.5	73.3	61.3
OECD average	4.4 (2.9) <sup>d</sup>	2.6	28.9	27.2	16.4	15.4	12.3	10.7	23.1	22.0	53.2	48.6
South Africa (1997)	3.6 (2.0)	4.8	37.0 (41.0)	18.0	18.0 (18.0)	10.1	11.2 (9.2)	6.2	27.0 (27.8)	15.8	41.4 (33.2)	39.4

**Notes:**

- a An adult full-time worker in the covered industry sectors whose wage earnings are equal to the average wage earnings of such workers.
- b Top PIT threshold as multiple of the average wage.
- c Gross average earnings are calculated using a broad set of industry sectors including categories C to K inclusive as defined in the International Standard Industrial Classification of All Economic Activities (ISIC Revision 3.1, United Nations).
- d Excluding Mexico.

**Sources:** StatsSA (1998, 2003, 2011); National Treasury, Budget Review (various issues); OECD (2010b)

Table 1 shows that both the marginal tax rate (column 2) and average tax rate (column 3) for the average earner in South Africa declined between 1997 and 2009. This trend is also observed in some of the OECD countries, but was not that drastic considering the 1.0% decline in the average tax rate in all OECD countries. A second measure of progressivity that can also be used here is to calculate the difference between the marginal tax rate (column 2) and average personal income tax rates (column 3), divided by 1 minus the average personal income tax rate, for an average worker (see OECD 2010a: 34 & 44). A higher number indicates higher progressivity at the earnings level of an average worker. In 1997, the percentage was 0.28, compared to 0.08 in 2009 implying that progressivity declined over this period. In 2009, the OECD average was 0.14, with Turkey at 0.07 and Hungary at 0.30. However, this progressivity measure does not consider the impact of tax changes on lower and higher incomes.

The third progressivity measure compares the burden faced by persons earning two-thirds of the average wage with the burden faced by their counterparts earning five-thirds of the average wage (see OECD 2010b:131). Column 4 is compared to column 5. In 1997, a South African worker earning two-thirds of the average wage (i.e. the 'poor' taxpayer) paid 33.2% of the tax burden faced by the worker earning five-thirds of the average wage level (the 'rich' taxpayer). In 2000, the tax burden of the lower-paid worker was 41.5% of the 'rich' taxpayer's burden, and in 2009 this ratio was 39.4%. Overall personal income tax was less progressive in 2009 compared to 1997, but when the within-time period is considered, personal income taxes first became less progressive (between 1997 and 2000) and then increased marginally in progressivity (between 2000 and 2009). The increased progressivity in the last decade is also observed in OECD countries where the worker earning two-thirds of the average wage level paid 53% in 2000 and 48% in 2009 of the tax burden of the worker earning five-thirds of the average wage level (OECD 2010b: 131). In eight OECD countries, personal income tax became less progressive (including Korea, Mexico and Poland), and in 20 countries personal income taxes became more progressive.

## **The distribution of personal income and PIT reforms**

According to the Income and Expenditure of Households 2005/06 Survey (IES) of Statistics South Africa (StatsSA), income inequality is confirmed by high Gini coefficients. Based on disposable income (from work and social grants) for the whole country, the Gini coefficient was 0.72. If social grants and taxes are excluded, the Gini coefficient for the whole country would be 0.80 – that is, the reduction of inequality through redistributive policies reduces the Gini coefficient by 8 percentage points (StatsSA 2008: 4). The top 10% of the population and the bottom 90% of the population each account for approximately 50% of household income reported in IES, with the poorest 20% accounting for less than 1.5% of income (StatsSA 2008: 33).

Measures to redistribute conventionally include social transfers and a progressive income tax system. When reported income tax in the IES is considered, the income skewness in South Africa is matched by a similar skewness in personal income tax paid. Statistics South Africa (2008: 10–11), however, cautions that the income tax reported in the IES 2005/06 Survey 'appears low' and is poorly captured. The most affluent 10% of households reported 68% of income tax, while the 50% of households receiving the lowest incomes accounted for just 1.4% of income tax. The average effective tax rate – defined as the share of income tax within gross income minus imputed rent – rises from approximately 1% in decile 1 to 9.3% in decile 10, reflecting

the progressive nature of the South African personal income tax system. StatsSA (2008: 33) nevertheless concludes that taking taxation into account “reveals no statistically significant impact on inequality”.

