

# An assessment of the contribution of the zero-rating of fruit in South Africa to vertical equity

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## **APPROACH OF STUDY**

According to the North-West University (General Academic Rule A4.1) a dissertation could be submitted in the “traditional book format” or in the more contemporary “article format”. As the author of the study is of the opinion that the study has practical value for tax practitioners and other researchers, the last mentioned format was selected.

Chapter 1 of the study is the introduction, Chapter 2 the article and Chapter 3 provides a summary and conclusion to the study. In order to present the article in a logical manner, it was necessary to repeat certain information that is also presented in Chapters 1 and 3.

This is a mini-dissertation in partial fulfilment of the requirements for this Masters’ Degree which means that the scope is limited. There is therefore only one main focus, which justifies a single article.

The research article and dissertation comply with the writing guidelines as required by the South African Business Review.

## **KEYWORDS**

VAT, zero-rating, fruit, vertical equity, alleviating poverty, regressive.

## **ABSTRACT**

Value-added Tax (VAT) is a highly effective and easily administered tax, and it contributes significantly to the national budget every year. Unfortunately, VAT affects the poorer members of society significantly more than the rich. This is due to the fact that the poorer members spend proportionally more of their income on consumables. To counter this regressiveness VAT zero-rating of certain basic products and services was put in place.

The aim of this study is to consider the VAT zero-rating of certain products, and determine who benefits from it. A comparison has been made between standard, reduced and zero-rating of VAT in other countries and the relevance of the zero-rating considered. This study also considers vertical equity and how it is achieved, assesses the importance of equity vs the alleviation of poverty to determine whether one is more important than the other and compare equity and efficiency. This all contributes to the discussion of the zero-rating of fruit and the contribution thereof to vertical equity in South Africa.

It was found that the disparity in revenue lost by the fiscus due to the zero-rating of fruit is significantly more in the richer portion of the population than in the poorer. This is a direct result of the fact that the poor simply consume significantly less fruit than the rich do.

The findings of this study lead to the conclusion that the zero-rating of fruit does not contribute to vertical equity.

## **ABBREVIATIONS**

ACCA	Association of Chartered Certified Accountants
DTC	Davis Tax Committee
SAICA	South African Institute of Chartered Accountants
VAT	Value added tax
VAT Act	Value added tax act

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# CHAPTER 1 INTRODUCTION

## 1.1 BACKGROUND

Value-added tax (VAT) as imposed by the Value-Added Tax Act (28 of 1991) (VAT Act) is considered to be a highly effective and easily administered tax. In South Africa it contributes about a quarter of the total budget revenue annually (Davis Tax Committee, 2014:14). Unfortunately, as the poorer members of our society spend more of their income on consumable goods, proportionally to the more affluent members, VAT would be considered a regressive tax that does not contribute to alleviating poverty in our country (Calitz & Jansen, 2015a:2). A “regressive tax” would be one affecting the poor more than the rich, i.e. where the poor pay more tax proportionally than the rich – as would be the case with a tax charged at a single uniform rate (Botha, 2014:15). To combat the regressiveness of the VAT, basic foodstuffs and other goods were allocated a zero-rating, meaning that there is zero VAT raised on these items (Section 11, VAT Act). Although zero-rating was implemented to ensure that VAT is not a regressive tax – i.e. to assist the poorer members of society – the rich obviously also benefit from it (Davis Tax Committee, 2014:8).

The Minister of Finance, Pravin Gordhan, projected the budget deficit for the 2016/2017 financial year at 3.2% of the total budget (National Treasury, 2016a:9). In the 2015 budget speech delivered by then Minister of Finance Nhlanhla Nene, the personal income tax rate was increased for the first time in 20 years (Anon., 2015a). Debate has since been rife whether the next tax increase should be on personal income tax or, more controversially, on VAT (Conversation, 2015; Barry, 2015). With growth in the South African economy at little more than one per cent in 2015 (Ferreira, 2016), it seems that a tax hike in some form or another is definitely on the cards. That is before taking into account the fact that the country has been facing an unemployment rate of around 25% for at least the past three years (Anon., 2015a). This undoubtedly contributes to the budget deficit as the larger the unemployment rate, the smaller the base of tax-payers and the greater – in all likelihood – the number of disadvantaged individuals.

The Davis Tax Committee (2014:11) (DTC) describes VAT as a “transparent tax” that is “self-enforcing” and an “efficient means of raising revenue with very little distortion to an economy”. VAT is charged at a uniform rate (for the most part), and the payment significantly eases administration due to its very simplistic collections method (Aizenman & Jinjara, 2005:3). VAT is also more difficult to evade, due to payment being necessary at every point of value added, not merely by one person at the end (DTC, 2014:12). Furthermore, VAT is a tax on the consumer, but is paid to SARS by the vendors, which adds an additional layer of security in

ensuring collections. According to the paper *An analysis of South Africa's Value Added Tax*, "a VAT is the most effective instrument for generating government revenue" (Go, Kearney, Robinson & Thierfelder, 2005:19).

VAT consistently contributes at least 25% of the revenue that funds the South African budget (DTC, 2014:14). The South African VAT rate is also lower than in the majority of that of other countries – both developing and developed (Ernst & Young, 2016:916). The above possibly all point to an argument for the increase of VAT as a possible solution for the national deficit. At the very least, it seems to point towards an effective method of raising additional revenue in South Africa.

As mentioned before, VAT is considered a regressive tax – meaning that the "marginal cost of funds for the VAT is higher for low-income households than for high-income households" (Go, *et al.*, 2005:17). As such, any increase in the rate charged will affect the impoverished portion of our country more than it will affect the more affluent person.

In *An enquiry into the nature and causes of the wealth of nations*, Smith (1776:loc. 12550) stated that a good tax system is one in which (amongst others) "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities."

This entails both vertical equity as well as horizontal equity. Horizontal equity requires that "equals be treated equally" (Kaplow, 1989). Coetzee (1995:44) felt that the best way to describe horizontal equity is that "no discrimination should be made between taxpayers on any grounds but their income". On the other hand, vertical equity would be achieved by taxing the rich at a higher rate than the poor (Coetzee, 1995:38), i.e. those who have more pay more than those who have less. This research will be focusing on the vertical equity of the tax system, in particular the vertical equity of the VAT system.

Vertical equity indicates differential treatment for unequal individuals (Musgrave, 1990:113). Botha (2014:13) further elaborated on this by stating that vertical equity would be achieved where an individual is taxed in proportion to income earned. VAT as a single rated tax applied to all goods, would then presumably not promote vertical equity and as such, several goods and services in South Africa are zero-rated (Jansen & Calitz, 2015a:2). An item or service will be zero-rated where it is not exempt from VAT in terms of section 12 of the VAT act, but the VAT that is charged on the item is at 0% per section 11 of the VAT Act. Section 11(1)(j) of the VAT Act (89 of 1991), read in conjunction with the VAT Act's Second Schedule, lists all goods and services considered to be zero-rated. Specifically listed as a zero-rated item for VAT purposes is fruit, as long as it is "not cooked or treated in any manner except for the purposes of

preserving such fruit in its natural state, but excluding dehydrated, dried, canned or bottled fruit and nuts.” (VAT Act, s11(1)(j); Schedule 2 part B paragraph 1 item 13). Fruit, more particularly untreated fruit, will be zero-rated, along with vegetables, milk, eggs and brown bread (among other products) as these are deemed “basic foodstuff” in South Africa and the zero-rating thereof is considered to assist in promoting equity and providing a positive impact on the food consumption of the poor (Alderman & Del Ninno, 1999).

The problem is not specifically with the zero-rating of foodstuffs, but rather where the zero-rating becomes so beneficial to the more affluent part of society that it cannot really be rationalized to have been zero-rated at all. According to the DTC (2014:25), although the majority of zero-rated food products are consumed across all or most deciles of the population - and in several groups are used more by the richest decile – fruit shows itself to be an anomaly due to the degree that it is consumed more by the richer decile than the poorer deciles. Merriam-Webster’s dictionary defines a decile as “any one of nine numbers that divide a frequency distribution into 10 classes such that each contains the same number of individuals” and also “any one of these classes” (2015a). Revenue foregone due to the zero-rating of fruit purchased by the wealthy is more than 10 times the revenue foregone due to the zero-rating of fruit by the poorest decile. Furthermore the revenue foregone on the sale of fruit increases significantly for the richest two deciles (DTC, 2014:25).