In a fiscal incidence study conducted by Van der Berg (2009), a Gini coefficient for pre-transfer income of 0.69 is reported. This coefficient dropped to 0.52 for income plus benefits and to 0.47 after taxes had also been subtracted. Van der Berg (2009: 17) concluded that this illustrated that the South African fiscal process was highly distributive and that social spending in particular reduced the Gini coefficient much more than the progressive income tax system did.

Nyamongo and Schoeman (2007) also considered the redistributive effect of the tax burden in South Africa. Using the Musgrave and Thin approach, their results indicate a small decline in redistribution between 1994 and 1999/2000, but a significant deterioration between 1999/2000 and 2003/2004. In contrast, the Kakwani redistributive measure shows a marginal decline in progressivity since 1994 (Nyamongo & Schoeman 2007: 489).

The empirical evidence on the impact of taxation on redistribution in South Africa since 1994 is not very encouraging. This conclusion is confirmed by other fiscal incidence studies that show that the redistributive effects of taxes are minor in developing countries and that expenditure programmes are much more progressive (see Bird & Zolt 2005: 931). For example, Barreix and Roca (2007: 137–138) show that in Latin America, the PIT improves the Gini coefficient by more than 1 percentage point in the case of Mexico only. Unsurprisingly, Bird and Zolt (2008: 81) state that “the most effective way to reduce inequality is not through taxation but rather through spending programs targeted at the poor”.

## **PIT rate changes and thoughts on reforming personal income tax**

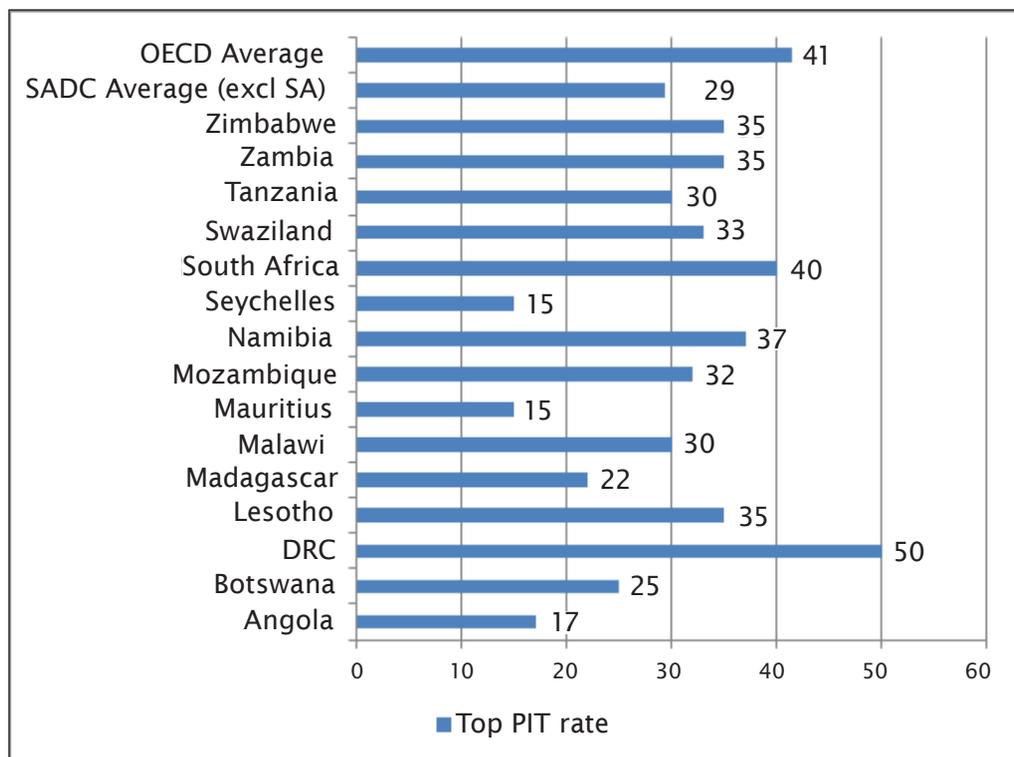
Improving the income distribution and more (not less) tax revenue to meet ever-increasing demands for public services remain challenges that South Africa faces. Conventional wisdom, or good tax policy, requires a reduction in PIT rates and of course that tax collection be further improved and the tax base broadened. PIT rate changes will be considered here. Another perspective that may shed light on the revenue and distributional challenges is the possibility of system failure. In other words, should the tax system not be redesigned to meet these and other challenges? A comprehensive evaluation of the present system cannot be attempted here, but brief attention will be given to current thinking on possible alternatives.

## PIT rate changes

Because of the recent global economic crisis, the OECD (2010a: 98) notes that further reductions in the top PIT rate will be resisted and remarks that many countries are actually considering raising their top PIT rates. In the UK, the Liberal Democrats called for a new and draconian tax on bank bonuses (*Guardian* 2010), and even billionaire investor Warren Buffet favours the United States taxing the wealthy more (Timeslive 2010). The OECD (2010a: 98) suggests that a second-best solution to promote entrepreneurship might be the implementation of an increase in the top marginal PIT rate accompanied by more generous loss-offset provisions to increase risk-taking by risk-averse entrepreneurs (OECD 2010a: 98). When developing countries face revenue challenges, the politically most acceptable approach is also to raise tax rates. Bird (2008a: 10–11) cautions against this option when the tax base is small and also politically weak. Horizontal and vertical inequity may be exacerbated, and the efficiency cost created by tax distortions increases (more or less with the square of the tax rate).

Another angle on increasing (or decreasing) PIT rates comes from the association between company income tax (CIT) rates and personal income tax rates. Without going into the whole debate concerning tax arbitrage opportunities where a gap between the top PIT and CIT rate occurs, it would suffice to say that low company tax rates increase the cost of maintaining high personal rates (Ganghof 2006). If company tax rates are assumed to be exogenous, the results from a simple cross-sectional regression analysis of 38 OECD and EU member countries suggest that lower company tax rates pull down PIT rates on high wages and above-normal capital income (Ganghof 2006).

In concert with global tax practice, PIT rates in South Africa have reduced from time to time since 1994. The top marginal personal income tax rate was lowered in steps from 45% to 42% in 2000/01, and to 40% in 2002/03. Figure 3 compares the statutory top marginal personal income tax rates in South Africa with those of countries of the Southern African Development Community (SADC) for 2009. The average top marginal PIT rate in SADC (30%) is much lower than in the OECD (41%) and in South Africa (40%). In SADC, the only country where the top marginal personal income tax rate exceeds that of South Africa is the Democratic Republic of the Congo (DRC). The PIT rate in South Africa is therefore at the same level as the average OECD PIT rates. The scope for higher personal income tax rates seems to be constrained by already-high marginal tax rates, a small tax base and a CIT rate that is lower than the top marginal PIT rate.



**Notes:**

- Unweighted averages for OECD are the top statutory tax rates (combined central and sub-central) that apply at the threshold level.
- Tax rates for SADC are for central government.

**Sources:** SADC (2011); OECD (2011); OECD (2010b)

**Figure 3:** Statutory top marginal PIT rates (2009)

### Alternative PIT designs

Given the current thinking and empirical evidence on personal income tax policy and reform, the direction of fundamental personal income tax reform globally can be categorised into four alternative personal income tax approaches: reforming the comprehensive personal income tax (CPIT) system, the flat tax system, presumptive taxation and the dual income tax (DIT) system (see IFS 2010, 2011; OECD 2006, 2010; Bahl & Bird 2008, Bird 2008a, 2008b; Keen, Kim & Varsano 2008; Bird & Zolt 2005, 2008, 2010). In brief, the CPIT combines a progressive rate schedule for all sources of income with a system of tax reliefs; the flat tax system provides for a single tax rate with a basic tax allowance; presumptive taxation is an administrative

assessment system using indicators such as assets or turnover; and the DIT combines a single (low) tax rate on capital income with a progressive rate structure for labour income.