Jansen and Calitz (2015a:2) consider the fact that the zero-rating of some goods produces a more equitable VAT, but does not do much to help combat poverty, as “goods that are zero-rated are consumed across the board by all consumers (poor and rich)”.

Several studies have shown the benefits of social grants in alleviating poverty (Ferreira, 2015). Considering the amount of revenue that the government does not collect due to the zero-rating of fruit specifically, there might be room to argue for the abolition of zero-rating of fruit and applying that revenue to alternative sources, which might contribute more to combatting poverty.

## **1.2 PROBLEM STATEMENT AND RESEARCH QUESTION**

This research considers the problem that the VAT zero-rating of fruit is no longer appropriate as a means to achieve vertical equity.

To address this problem, this paper will aim to answer the following question: does the VAT zero-rating of fruit still contribute to achieving vertical equity, and alleviating poverty?

## 1.3 RESEARCH OBJECTIVES

### 1.3.1 Main objective

The main objective has been to assess the contribution of the zero-rating of fruit in South Africa to vertical equity

### 1.3.2 Secondary objectives

The main objective is addressed by the following secondary objectives:

- (i) to consider the **background, relevance and benefits** of the zero-rating of VAT in South Africa – and who primarily benefits from zero-rating in part and in its entirety will be addressed in chapter two;
- (ii) to consider **vertical equity**, its meaning and how this is practiced in South Africa. A look is also taken at how it might be achieved considering the zero-rating in terms of the VAT Act. It also considers the difference – if any – between vertical equity and the alleviation of poverty, and which one, if either, is more prevalent. There is also a comparison between “equity” and “efficiency”. This objective is achieved in chapter two.
- (iii) to conclude based on the above considerations whether the zero-rating of VAT on fruit is still relevant for the promotion of vertical equity in South Africa, and to give recommendations based on the results noted during the study. This objective is achieved in chapter two and three.

## 1.4 RESEARCH METHOD

### 1.4.1 Literature review

The research was conducted by means of a non-empirical literature review within the legal interpretive research paradigm and will be aimed at gathering information on zero-rating of VAT, consumption of fruit by the various deciles of the population and the use of social grants in alleviating poverty. The main focus was on social grants as a preferred tool in alleviating poverty in comparison with zero-rating of certain food items. The literature to be reviewed will include legislation, textbooks, academic journals, articles and internet sources – such as online dictionaries, online publications and government data published online.

#### 1.4.1.1 Ontological assumptions

Before discussing the ontological assumptions used in this study we need to look at the meaning of “ontology”. Ontology is defined by Merriam-Webster’s dictionary as “a particular

theory about the nature of being or the kinds of things that have existence” (2015b). This study uses an ontology which is a social world of people with their own actions, thoughts and interpretations of reality, that differs based on their circumstances (McKerchar, 2008:5-22 & Coetzee, Schutte, Van der Zwan, 2014:27). This encapsulates a relativist view.

#### **1.4.1.2 Epistemological assumptions**

Based on a relativist world view, knowledge is viewed as “multi-layered and complex” (McKerchar, 2008:6 & Coetzee, et al., 2014:28).

The combination of a relativist world view and the belief that knowledge is “multi-layered and complex” (McKerchar, 2008:6 & Coetzee, et al., 2014:28), this research was conducted in the interpretivist paradigm.

#### **1.4.1.3 Methodological assumptions**

“Methodology” is defined by Merriam-Webster’s online dictionary as “a set of methods, rules, or ideas that are important in a science or art: a particular procedure or set of procedures”. The methodology for this study was a critical analysis using available literature.

#### **1.4.2 Limitations of study**

A comparison was made between the application of the zero-rating of VAT in South Africa with other countries world-wide. Both developed and developing countries were considered in order to obtain a clearer view of the assumed purpose of zero-rating in different countries. Countries to be used in the comparison are: the United Kingdom, Germany, Netherlands, Brazil, Russia, India, China and South Africa. The inclusion of the developed countries was based on the fact they all rank within the top 15 countries when considering the quality of life in the country (Numbeo, 2016) – and also have single standard and reduced VAT rates (KPMG, 2016b). The developing countries were selected for comparison due to their inclusion in the BRICS countries, which are all considered to be major emerging markets (Ramakrishnan, 2016:1).

The terms “poor” and “rich” are used to refer to the less or more affluent members of the society. Although these terms have not been defined, it is used in the same manner as done in the Davis Tax Committee First Interim Report on VAT.

### **1.5 OVERVIEW OF CHAPTERS**

**Chapter one: Background, objectives and introduction to topic**

This chapter contains an introduction to the topic and background of the areas to be addressed. It determines the problem statement and objectives of the study and sets out the research methodology used in this study.

## **Chapter two (article): A consideration of the contribution of the zero-rating of fruit in South Africa to vertical equity**

This chapter (article) contains a background on the zero-rating of goods in South Africa and whether it is still relevant today. It also considers vertical equity, its meaning and how it is applied in South Africa and also further abroad. This chapter also addresses the secondary objectives as identified in paragraph 1.3.2 (i) and (ii).

The objective with chapter two (the article) is firstly to provide a background on zero-rating. Its relevance 25 years after VAT was first implemented is also considered, as well as who benefits primarily from zero-rating, in its entirety and also per certain individual zero-rated products.

Chapter two further considers the meaning of vertical equity and how it is achieved, especially through the zero-rating of fruit and also alternative methods. The difference between alleviating poverty and vertical equity, if it does exist, is also considered, and an evaluation of which of the two is more prevalent in our country, is done. Furthermore, this chapter (article) includes a comparison between “equity” and “efficiency” and considers the importance of each.

Lastly, the relevance of zero-rating’s aid to achieving vertical equity, specifically with regards to fruit, is considered in this chapter.

A brief conclusion on this discussion is also included in this chapter.

## **Chapter three: Conclusion**

This chapter summarises the findings of the research performed, and concludes whether the VAT zero-rating of fruit contributes to vertical equity and the alleviation of poverty. Moreover, recommendations are made based on these conclusions to aid in the promotion of vertical equity. This chapter addresses the secondary research objective as identified in paragraph 1.3.2 (iii).

## **CHAPTER 2: RESEARCH ARTICLE**

### **An assessment of the contribution of the zero-rating of fruit in South Africa to vertical equity**

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## **ABSTRACT**

Value-added Tax (VAT) is a highly effective and easily administered tax, and it contributes significantly to the national budget every year. Unfortunately, VAT affects the poorer members of society significantly more than the rich. This is due to the fact that the poorer members spend proportionally more of their income on consumables. To counter this regressiveness VAT zero-rating of certain basic products and services was put in place.

The aim of this study is to consider the VAT zero-rating of certain products, and who benefits from it. A comparison is made between standard, reduced and zero-rating of VAT in other countries and the relevance of the zero-rating will be considered. This study also considers vertical equity and how it is achieved, assesses the importance of equity vs the alleviation of poverty to determine whether one is more important than the other and compares equity and efficiency. All these contribute to the discussion of the zero-rating of fruit and the contribution thereof to vertical equity in South Africa.

It was found that the disparity in revenue lost by the fiscus due to the zero-rating of fruit is significantly more in the richer portion of the population than in the poorer. This is a direct result of the fact that the poor simply consume significantly less fruit than the rich do.

The findings of this study contribute to the conclusion that the zero-rating of fruit does not contribute to vertical equity.

## **LIST OF ABBREVIATIONS**

ACCA	Association of Chartered Certified Accountants
DTC	Davis Tax Committee
SAICA	South African Institute of Chartered Accountants
VAT	Value added tax
VAT Act	Value added tax act

## **KEYWORDS**

VAT, zero-rating, fruit, vertical equity, alleviating poverty, regressive.