The income tax system in South Africa conforms to a semi-comprehensive income tax system. The semi-CPIT system is prone to tax arbitrage as individuals restructure their tax affairs to exploit exemptions, allowances and (savings and investment) after-tax rate differentials. Globalisation forces least developed countries (LDCs) to lower tax rates on mobile resources (for example, professionals). Tax revenue comes under pressure, and both horizontal and vertical equity principles are violated. It is also a complex system. In the past two decades, a number of alternative approaches to reforming personal income tax were proposed. One option is to make the CPIT system better by a further reduction in rates, broadening the labour and capital tax base, more withholding, even fewer rates (two to three) and allowing expensing of costs incurred in generating income (including expensing of costs on cash saved and invested) (see OECD 2010a: chapter 5; IFS 2011). Bird and Zolt (2005: 938) note that it is far from certain that the expected additional revenue and other benefits expected from these reforms “will justify the additional administrative and political costs”.

The flat rate income tax option is a response mainly to the administrative complexity of the comprehensive income tax and the inefficiencies created by taxing labour income and capital income at different rates (see Barreix & Roca 2007: 127; Keen et al. 2008).<sup>1</sup> Horizontal equity is promoted, but a movement away from a progressive system will imply large revenue losses and an increase in the tax burden of low-income and middle-income taxpayers (to maintain revenue neutrality), jeopardising vertical equity (see Keen et al. 2008: 736–737). The third option for personal income tax reform is a presumptive tax approach (see Taube & Tadesse 1996; Balestrino & Galmarini 2005; Bird & Zolt 2005). It is an effective way of raising revenue and broadening the tax base whenever the government lacks the capability of properly administering an income tax, and horizontal and vertical equity may be enhanced (by taxing the informal sector and the self-employed). At most, however, it serves a complementary role to the CPIT system in taxing the hard-to-tax and drawing this group of informal income earners into the tax net.

The dual income tax (DIT) approach is the “more promising alternative” suggested for reforming personal income tax in developing countries (see Bird & Zolt 2005: 940; Bird & Zolt 2010; Boadway 2005).<sup>2</sup> The dual income tax system taxes personal capital income (for example, interest, capital gains, profits from personal businesses) separately from labour income. A single proportional rate for capital income is set equal to the lowest income tax rate (the first income tax bracket) on personal (wage) income. Labour income (for example, wages, salaries) is subject to

a progressive rate structure, which provides for tax deductions and exemptions to achieve equity objectives. Overall, the taxation of labour income is therefore higher than on capital income. A lower flat tax rate on capital income and a progressive tax on labour income is a pragmatic way to deal with problems of capital flight and tax arbitrage activities, and reduces the distortions implicit to the differential treatment of different sources of capital income. By lowering the tax rate on capital, the capital tax base can be expanded by eliminating tax incentives. The tax system is simplified, and compliance may improve with concomitant revenue effects. Horizontal inequities are avoided, and discrimination against savings (using the life-time income approach) is reduced. Because the tax base is broadened (in that there are no tax preferences and exclusions), the DIT system is administratively simplified.

Income-splitting mechanisms with all kinds of special tax rules are, however, required for self-employed and other small entrepreneurs, which makes the DIT imperfect. This administrative challenge is the Achilles heel of the system (Sørensen 2007: 566; Sørensen 2005: 780–781). It is a matter of concern that adopting different tax rates for labour and capital income will have revenue implications. If lower rates are levied on capital income, tax rates on labour income will have to be increased to maintain or increase income tax revenue. This will have equity consequences. From a vertical equity perspective, lower tax rates on capital may be viewed as unfair, since capital income is earned mainly by the rich. Introducing a dual income tax system in developing countries will not be problem free. A number of design issues emerge (see Bird & Zolt 2010: 197–206; Barreix & Roca 2007). Policy-makers have to consider the relative tax rates for labour (i.e. the top marginal PIT rate) and capital income (for example, equal to or higher than the lowest PIT rate), the zero bracket amount for labour and capital, the definition of capital income (active and passive capital income), setting the company tax rate (for example, equal to or higher than the rate for unincorporated business profits) and taxing normal returns on capital (or only excess returns).

The DIT provides the flexibility that developing countries need both to meet the international competition for capital and to maintain or even increase the progressiveness generated by the personal income tax system. A progressive dual income tax (and CPIT) satisfies the vertical equity tax principle ‘more accurately’ than a flat tax rate system, and once the life-time income approach is used as the basis of comparison, the DIT is also horizontally fair (OECD 2006: 131). The Uruguayan version of a dual income tax shows a more than 2 percentage point improvement in the after-tax Gini coefficient (Barreix & Roca 2007: 133). This exceeds the disappointing results obtained using the comprehensive income tax system. The dual income tax system appears to sacrifice neutrality; income from capital is taxed differently to

income from labour. Furthermore, vertical equity is sacrificed for horizontal equity. The real advantage of the DIT is that efficiency gains can be achieved by taxing all capital at the same low rate.