## 2.1 Introduction

Value-added tax (VAT) is an indirect tax on the supply of goods and services which has been imposed in South Africa to replace general sales tax (GST) since 1991 by the Value-Added Tax Act (28 of 1991). VAT is considered to be a highly effective, easily administered tax and consistently contributes approximately 25% of the total budget revenue annually (Davis Tax Committee, 2014:14). It has also been described as a “transparent tax” that is “self-enforcing” and an “efficient means of raising revenue with very little distortion to an economy” (Davis Tax Committee, 2014:11). Furthermore, it is charged at a (mostly) uniform rate of 14% and the payment method’s simplistic collection means administration of the tax is simpler (Aizenman & Jinjarak, 2005:3). As an added layer of security in ensuring collections, VAT is a tax on the consumer, but it is collected and paid over by the vendor. In short “A VAT is the most effective instrument for generating government revenue” (Go, Kearney, Robinson & Thierfelder, 2005:19).

However, as a result of the uniform rate, VAT is also considered to be a regressive tax, i.e. “a tax that takes a larger percentage of income from low-income earners than from high-income earners” (Investopedia, 2016a). Botha (2014:13) further elaborated on this by stating that vertical equity would be achieved where an individual is taxed in proportion to income earned. This is due to the fact that the less privileged members of our society spend proportionally more of their income on consumable products than the wealthier and it is for this reason that basic foodstuffs and certain other goods have been allocated a zero rating (Jansen & Calitz, 2015a:2). The zero-rating means that the VAT raised on these products is raised at zero per cent and, effectively, no VAT is paid on these items (Section 11, VAT Act).

This zero-rating of certain products might have been implemented to aid the less affluent members of society, but the rich also benefit from it (Davis Tax Committee, 2014:8). The Davis Tax Committee (2014:25) included in their first interim report on VAT, tables indicating the revenue foregone due to the zero-rating of products, per type of product and also per consumption decile. A decile is any one of the classes where a frequency distribution is divided into ten classes, in such a way that each contains the same number of individuals (Merriam-Webster’s Dictionary, 2015a). These clearly indicate that, although for the majority of the products selected the consumption in the lower deciles is more than in the higher deciles, that there are a few where the higher deciles’ spend is more than the lower. In fact, with no product is the discrepancy more significant than with fruit, where the revenue lost from the lowest decile (R14 million) is less than 10% of revenue lost from the highest (R167 million) (Davis Tax Committee, 2014:8).

One of the principles of a good tax system is one where “the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities” (Smith, 1776:loc. 12550). This principle is further expanded on by vertical and horizontal equity. Horizontal equity requires that “equals be treated equally” (Kaplow, 1989). Coetzee (1995:44) was of the opinion that the best way to describe horizontal equity is that “no discrimination should be made between taxpayers on any grounds but their income”. Musgrave (1990:113) defined vertical equity as differential treatment for unequal individuals, i.e. people who have more, should be contributing more than those who have less. Botha (2014) further elaborated on this by stating that vertical equity would be achieved where an individual is taxed in proportion to income earned. VAT at a single, standard rate would then not promote vertical equity, hence the application of zero-rating of certain goods.

The problem is not with the VAT zero-rating altogether, but rather the zero-rating of certain products where the zero-rating benefits the rich significantly more than it benefits the poor. For the purposes of this article, even more specifically, the problem lies with the zero-rating of fruit and how – if at all – it contributes to vertical equity.

### **2.1.1 PROBLEM STATEMENT AND RESEARCH QUESTION**

This research considers the problem that the VAT zero-rating of fruit is no longer appropriate as a means to achieve vertical equity.

To address this problem, this paper aims to answer the following question: does the VAT zero-rating of fruit still contribute to achieving vertical equity, and alleviating poverty?

### **2.1.2 RESEARCH OBJECTIVES**

#### **2.1.2.1 Main objective**

The main objective would be to assess the contribution of the zero-rating of fruit in South Africa to vertical equity.

#### **2.1.2.2 Secondary objectives**

The main objective will be addressed by the following secondary objectives:

- (i) to consider the **background, relevance and benefits** of the zero-rating of VAT in South Africa – and who primarily benefits from zero-rating, in part and in its entirety;
- (ii) to consider **vertical equity**, its meaning and how this is practiced in South Africa. It is also considered how vertical equity might be achieved, considering the zero-rating in terms of the VAT Act. The difference between vertical equity and the alleviation of

poverty is considered as well as which one, if either, is more prevalent; Lastly, “equity” and “efficiency” is also compared.

- (iii) to conclude based on the above considerations whether the zero-rating of VAT on fruit is still relevant for the promotion of vertical equity in South Africa, and to give recommendations based on the results noted during the study.

## **2.2 Zero-rating of VAT**

When VAT was introduced in 1991 as the replacement for general sales tax, there were concerns regarding the regressiveness of the VAT (Go et al., 2005:2). This was an indirect tax levied at a uniform rate of 10% (which was amended to 14% in 1993). To counter the effect on those less privileged, certain foodstuffs were zero-rated – meaning that VAT is levied at a rate of nil per cent (Calitz & Jansen, 2015). The suppliers are, however, still able to claim the input VAT on expenses incurred in the producing, obtaining and/or selling of these items (if any). This differs from exempt supplies per Section 12 of the VAT Act (1991) – that are not subject to any VAT - in that although the VAT levied on these items were at nil per cent, it would still be classified as taxable supplies.

The following items are included in the list of zero-rated products and services per Section 11 of the VAT Act: brown bread, dried mealies, dried beans, lentils, pilchards or sardinella in tins or cans, rice, fresh fruit and vegetables, vegetable oil, milk, eggs, edible legumes, paraffin and “goods used or consumed for agricultural, pastoral or other farming purposes”. In addition to these items, exports are also zero-rated, as in the majority of countries (SAICA, 2008).

Pomerlau (2015) in his discussion regarding the United States’ possible implementation of VAT notes that the majority of countries in the world have a VAT – or a general sales tax (GST) with VAT-like features – with the exception of the United States. In fact, KPMG’s (2016a) report on indirect taxes worldwide details the rates for approximately 140 countries. This report further shows that the rates vary greatly from country to country, ranging from 0% in several countries to 27% in Hungary.

If specific countries’ VAT rates are considered, it is noteworthy that some of the developed countries, especially in Europe, have VAT rates at the higher end of the scale – such as the United Kingdom at 20%, Germany at 19%, and the Netherlands at 21% (Avalara, 2016b). These countries also have zero-rated and/or reduced rate items. In the United Kingdom, for example, along with basic foodstuff, including raw meat and fish, the following items are amongst those charged VAT at 0%: baby and children’s clothes, motorcycle helmets, books, magazines and newspapers (United Kingdom Government, 2016). While the Netherlands only applies zero-rating to very specific and limited supplies – “exported goods, seagoing vessels

and aircraft used for international transport, gold destined for central banks, and any activities which may take place within bonded warehouses or their equivalent” – they do apply a significantly reduced rate of 6% to foodstuffs as well, but also to medicine, art, books, newspapers, magazines, cinemas, zoos and amusement parks (Belastingdienst, 2015a). Similarly, Germany zero-rates very few supplies – all of which are similar to those zero-rated in the Netherlands – but also offers a significantly reduced rate on foodstuffs, books and newspapers, works of art and entrance to cultural sites, amongst others (Expatax, 2016; KPMG, 2011; Belastingdienst, 2015a; Belastingdienst, 2015b).

This is more prevalent when comparing those developed countries to the BRICS countries, which are all developing countries – even though China is considered to be the world’s second largest economy. The BRICS countries have VAT rates as follows: Brazil has an average GST of between 17% and 19%, with certain items being exempt and some being taxed at a reduced rate (Trading Economics, 2016b). Russia has a standard VAT rate of 18%, with zero-rating of “exports of goods, international transportation and other services related to the export of goods from Russia, international passenger transportation, and certain other supplies” and a reduced rate on certain other products, such as basic foodstuffs (PwC, 2016b; Deloitte, 2015; Hellevig, 2015). India currently has an average general sales tax rate of 14.5% (Trading Economics, 2016a) with exports, natural produce and essentials being the only zero-rated items (Avalara, 2016a; Bankbazaar, 2016). China has a standard VAT rate of 17% (KPMG, 2016a), with several items being charged VAT on at lower rates and with regards to zero-rating, this mainly applies to exports, and even then, not entirely (KPMG, 2015). In Table 2.1 below, a summary of these countries’ policies are compared to provide an overall view of the countries utilised.

**Table 2.1 A comparison between different countries' rates and standard and zero-rated items**

Country	UK	Germany	Netherlands	Brazil	Russia	India	China	South Africa
<b>Standard rate</b>	20%	19%	21%	17%	18%	Average 14.5%	17%	14%
<b>Reduced rate</b>	5%	7%	6%	0%, 4%, 7%, 12%	10%	1%, 4%, 5%	3%, 13%	n/a
<b>Zero-rated items include</b>	<ul style="list-style-type: none"> <li>- Certain items and services for charity, and the elderly and disabled</li> <li>- Certain products and services for citizens' health</li> <li>- Certain building and development</li> <li>- Public transport</li> <li>- The sale of publications</li> </ul>	<ul style="list-style-type: none"> <li>- Supply and import of gold to central banks</li> <li>- Cross-border passenger transport by air</li> <li>- Financial services provided to private recipients resident outside the EU</li> </ul>	<ul style="list-style-type: none"> <li>- Exports</li> <li>- Delivery and supply of airplanes and ships</li> <li>- Fishing</li> <li>- Excisable goods</li> </ul>	<p>Brazil employs varied VAT (ICMS) rates across different states and for different products. Very little is available about their specific products' where zero ratings are applied.</p>	<ul style="list-style-type: none"> <li>- Exports of goods</li> <li>- Sales to diplomatic missions and their personnel</li> <li>- Sale of goods in the field of aerospace</li> <li>- Transport of passengers and baggage to and from Russia</li> <li>- Services for transport of</li> </ul>	<ul style="list-style-type: none"> <li>- Natural produce and essentials are zero-rated items for VAT purposes.</li> </ul>	<ul style="list-style-type: none"> <li>- Mainly exports</li> </ul>	<p>The list of zero rated items includes the following items – provided in an unaltered state:</p> <ul style="list-style-type: none"> <li>- Samp</li> <li>- Brown bread</li> <li>- Dried mealies</li> <li>- Dried beans</li> <li>- Lentils</li> <li>- Rice</li> <li>- Fresh fruit and vegetables</li> <li>- Vegetable oil</li> <li>- Milk</li> <li>- Eggs</li> </ul>



	<ul style="list-style-type: none"> <li>- Baby and children's clothes</li> <li>- Helmets</li> <li>- Protective clothes</li> </ul>				goods in connection with export and import			
Reduced rate items	<p>Goods and services for:</p> <ul style="list-style-type: none"> <li>- Energy saving</li> <li>- Assisting the elderly</li> <li>- Smoking cessation</li> <li>- Heating, ventilation, and safety of homes</li> <li>- Renovations and construction of buildings</li> <li>- Babies' and children's' safety</li> </ul>	<ul style="list-style-type: none"> <li>- Food, plants, and animals</li> <li>- Books and newspapers</li> <li>- Works of art</li> <li>- Entrance fees to cultural sites</li> <li>- Supplies of certain films</li> <li>- Supplies made for charitable, aims</li> <li>- Certain passenger transport</li> </ul>	<ul style="list-style-type: none"> <li>- Works of art</li> <li>- Food</li> <li>- Water</li> <li>- Agricultural products</li> <li>- Medicines and medicinal devices</li> <li>- Art, collectibles and antiques</li> <li>- Books and magazines</li> <li>- Gas and mineral oil for gardening</li> </ul>	<p>Brazil employs varied VAT (ICMS) rates across different states and for different products. Very little is available about their specific products' reduced rates.</p>	<ul style="list-style-type: none"> <li>- Basic foodstuff</li> <li>- Certain kinds of products for children</li> <li>- Medical supplies and medicines</li> <li>- Periodicals scientific literature and text books.</li> </ul>	<ul style="list-style-type: none"> <li>- Items that tend to be highly expensive are taxed at 1% to prevent the VAT from being too expensive</li> <li>- Certain daily consumption goods are taxed at 4%-5% - such as oil, coffee and medicines</li> </ul>	<ul style="list-style-type: none"> <li>- 'Small scale taxpayers', pay VAT at the rate of 3%, but they may not claim input tax credits on purchases</li> <li>- A reduced rate of 13 percent applies to the sale of certain basic food items</li> </ul>	<p>South Africa does not employ a reduced rate</p>

(Source: Author's compilation of sources mentioned above)

From the information in Table 2.1 above, when the developed countries (United Kingdom, Germany and the Netherlands) are considered it is evident that, in these developed countries at least, safety, culture and children's interests are key issues that are as keenly protected as basic nutrition and survival.

When the difference in the zero-rating of items in the various countries is considered from the above table, certain conclusions can be made. Firstly, in the developed countries, it is noted that the aim with the zero-rating is not merely to counter the effect of tax on the poor, but also to promote certain behaviours, such as safety in road travel, protection of and aid to children, the disabled and the elderly, and encouraging cultural and educational development. It also seems to place significant value on protecting and promoting their history and traditions. There is also an incentive to develop property – especially in Britain. In South Africa and other developing countries very little promotion is done, in fact it is mainly used as a tool to prevent further loss to those less affluent members of society. It can therefore be said that although reduced VAT or zero-rating in certain countries seems to be an incentive to encourage certain behaviours, the main aim in South Africa is to prevent a regressive tax affecting the poorer members of society.

The argument in South Africa to retain the VAT zero-rating of certain items, has always been in order to counteract the regressiveness of the system, and to make the South African VAT system fairer towards the poorer and less privileged (Calitz & Jansen, 2015a). It can therefore not likely be argued that one of the main reasons for the VAT zero-rating in South Africa is to serve as an incentive to use any of the products more. Rather, the items that have been zero-rated in South Africa are “basic” foodstuffs. Basic is defined as “forming an essential foundation or starting point; fundamental: offering or constituting the minimum required without elaboration or luxury...” (Oxford Dictionary, 2016).

The Davis Tax Committee (2014) in their First Interim Report on VAT compiled information regarding the degree of revenue foregone due to zero-rating of certain products, set out per product as well as per section of the population, as illustrated below in Table 2.2

**Table 2.2** Revenue foregone (in Rand million, 2012 prices) on zero-rated goods per consumption decile in South Africa

Decile	Rice	Brown Bread	Maize meal	Mealie rice	Samp	Dried beans	Dried lentils	Canned pilchards	Milk	Cooking fat (veg)	Edible oils	Eggs	Fruit	Vegetables	Paraffin
1	61	125	157	0	12	19	0	17	32	0	48	20	14	115	26
2	96	148	223	0	17	22	0	25	44	0	69	37	21	147	30
3	105	153	216	1	15	22	0	27	52	1	72	39	24	155	33
4	100	152	185	1	12	18	0	27	63	1	68	46	27	158	32
5	102	154	175	0	13	16	1	26	79	1	66	51	31	165	29
6	94	149	154	0	10	11	1	31	90	1	60	55	36	170	24
7	85	137	119	0	8	8	0	28	100	1	57	61	43	167	19
8	73	121	89	0	5	6	1	24	131	0	49	58	60	177	13
9	64	100	50	1	3	5	1	16	181	1	38	63	101	215	4
10	52	80	27	0	2	3	1	10	208	0	32	60	167	297	2

(Source: Davis Tax Commission, 2014)

In Table 2.2 above the DTC divided the country's population into 10% groupings, ranging from the poorest, or least affluent 10% (decile 1) to the richest, or most affluent (decile 10). With reference to Table 2.2 above it is evident that the majority of "basic" foodstuff is consumed more by the poorer, lower deciles, than the richer, higher deciles, thus supporting the reason for zero-rating in the first place. The exception to this rule is the expenditure on milk, fruit, eggs and vegetables – these are then not only basic food items, but also staples of any diet. Of those where VAT foregone is more in the top deciles, fruit is the only product where that revenue lost is not only more in the higher deciles, but 10 times as much in the top decile as in the bottom one. This can be explained in part by fruit's significantly higher price when compared to vegetables (where the revenue lost in the top decile is only 2.58 times as much as in the bottom decile).

In order to confirm this fact, a comparison was made through observing prices of a selection of common fruit and vegetables indigenous to South Africa (Brand South Africa). The comparison was performed at three stores on 6 August 2016 and is set out in the table below.