## Conclusions

Since 1994, the personal income tax system in South Africa has been reviewed and reformed in many respects. All these reforms were aligned with government's tax policy, which aimed to improve collection efficiency, reduce the economic distortions associated with the tax structure and lower the costs of investment and job creation, and release household spending power. The approach taken by National Treasury was in line with the 'holy trinity' of tax reform suggested by tax experts (including the Katz Commission), and required improving tax administration, broadening the tax base and lowering tax rates.

From the preceding sections, it is evident that before 1994, the share of personal income tax in total tax revenue relative to other tax sources was at a very high level. Since 1994, the relative contribution decreased somewhat but remains high. When the incidence of VAT, the fuel levy and user charges are added and the limited size of the tax base is considered, it is doubtful whether there is room to increase the burden. The total tax burden on individuals has remained more or less constant since 1994 and is high in comparison with other developing countries. Moreover, the South African PIT base is already taxed very intensively compared with developing countries. The personal income tax structure is progressive. Between 1997 and 2000, personal income taxes first became less progressive and then increased marginally in progressivity between 2000 and 2009. Unfortunately personal income tax reforms over the last two decades have not really resulted in an improvement of the income distribution. Furthermore, there is some consensus that personal income taxation is not a very suitable instrument for redistribution purposes in developing countries. South Africa, however, still faces the twin challenges of improving the income distribution and increasing tax revenue to meet ever-increasing demands for public services. Conventional wisdom, or good tax policy, dictates a reduction in PIT rates, but as part of the fall-out of the global financial crisis (and for equity reasons), further reductions will be resisted. Instead, globally there is populist sentiment in favour of raising top marginal PIT rates. The PIT rate in South Africa is at the same level as the average OECD rates. The scope for higher personal income tax rates seems to be constrained by already-high marginal tax rates, a small tax base and a CIT rate that is lower than the top marginal PIT rate.

Consideration was given to the possibility that the revenue and distributional challenges are due to the failure of the semi-comprehensive income tax system to which South Africa adheres. An in-depth analysis of this possibility is simply beyond the scope of this study, but current international thinking on tax reform by eminent policy researchers and recent tax reform studies by the Institute for Fiscal Studies (IFS) and the OECD provided a foundation for a brief discussion of alternative PIT design options. The tax reform option that holds promise for South Africa (and developing countries) is the dual income tax system. The DIT provides the flexibility that developing countries need both to meet the international competition for capital and to maintain or even increase the progressiveness generated by the personal income tax system. In designing tax systems, it is almost inevitable that governments will be faced with policy conflicts and goal choices. Tax fairness, efficiency, neutrality and administrative simplicity cannot always be achieved simultaneously and must sometimes be traded off. The dual income tax system appears to sacrifice neutrality, since income from capital is taxed differently to income from labour. It does have the advantage of improving horizontal equity.

The forces that impact on tax reform are clearly diverse, but Norregaard and Kahn (2007: 3–7) suggest that a common set of factors steers countries to adopt the same approach to tax reform. These include globalisation (and the increased mobility of factors of production), employment creation and the need to remove labour tax impediments, a ‘subtle’ change of views in favour of tax efficiency in the efficiency–equity trade-off and ‘herd behaviour’, involving the adoption of fashionable tax policies (for example, flat taxes). The dual income tax may well become a popular alternative to the present comprehensive income tax system in developing countries. A much more comprehensive analysis is required, however, to determine whether South Africa should run with the herd.

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## Endnotes

- 1 The sections on the flat rate income tax and DIT draw to some extent from my contribution to income tax reform in Black, Calitz & Steenekamp (2011: 234–239).

- 2 For a comprehensive analysis of the dual income tax system in developed countries, see Sørensen (2005: 777–801), Sørensen (2007: 557–602) and Sørensen and Johnson (2010: 179–235). The potential for introducing the dual income tax in developing countries is discussed in great detail in Bird & Zolt (2010) and Boadway (2005: 910–927).

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