**Table 2.3            A comparison between common fruit and vegetable prices in South Africa – 6 August 2016**

Product	Quantity	Price shop A	Price shop B	Price shop C
Orange (F)	1kg	R15.99	R8.38	R9.99
Apples (F)	Golden delicious 1.5kg	R24.99	R28.43	R22.99
Bananas (F)	1.2kg	R24.99	R27.96	R18
Pawpaws (F)	2 pack	R23.99	R36.99	R34.99
Avocados (F)	Ripen-at-home 1 kg	R25.99	R19.97	R21.99
Potatoes (V)	1 kg	R15	R10	R12.99
Onions (V)	Brown onions 1 kg	R17.99	R16.99	R14.99
Sweetcorn (V)	4 pack	R22.99	n/a	R22.99
Tomatoes (V)	Salad tomatoes 1 kg	R14.99	R15.99	R15.99
Cabbage (V)	1 head, loose	R14.99	R8.33	R10.99

(Source: Author's own observation)

**Legend:**

F = Fruit

V = Vegetables

From Table 2.3 above it is evident that, firstly, the prices for different produce respectively do not differ materially among the different stores. This is important to consider when taking into account that richer people shopping at more expensive stores could skew the data in such a way that it appears that the rich consume more fruit, but they are in actual fact merely paying more for the fruit they do consume. Not taken into consideration are the fruits that have been prepared in any way – which do become significantly more expensive – as these items are not zero-rated per Section 11 of the South African VAT act.

Grant (2015) clearly illustrated the depth of poverty in South Africa, with more than 50% of citizens living below the poverty line. The minimum daily energy requirement, on which the

poverty line is calculated, is inclusive of a basket of food items totalling at least 2100 kilojoules – it bears noting that no fruit items are included in this basket. The three poverty lines in South Africa (i.e. the “measure used to separate the poor and the not poor”) are R779, R501 and R335 per month. The upper bound poverty line is R779 per person per month or R25.50 per day. These people can afford sufficient food and still have money left to purchase other essentials, such as clothing and transport. The lower bound poverty line is R501 per person per month or R16.50 per day. These people will most likely need to sacrifice some food in order to purchase other essentials. The lowest food poverty line is R335 per person per month or R11 per day. People living below this line will “struggle to afford their daily food requirements” (Grant, 2015).

The data from Table 2.3 indicates that the average price per item for fruit (as concluded from the data) is R23.04, with the average price per vegetable item being around R15. Considering then the poverty line as set between R11 and R25.50 per day, it can be assumed that the R8 difference between fruit items and vegetable items plays a major role in the lack of expenditure on fruit in the lower deciles – it is simply too expensive and likely viewed as a luxury.

From the above it can be concluded that for the majority of zero-rated products the benefit enjoyed by those less affluent is significantly more than the benefit enjoyed by the rich – with fruit being an exception. It could also be concluded that although the zero-rating in developing countries might not serve exactly the same all-round purpose it does in developed countries, the VAT zero-rating is still relevant in South Africa – evidently more so on certain products than others.

### **2.3 Vertical equity**

In *An enquiry into the nature and causes of the wealth of nations*, Smith (1776:loc. 12550) stated that one of the pillars of a good tax system is that “the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities”.

This would then address horizontal and vertical equity. Horizontal equity states simply that people who are equally wealthy should be equally taxed (Kaplow, 1989). Vertical equity conversely says that people who are not equally wealthy, should not be equally taxed (Botha, 2014:15); the rich should be taxed more; the poor should be taxed less.

Considering the tax rates for individuals according to the South African Revenue Service (SARS), it is evident that we have a progressive tax system in South Africa (SARS, 2016). Tax tables for the 2016/2017 tax year illustrated below clearly indicate that the lower income groups

are taxed at a marginal rate of 18% and this rate increases for the highest income groups up to a marginal rate of 41%.

**Table 2.4 Rates of Tax for Individuals**

<b>Taxable income (R)</b>	<b>Rates of tax (R)</b>
0 – 188 000	18% of taxable income
188 001 – 293 600	33 840 + 26% of taxable income above 188 000
293 601 – 406 400	61 296 + 31% of taxable income above 293 600
406 401 – 550 100	96 264 + 36% of taxable income above 406 400
550 101 – 701 300	147 996 + 39% of taxable income above 550 100
701 301 and above	206 964 + 41% of taxable income above 701 300

(Source: SARS, 2016)

Considering VAT, charged at a flat rate of 14%, it is then clearly the opposite thereof. The flat rate being charged consistently to all consumers would make it seem as if VAT is a proportional tax. However, as evidenced in Statistics South Africa's (2011:59) income and expenditure survey, where the lowest income group spends 35% of their income on food and non-alcoholic beverages, the highest income group spends a mere 5.6% of their income on these items. Considering then that the poorer members of society proportionally spend a much greater part of their income on consumable products, VAT would become a regressive tax – as “individuals and entities with low incomes pay a higher amount of that income in taxes compared to high-income earners” (Botha, 2014:15). VAT in itself would then not contribute to vertical equity; where those members of society earning less should be paying less tax in order to facilitate vertical equity, the opposite is occurring – those earning less are paying more VAT. According to SAICA (2008), “the reasoning behind this zero rating is to provide basic foodstuffs at a reduced price to benefit the poor”, which supports the argument that the main purpose with zero-rating is to assist in achieving vertical equity. How then does the zero-rating of fruit contribute to vertical equity and benefitting the poor, when the poor does not consume it to even nearly the degree in which the rich do?

The OECD (2011) considers a number of contributors to a competitive tax system; amongst others, good administration, low compliance costs, transparency and fairness. To be fair is defined as “treating people in a way that does not favour some over others” (Merriam-Webster's Dictionary, 2015c). Considering South Africa's tax system, it is a fair system: those who have the same ability to pay tax, pay the same; those who do not have the same ability to pay tax,

pay at different rates; and where VAT is regressive and affects the poor more than the rich, the zero-rating is in effect to ensure they are not unduly penalised by the single rate.

In the ACCA's (2013) view the foundations of a good tax system are simplicity, certainty and stability. The single VAT rate – that would not have as significant an impact on the richer members of the population – as well as the fact that these more affluent individuals also benefit from the zero-rating, then would be attributable to the fact that while fairness is paramount, simplicity is also needed for a tax system to operate effectively. It has been mentioned above that VAT is “the most effective instrument for generating government revenue” (Go et al., 2005:19). It is easy to assume that the single rate applied to VAT in South Africa – as well as the zero-rating applied to all consumers equally – plays a significant role in its effectiveness.

Considering the above, it seems that there must at times be a trade-off between a system being completely fair and completely effective. The zero-rating applying to purchases by the rich might then not be completely fair, but the efficiency attained by having a single set of rules for all consumers is doubtless worth more than the alternative.

If Table 2.1 is considered, several countries employ (at least) a reduced VAT rate on medicines and/or medicinal services. According to Maslow's hierarchy of needs, even though health is not a very basic physiological need – as food is – it is still one of our most basic needs, in terms of safety and security (Research History, 2012). Both food and health care are basic needs that certain individuals are aided in obtaining through assistance from the government: basic food necessities are made more affordable through the zero-rating of basic foodstuffs as per Section 11 of the VAT Act (1991) and the Department of Health is in the process to implement National Health Insurance that will ensure that all South African citizens have access to vital health care, regardless of their income (Dahms, 2014:1). “What we eat is central to our health” (University of Minnesota, 2016). Food then could be considered just as critical to maintaining and improving physical health as medication and medical services and the cost and impact of food to the poor is then tantamount to that of the health care.

“Fairness in financial contribution is an intrinsic goal of a health system because it is a desired outcome in and of itself” (Kawabata et al., 2001:3). Kawabata et al. (2001:3) make the point in discussing the financing of the health system that several goals exist, of which fairness is one, and there needs to be a trade-off between some of the goals in order to achieve a functioning health system. For example, if all households were to contribute 0% of total income to health, this would be an enormously fair system – however, it would fare much worse in achieving the goal of providing health care. With fairness being one of the intrinsic goals for a health system, it is obvious then also that catastrophic payments – i.e. payments “causing a lot of damage” (Macmillan Dictionary, 2016) or potentially crippling the payer financially - for necessary health

care would not be fair or wanted. However, “catastrophic payments for rich households might actually improve the distribution of income and catastrophic payments for a small number of poor households would have a negligible effect on overall income distribution” (Kawabata et al., 2001:8).

From this it can be stated that, although the impact of catastrophic payments for a few poorer households would not have a significant effect on the overall fairness of the system, it is clearly not in aid of vertical equity when this does happen. In fact, in a country such as South Africa where poverty is prevalent, it should be in everybody’s best interest to avoid any degree of expenditure that would result in the poor (or any portion of the less affluent members of society) becoming poorer. Furthermore, these catastrophic payments for a small number of poor households would merely have a “negligible effect on overall income distribution”. Those same catastrophic payments for rich households (who are much more able to foot the bill without devastating entire families) might “actually improve the distribution of income”. Considering these statements, it seems an easy enough deduction to lean toward higher expenditure for the rich, and lower for the poor. In fact, Kawabata et al. (2001:9) also state that “many think that fairness should include some notion that the rich contribute more for the health system than the poor on a per capita basis”. This is, however, to a great extent already achieved with South Africa’s progressive personal income tax (South African Revenue Services, 2016), grants (Ferreira, 2015) and subsidies (South African Government, 2016) allotted for the poorer members of society.

Considering the consumption and expenditure from Table 2.2 it is also evident that the poorer members of society benefit more – if not significantly more – from the majority of the zero-rated items being purchased. It is apparent then that the zero-rated products serve the purpose they were identified for and assist in achieving vertical equity and assisting the poor. The revenue foregone due to purchases by the poorer 50% of South Africans, totals more than 50% of the total revenue foregone by the government, due to zero-rating, for nearly all the products listed in Table 2.2. The exceptions are dried lentils – excluded due to the small nature of their sales - milk, eggs, vegetables and fruit. Eggs’ and vegetables’ revenue lost due to consumption by the rich is about 1.5 times more than that lost due to consumption by the poor.



**Table 2.5            A comparison between milk and egg prices in South Africa**

<b>Product</b>	<b>Shop A</b>	<b>Shop B</b>	<b>Shop C</b>
Milk, fresh full cream, 2 litres, own brand	R26.95	R22.49	R24.79
Eggs, free range, large, 18	R59.99	R44.99	Does not stock free-range eggs
Eggs, own brand, large, 18	Does not stock any eggs other than free range	R24.95	R35.99

**(Source:** Author's own observation)

From Table 2.5 it is evident that not only do the prices of similar products vary significantly (at least more so than with the fruit and vegetables) from store to store, there is also much more variation in the products (only three products were compared for simplicity). It was further observed that eggs and milk come in various forms in their unaltered states. Eggs are available as organic, free-range, grain-fed, cage free, confined and vegetarian options. You can purchase long-life, fresh, low fat, fat free, full cream, skim and organic milk. All these options are also untreated and as such, zero-rated. It can therefore be assumed that, although the expenditure is more within the richer deciles, this can likely be attributed to their purchasing of more expensive variations (e.g. free range eggs and organic milk) at more expensive stores, rather than necessarily being due to a greater consumption of eggs and milk.

Vertical equity aims toward having people not in the same financial position contributing differently to taxation (Musgrave, 1990:113). The majority of zero-rated food products are consumed vastly more by the poorer segment of our population than by the richer (per table 2.2). For these products the zero-rating clearly aids in achieving vertical equity: the poor pay less tax on their basic food needs than the rich do. With products where both rich and poor are consuming and/or saving the same on certain goods – due to zero-rating – the benefit to the poor does not necessarily aid in achieving vertical equity, although it does still contribute to assisting the poor in affording basic needs. This is especially true for milk and eggs, as above, where more expenditure on a product does not necessarily indicate greater consumption. However, when the difference in consumption and expenditure becomes as vast as it does with fruit, the zero-rating does not contribute to vertical equity at all, and the poor do not benefit from it – but the rich do to a great extent.

A consideration of vertical equity and alleviating poverty follows. This is relevant due to the fact that vertical equity is one of the pillars of a good tax system, insofar as the subjects of every state contributing in proportion to their respective abilities (Smith, 1776:loc. 12550). However,

the poverty in South Africa – with more than 50% of the population currently earning less than the poverty line (Grant, 2015) – necessitates the considering of avenues that not only contribute to equity, but also to alleviate the impact on the poor.

### **2.3.1 Vertical equity and alleviating poverty**

There exists a difference between vertical equity and alleviating poverty, insofar as vertical equity is the idea that individuals should pay taxes in proportion to their income earned (Botha, 2014:15), not necessarily improving the financial position of the payers of that tax, whereas poverty alleviation's main aim is to "improve the quality of life for those people currently living in poverty" (Bradley, 2013). "Those people currently living in poverty" would be a significant portion of South Africans, considering that more than 50% of the population are currently earning less than the poverty line of R779 per month (Grant, 2015). However, the alleviation of poverty might be a by-product of vertical equity; with "policy towards inequality and poverty influenced by the desire to achieve both horizontal and vertical equity" (Economics Online, 2016).

Steenkamp (2012:39) states that the "imperative to reduce poverty levels in South Africa requires not less but more public expenditure and probably higher tax levels". Considering that the top 10% and bottom 90% of the population each contribute about 50% of total household income in South Africa (Steenkamp, 2012:47), an increase in tax could be a significant contributor to assist in the alleviation of poverty in South Africa. This does not have to be an increase in personal income tax – which is already progressive (South African Revenue Services, 2016). It could be an increase in capital gains tax. A taxable capital gain from the disposal of an asset of a person, as determined by the Eighth Schedule, exceeding R30 000 in a year, is included in their taxable income in terms of section 26A of the Income Tax Act. Weyers (2004) considers the contribution of capital gains tax to vertical equity, stating that several international surveys have confirmed that the majority of capital gains are paid by the wealthiest. Capital gains tax then is clearly not a tax on the poor, but rather only on the more affluent that can afford to invest capital in assets, and sell them at a significant profit – R30 000 would be considered significant, when taking into account that the 50% or so of South Africans living on or below the poverty line will earn less than R9 348 per annum (Grant, 2015). There have been numerous discussions on the possible implementation of a so-called "wealth tax", which – if applied correctly – could assist in alleviating poverty in our country, by being applied to quality education and job creation (Peyper, 2016).

Although an increase in VAT would be have a greater effect on inflation initially, bearing in mind that the prices of all standard rated products would increase overnight, the impact of a VAT increase in the long run would be "far less severe than that of a rise in personal income tax or corporate income tax" (Davis Tax Committee, 2014:38). An increase in VAT would unfortunately

also have a greater negative impact on the poor, considering the proportional nature of standard rated items, all taxed at 14% (VAT Act 28 of 1991). Unless VAT can be increased in a way or in a sector where the poor are not affected by it, increasing the rate or eliminating zero-rated products in its entirety would not contribute to vertical equity or the alleviation of poverty.

Based on the above, although a difference exists between vertical equity and alleviation of poverty, it can be stated that both are currently essential in South Africa – considering firstly the extreme poverty that is currently prevalent and secondly the need to uplift those poorer members of the population, and although a difference does exist, it can be argued that the achievement of one would likely contribute to the achieving of the other – they are therefore not mutually exclusive goals.

### **2.3.2 Equity and efficiency**

According to ACCA (2013) two of the pillars of a good tax system is fairness and simplicity – it can be stated that a simpler system would doubtless be more efficient due to ease of understanding. The trade-off between equity and efficiency needs to be considered again. Steinbach (2009) describes equity as being the “fair distribution of benefits across the population”. This differs from equality in the sense that equality is the “equal distribution” of said benefits, which is much more easily quantified (Steinbach, 2009). Steinbach (2009) also considers the health services sector, and therein equity is achieved in any of several ways, amongst which:

- Equal health services rendered;
- equal costs paid by individuals for the same services and products required;
- equal access to health care, and
- equal resources available for the same need.

The achieving of equity with regards to the purchasing of food would doubtlessly be achieved through the use of the same principles: the same level of nutrition received for the same proportion of income and the same availability of nutrition for people with the same need therefore – i.e. different phases of life and levels of health should be taken into account. Equity, as achieved through fairness, is a driving factor in any good tax system (ACCA, 2013), but redistributing benefits comes at a price. This can be expanded upon by looking at the progressive personal income tax system and the proportional VAT system in South Africa. It is also worth considering in terms of personal income tax, although South Africa’s rates are slightly higher than the African average (about 7% difference) which are very much in line with the OECD’s average rates – about 2% lower in fact (KPMG, 2016b). Although not discussed here, when considering corporate taxes and rates, South Africa employs on average a lower rate than

the majority of the other 188 countries assessed (ranking 38th) and in terms of ease of administration, lies at the 20th position (PwC, 2016a). Crotty (2011) also notes how well South Africa's total tax rate of 33.2% compares to Japan's rate of 58.3%, and that Belgium has 92 types of tax, with South Africa only having 26. It can be deduced, then, that South Africa employs the same strategy and applies equal principles to all forms of taxation – personal, corporate and indirect - where it relates to fairness and ease of administration (insofar as this is reasonably achievable).

Personal income tax is considered a progressive tax; the more an individual earns, the more he is charged proportionally, percentage-wise on that income. For example, an individual earning up to R188 000 per year will be taxed at 18% on that amount. A person earning R750 000 will also be taxed at 18% on his first R188 000, however the percentage tax per additional increment will increase, he will be taxed at 26% of his income between R188 000 and R293 600 and so on, eventually resulting in this person eventually being taxed at 41% on all his earnings over and above R701 300 (South African Revenue Services, 2016). This system is more complex, considering firstly the scales applied to individuals – i.e. personal income tax not being charged at a single rate. Secondly, the collection method is diverse (this is especially true for individuals possibly self-employed for whom no PAYE is paid by an employer throughout the year) and opportunity still exists for individuals to structure their income in such a manner that less tax is paid – be it because of avoidance or evasion techniques. A progressive personal income tax can as such be seen as aiding in the achievement of equity – vertical and horizontal – but would be less efficient than a flat rate tax in terms of more complex collection and increased difficulty to calculate (Davidson, 2015).

VAT is easily administered, it is easily collected – although it is a tax on the consumer, the vendor pays it to SARS - and it is considered a highly effective tax (Go et al., 2005). However, with VAT being charged at a single proportional rate, as discussed before, due to the poor spending a proportionally greater part of their income on consumable products, VAT will be considered a regressive tax (Davis Tax Committee, 2014:22). As such, the efficiency of VAT is excellent, but the trade-off is a certain degree of equity.

Steinbach (2009) states that in the health-care system the trade-off between equity and efficiency is also a challenge, with no consensus existing as how to best balance the two. According to Carrin et al. (2005) cost-effectiveness might be used to determine efficiency, with the “reduction of severe health issues and poverty” determining equity, this will be done with different weightings allocated to each criterion to determine the trade-off more accurately.

“Social protection instruments” are defined by the United Nations as “the set of public and private policies and programmes undertaken by societies in response to various contingencies

to offset the absence or substantial reduction of income from work; to provide assistance for families with children as well as provide people with health care and housing” (as cited by Baipethi et al., 2010). It can be said that there are four main sub-categories of social protection instruments: those that are aimed at protecting people from risk and decreasing their vulnerabilities, social assistance and welfare (this would include social grants), labour market policies and minimum workplace standards (Baipethi et al., 2010). In terms of the efficacy of social protection instruments, the OECD (2009) states that “social protection directly reduces poverty and helps make growth more pro-poor”. It elaborates on this point by stating that social protection motivates poor men and women to get involved in economic growth, aids in protecting the poorest individuals in society and it encourages stability and social unity. It assists in developing individuals who can contribute more effectively to society, managing threats, promoting investment, encouraging entrepreneurship and improving involvement in labour markets. The OECD (2009) also states that these programmes do not need to be expensive and are in fact “good value for money”, so much so that even the most impoverished countries can afford and benefit from it. In short, then, it is easy to assume that social protection instruments do much more than simply aid in alleviating poverty, but that is certainly attained as well.

A number of policies are in place worldwide to assist in combatting poverty and inequality. These include social pension schemes, minimum wage policies, abolishing of fees in education, investment in infrastructure, food security programs and increased public expenditure on education, to name a few (UNESCO, 2016).

In South Africa seven long-term grants are administered by the South African Social Service Agency (SASSA). These include a grant for older persons (R1 500 per month for 3.1 million recipients), a disability grant (R1 500 per month for 1.1 million recipients), a war veteran’s grant R1 520 per month for 277 recipients), a foster child grant (R890 per month for 533 000 recipients), a care dependency grant (R1500 to the main caregiver of a child with a permanent, severe disability, for 120 000 recipients), a child support grant (R350 per month for 11.9 million recipients), a grant-in-aid (R320 per month for 126 600 recipients, receiving a grant for older persons, a disability or war veteran’s grant and needs full-time care) and a social relief of distress (a temporary grant for people in dire need) (Ferreira, 2015).

The South African Government (2016) offers several housing subsidies and initiatives to aid individuals in acquiring shelter, purchasing homes, and improving their living conditions. A housing subsidy exists, available for individuals earning less than R3 500 per month. The government deployed the Bucket Eradication Programme, through which it aims to eradicate all bucket toilets across the country – the budget for this indirect grant was R899 million for the 2014/2015 year, and R975 million for the 2015/2016 financial years. The Human Settlements

Vision 2030 aims to assist those individuals in the “gap housing market” – i.e. those individuals earning more than R3 500 per month, therefore not qualifying for a housing subsidy, but less than R15 000 per month, which is not sufficient to qualify for a home loan from banks. The Human Settlements Capacity Grant aims to “develop capacity for municipalities and metros that have received Level 3 accreditation”. The entire budget for the Human Settlements Capacity Grant for the six metros (Ekurhuleni, City of Johannesburg, City of Tshwane, Ethikweni, City of Cape Town and Nelson Mandela Metros) in South Africa for 2014 was R300 000 000.

As seen from the above paragraphs, both tax and social assistance have elements of equity and efficiency and trade-offs need to exist in order to enable the enforcing thereof and maximising the benefit.

## **2.4 Conclusion**

Firstly considering the background, relevance and benefits of the zero-rating of VAT, it was found that at VAT’s standard rate, it would be a regressive tax, with the poorer members of society spending more on consumable products than the more affluent. The zero-rating of products is a measure set in place to aid in combatting the regressiveness of the VAT, and assist in attaining vertical equity. As such, the zero-rating of certain basic necessities was not only relevant, but crucial to contributing to a fair and equitable tax system.

In fact, the majority of those zero-rated basic foods are consumed significantly more by the poor. However, there are four exceptions: milk, eggs, vegetables and fruit. Although there is still a benefit to the poor in the zero-rating of eggs, milk and vegetables, this is not the case with fruit. Fruit is not sold at considerably different prices from store to store, and different varieties do not have as big an influence as with eggs and milk. The disparity between the consumption of fruit by the poorer members of society and the richer is so significant that there can be no doubt that although a small portion of the poor do benefit from the zero-rating of fruit to a small extent, the benefit for the rich is so disproportionate that it can in no sense be considered fair. In fact, the disparity in consumption between the rich and the poor is so diverse, that it is a policy that not only doesn’t aid the poor, it actively benefits the rich.

In several countries, the reduced or zero-rating of items is clearly in place to encourage certain behaviour. The argument can exist that the zero-rating of fruit is also intended to encourage a healthy diet for all individuals – the inclusion of fruit and vegetables in a diet decreases an individual’s risk of cardiovascular disease, aids in reducing blood pressure, protects against cancer and the inclusion of fruit specifically reduces the risk of diabetes (Harvard, 2016). This might be true; however, looking at the usage of fruit, the zero-rating in no significant way contributes to the consumption thereof – be it for health or other reasons.

Secondly, vertical equity was considered, and how the zero-rating in terms of the VAT Act helps to achieve it. Vertical equity is achieved when those able to pay more do pay more, and those unable to pay, pay less. This is evidenced in our progressive personal income tax system – as discussed in the article. A single rate VAT does then not contribute to vertical equity, due to its regressive nature, as discussed above. Employing a zero-rating to certain basic goods and services in the country also countered this problem to a great degree. In fact, with most of these zero-rated basic foodstuffs being consumed significantly more by the poorer individuals in our country, the zero-rating on these items saves the poor more “tax money” than the rich, and in so doing undoubtedly aids in achieving vertical equity. The fact that the poor can then more easily afford their basic food needs, at a lower cost than they would have where a standard VAT rate was charged on everything, also aids in improving the quality of life for South Africans.

It can then be concluded from the above that although the zero-rating in South Africa is not only still relevant, the benefit derived from it in terms of achieving vertical equity and in assisting the underprivileged in improving their quality of life clearly outweighs the benefits achieved by those richer members of society also benefiting from zero-rated items. This is true even for those few exceptional products that are utilised more by the rich than the poor, with the exception of fruit. The trade-off between efficiency (VAT charged at one single rate) and equity (fairness of the system) here is undoubtedly not only necessary, but critical – especially in South Africa.

The revenue lost due to this zero-rating, although not significant in terms of the South African budget (in fact a mere 0.036% of the budgeted expenditure of over R1 463 billion), is still a significant amount of money that could have a significant positive impact if applied correctly. The R524 million rand in revenue foregone annually, due to the zero-rating of fruit (see Table 2.2) would contribute almost double the necessary amount for one year’s Human Settlements Capacity Grant. It would be enough to allocate a foster child grant for almost 50 000 additional children. The Minister of Higher Education and Training, Blade Nzimande, recently announced that it was likely that universities would implement an eight per cent fee increase for the 2017 academic year, but that the government would subsidise this increase for those students that are “financially needy”. This is expected to result in an expense of around R2.6 billion for the year (Bateman & Bendile, 2016). In the interim budget presented by Finance Minister Pravin Gordhan on 26 October 2016 there is additional expenditure needed for higher education for 2017 of R16.7 billion and increases in income tax are virtually assured (National Treasury, 2016b:34,8). The revenue foregone due to the zero-rating of fruit alone could have funded around 20% of those expected subsidies. The revenue lost due to the zero-rating of fruit is enough to make a significant difference, if not necessarily in budgeted income (0.036% of budgeted expenditure), but to a great number of individuals. This money could better be applied to social grants, housing initiatives or bursaries for deserving students. The zero-rating of fruit

then not merely benefits the affluent; it deprives the government of significant revenue that could be used in aiding those poorer members of our country with more effective methods.

It could therefore safely be said that the zero-rating of fruit in South Africa does not contribute to vertical equity.



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## **CHAPTER 3 CONCLUSION**

### **3.1 Objective of this chapter**

The objective of this chapter is to deliver a summary of key findings of the study, as well as how these findings address the research question as formulated in chapter 1.

### **3.2 Research findings**

#### **3.2.1 Research objective 1 – Zero-rating of VAT**

The first research objective was to consider the background, relevance and benefits of the zero-rating of VAT in South Africa. This objective was addressed in the research article. It was found that, at its standard rate of 14%, VAT would result in a regressive tax – as the poorer members of the community spend proportionally more of their earnings on consumable products. The zero-rating of certain “basic” foodstuffs (in South Africa) is mainly to counteract the regressiveness of the tax – this is aside from the zero-rating of exports and other services, where the zero-rating was likely applied for completely different reasons. It was noted that the majority of the zero-rated products were in fact used significantly more by the poorer members of our society – with the exception of milk, eggs, vegetables and fruit – indicating that the zero-rating of basic needs clearly benefits the poor more. Several countries’ VAT policies were reviewed and it was noted that all eight countries compared, offered a reduced or zero-rating of certain products and services that are considered basic needs and/or to encourage certain behaviours. The eight countries compared consisted of five developing countries and three developed countries. The greatest disparity between the two was that where both offered reduced rates on basic needs, the developed countries offered reduced rates on a number of products and services not only intended to aid in the survival of their population, but to actively encourage certain behaviours. The fact that the consumption of these zero-rated items was so much higher within the poorer deciles clearly indicated that there is certainly still value in the VAT zero-rating in South Africa.

#### **3.2.2 Research objective 2 – Vertical equity**

The second objective was addressed in the second part of the research article. Firstly, vertical equity was considered, its meaning and how this is practised in South Africa. Secondly, it was considered how the zero-rating in terms of the VAT Act aids in achieving vertical equity. The difference between vertical equity and alleviating poverty was also considered. Vertical equity is achieved when those able to pay more do pay more, and those unable to, pay less. This is

evidenced in our progressive personal income tax system – where the first R188 000 of any individual's income is taxed at 18%, steadily increasing up to a tax of 41% for any amount earned over and above R701 300. VAT charged at a single rate, however, does not contribute to vertical equity, due to the poorer individuals spending a proportionally greater part of their income on consumables – thus having VAT resulting in a regressive tax. This problem was countered by employing a zero-rating to certain basic goods and services in the country. Lastly, the trade-off between the efficiency (the ease of a single VAT rate) and equity (fairness to all taxpayers) was considered and found to be not only necessary, but critical – especially in South Africa, it was seen that this is also addressed through the utilisation of amongst others social grants and subsidies.

As mentioned before, with the majority of these zero-rated basic foodstuffs being consumed significantly more by the poorer individuals in our country, the zero-rating of these items saves the poor more “tax money” than the rich, and in so doing undoubtedly aids in achieving vertical equity. The fact that the poor can then more easily afford their basic food needs, at a lower cost than they would have where a standard VAT rate was charged on everything, also aids in improving the quality of life for South Africans. Thus, although there exists a difference in the alleviation of poverty (improving quality of life for the poor) and the achieving of vertical equity (those who can pay more tax, should pay more tax), it can be stated that achieving one surely contributes to achieving the other.

### **3.2.3 Research objective 3 - Conclusion**

The final objective was to conclude on the research question utilising the above considerations. The four exceptions to zero-rated basic products' usage by the different deciles – eggs, milk, vegetables and fruit - pose interesting cases. Milk and eggs were found to be products that can, in their “natural state”, without having been altered in any way or provided as part of a meal, differ in price significantly from one store to the next, as well as in different options it is available in. The higher revenue lost on these products is not necessarily due to greater consumption by the more affluent members of our society, but could be due to more expensive varieties being purchased by the more affluent. Vegetables, having been measured and found to not differ significantly in price from store to store – as is the case with eggs and milk – it would be safe to state, are consumed more by the wealthier members of the population. However, despite this higher consumption rate amongst the affluent, the difference is not as significant and the increase in usage from the poorer to the richer deciles is very gradual. Furthermore, the eventual usage by the richest 10% is only around two and a half times as much as by the poorest 10%, and the distribution of consumption is around the same for the richer and poorer halves of the country – with 58% and 42% usage respectively. There is thus still a benefit to the poor in the zero-rating of eggs, milk and vegetables. Fruit, however, is also not sold at

considerably different prices from store to store, and different varieties do not have as big an influence as with eggs and milk. With fruit, however, the disparity between the consumption by the poorer members of society and the richer is so significant, with the consumption by the poorest decile being less than 10% of the richest decile, that there can be no doubt that although a small portion of the poor do benefit from the zero-rating of fruit to a small extent, the benefit for the rich is so disproportionate it can in no sense be considered fair.

For eggs, milk and vegetables, the case might then still be convincingly made that the zero-rating aids the poor and in so doing, contributes to vertical equity. Based on the discussion and considerations in this study, no such argument could be made for fruit.

### **3.3 Overall conclusion**

The zero-rating in South Africa is not only still relevant, but the benefit derived from it in terms of achieving vertical equity and in assisting the underprivileged in improving their quality of life clearly outweighs the benefits achieved by those richer members of society also benefiting from zero-rated items. This is mostly true even for those few exceptional products that are utilised more by the rich than the poor. However, the one exception would be fruit. The consumption by the richer deciles as opposed to the consumption by the poorer is so extreme that it is a policy that not only doesn't aid the poor, it actively benefits the rich.

The revenue lost due to the zero-rating of fruit is enough to make a significant difference, if not necessarily in budgeted income (0.036% of budgeted expenditure), but to a great number of individuals – at R524 million lost, that is equal to the lower poverty line for over 55 000 citizens. This money could better be applied to social grants, housing initiatives or bursaries for deserving students. Amending the status of fruit as a zero-rated VAT item, to that of a standard rated product might not shake the country, but its effect will be significant enough for it to at least be considered.

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